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(Volume 1 of 5)

104th Congress
1995-1996

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CONTRACT WITH AMERICA—SAVINGS AND INVESTMENT

HEARINGS

BEFORE THE

COMMITTEE ON WAYS AND MEANS HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

JANUARY 24, 25, 26, 31; AND FEBRUARY 1, 1995

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TAX PROVISIONS IN THE CONTRACT WITH AMERICA DESIGNED TO ENCOURAGE SAVINGS AND INVESTMENT

TUESDAY, JANUARY 24, 1995

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, D.C.

The committee met, pursuant to call, at 10 a.m., in room 1100, Longworth House Office Building, Hon. Bill Archer (chairman of the committee) presiding.

[The advisories announcing the hearings follow:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE
January 6, 1995
No. FC-2

CONTACT: (202) 225-1721

ARCHER ANNOUNCES DETAILS ON SAVINGS AND INVESTMENT HEARINGS

-January 24, 25, 26, and 31-

Congressman Bill Archer (R-TX), Chairman of the Committee on Ways and Means, today announced that the Committee will conduct hearings on January 24, 25, 26, and 31, 1995, on the tax provisions in the *Contract with America* designed to encourage greater savings and investment. The Committee will receive testimony on the proposed American Dream Savings Account provision in the American Dream Restoration Act and tax cuts in the Job Creation and Wage Enhancement Act, which includes the proposed capital gains tax cut, neutral cost recovery, increased expensing for small businesses, increased estate tax unified credit, and improved home office deduction. The hearings will feature invited witnesses, Members of Congress, and public witnesses. **All hearings will begin at 10:00 a.m., in the main Committee hearing room, 1100 Longworth House Office Building.**

BACKGROUND:

The American Dream Restoration Act would create a new personal savings vehicle, the American Dream Savings Account (the "ADS Account"), effective for tax years beginning in 1996. Individuals could make non-deductible contributions up to $2,000 (married couples could contribute up to $4,000) annually to an ADS Account and could rollover amounts from a regular deductible IRA into an ADS Account. Distributions from an ADS Account used for retirement, first-time home purchases, educational expenses, and medical expenses would receive favorable tax treatment. Current-law, deductible IRAs would be retained.

The Job Creation and Wage Enhancement Act contains several proposals to encourage savings, investment, and entrepreneurship. First, the Act includes three capital gains incentives: (1) a 50 percent capital gains deduction, (2) indexation of capital gains basis to eliminate inflationary gains, and (3) a capital loss deduction for homeowners who sell their homes at a loss. The 50 percent capital gains deduction and the home sale capital loss provision would apply to sales on or after January 1, 1995, and the capital gains indexation would apply to inflation (and sales of assets) occurring after December 31, 1994. Second, the Act contains a "neutral cost recovery" proposal. Effective for eligible property placed in service on or after January 1, 1995, the proposal would increase depreciation deductions to approach the economic equivalent of expensing. Third, the Act would allow small businesses to "expense" (*i.e.* deduct in the year of purchase) up to $25,000 of property annually (current law limits expensing to $17,500). Fourth, the Act would phase in an increase in the estate and gift tax exemption to $750,000 and index the exemption. The current $600,000 exemption has not been increased in several years and has been eroded by inflation. Fifth, the Act would clarify the tax laws to allow greater deduction of expenses arising from a taxpayer's use of an office in his or her home. Sixth, the Act would let taxpayers allocate up to 10 percent of their tax liability to a public debt reduction fund. The designated funds would be strictly earmarked for national debt reduction and would be enforced through automatic spending cuts.

Archer stated, "There is no question that we should provide greater incentives for people to save and invest. These provisions contained in the *Contract with America* will go far in helping people to achieve these goals."

DETAILS FOR SUBMISSIONS OF REQUESTS TO BE HEARD:

Requests to be heard at the hearings must be made by telephone to Diane Kirkland, Traci Altman, or Richard Scott, (202) 225-1721 no later than the close of business, Thursday, January 12, 1995. The telephone request should be followed by a formal written request to Phillip D. Moseley, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. The staff of the Committee will notify by telephone those scheduled to appear as soon as possible after the filing deadline. Any questions concerning a scheduled appearance should be directed to the staff at (202) 225-1721.

In view of the limited time available to hear witnesses, the Committee may not be able to accommodate all requests to be heard. Those persons and organizations not scheduled for an oral appearance are encouraged to submit written statements for the record of the hearing. All persons requesting to be heard, whether they are scheduled for oral testimony or not, will be notified as soon as possible after the filing deadline.

Witnesses scheduled to present oral testimony are required to summarize briefly their written statements in no more than five minutes. **THE FIVE MINUTE RULE WILL BE STRICTLY ENFORCED. The full written statement of each witness will be included in the printed record.**

In order to assure the most productive use of the limited amount of time available to question witnesses, all witnesses scheduled to appear before the Committee are required to submit 300 copies of their prepared statements for review by Members prior to the hearing. **Testimony should arrive at the Committee office, room 1102 Longworth House Office Building, no later 48 hours before hearings.**

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE:

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit at least six (6) copies of their statement by the close of business, Friday, February 3, 1995, to Phillip D. Moseley, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Committee office, room 1102 Longworth House Office Building, before the hearing begins.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. Statements must contain the name and capacity in which the witness will appear or, for written comments, the name and capacity of the person submitting the statement, as well as any clients or persons, or any organization for whom the witness appears or for whom the statement is submitted.

4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and the public during the course of a public hearing may be submitted in other forms.

*****

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE
January 20, 1995
No. FC-3

CONTACT: (202) 225-1721

ARCHER ANNOUNCES ADDITIONAL DAY OF HEARINGS ON SAVINGS AND INVESTMENT PROPOSALS

Congressman Bill Archer (R-TX), Chairman of the Committee on Ways and Means, today announced that the Committee will conduct an additional day of hearings on Wednesday, February 1, 1995, on the tax provisions in the *Contract with America* designed to encourage greater savings and investment. In response to significant interest on the part of the public in testifying on these issues, this additional day of hearings has been scheduled in order to accomodate as many witnesses as possible. Only members of the public who, in accordance with prior press releases, have requested to be heard and have been contacted by the Committee, will be scheduled to testify on February 1. Other interested members of the public are invited to submit written statements for the record of these proceedings. **The hearing will begin at 10:00 a.m., in the main Committee hearing room, 1100 Longworth House Office Building.**

All other details for the hearings remain the same. (See full Committee Advisory No. FC-2, dated January 6, 1995.)

*****

Chairman ARCHER. Good morning. Today we begin the last phase of our hearings on the tax proposals in the Contract With America. Last week we focused on what we can do within the Tax Code to strengthen families, and for the next 5 days of hearings we are going to be considering parts of the Contract that will increase savings and investment and protect existing savings.

One of the biggest threats to our economic security is that we don't save enough in America. I think every economist agrees about this whether they are liberal, moderate or conservative. The one thing we all know for sure is we don't need any efficient incentives for consumption. I think that if every one of us on the dais were willing to publicly show his or her wallet you would find at least one or more credit cards enclosed therein. So we are well along the road for consumption but are woefully weak in savings.

Many people talk about the incentive for new savings but few speak to the need to retain existing savings, amounts that have already been put aside at sacrifice and on which taxes have already been paid. Those savings need to be retained wherever they are in order to secure tools and technology to increase productivity and thereby increase the opportunity of American workers to have higher real wages. So that is what we will talk about in the next 5 days of hearings.

Our tax laws have a lot to do with whether we consume or whether we save. We must remove the disincentives to the greatest degree possible in the current tax law. We must also I believe in the long term find a method of raising money to pay for the government's bills that will reduce even further the disincentives to savings and create an agenda for the next century where we will become the economic juggernaut in a competitive world marketplace. That is where our future lies. This is not just the future of this country, but whether or not American workers will have the opportunity to realize their dreams of a better standard of living for their family, higher real wages, and an opportunity for their children to improve their economic lot in life.

But for now we must focus on the Contract With America. Later in the year I plan to hold hearings on alternative forms of taxation to replace the current income tax. Just as every blueprint is subject to modification, we welcome any constructive comments on how we can improve the basic provisions of the Contract.

I must say, though, I am not interested in hearing testimony as to how we can preserve the status quo. I don't want to hear why we can't make the Tax Code more friendly for savings and investment. I want to hear suggestions as to how we can do it. And I look forward to what our witnesses have to say as they present their testimony today and in the colloquy with our members.

[The prepared statement follows:]

Opening Statement of Chairman Bill Archer
Hearings on Savings and Investment Provisions in the Contract with America
January 24, 1995

Today we begin the last phase of our hearings on the tax proposals in the Contract with America. Last week, we focussed on the tax provisions to strengthen the American family. Over the next five days of hearings, the Committee will examine in detail the provisions in the Contract designed to encourage greater savings and investment.

One of the biggest threats to our long-term economic security is that Americans as a whole don't save enough. Without savings, a person cannot buy a house, a business cannot purchase new equipment, and our economy cannot create jobs. Unless we can raise our national savings rate, our standard of living and our children's and grandchildren's standards of living will not grow.

Our savings rate is important, and it's not because we want to win some statistical game with other nations. We want to create jobs in this country, and high paying jobs at that. Low savings means less capital is available to a business that wants to expand and hire new workers or invest in new technology to make its workers more productive.

Why is our savings rate so abysmally low? If you look at our tax laws, you will see a large reason why. Instead of encouraging people to save, the tax code often punishes people who save and invest.

The issue is not just whether we need to create more tax incentives to encourage people to save and invest; it's how do we reduce the current disincentives residing in the tax code. I think you'll find few defenders of our current tax code. It encourages consumption. It erects barriers to savings and investment.

From a long-term standpoint, we have got to look at alternative tax systems, systems more suited to our economic goals. I intend to have this Committee seriously examine alternative tax systems after we finish with the Contract with America.

But that's the long-term plan. In the short-term, we have to dismantle some of the barriers Congress has erected in the Tax Code. That's the real issue we will be examining in these hearings. The question I want all of us to ask ourselves is What is the fairest and most efficient way to increase savings and investment in this country.

The provisions in the Contract with America will be our blueprint. Of course, a blueprint often is modified upon closer inspection, and I welcome any constructive comments on how we can improve these basic provisions. However, I am not interested in hearing people defend the status quo. I don't want to hear why we can't make the tax code more friendly for savings and investment. I want to hear how.

I look forward to what our witnesses have to say about increasing savings and investment and creating more economic opportunity for all Americans.

Chairman ARCHER. I now recognize Mr. Matsui to make an opening statement on behalf of my Democrat colleagues.

Mr. MATSUI. Thank you, Mr. Chairman.

I think we, as you stated in your opening statements, do favor savings and investment as well. In fact, back in 1986 during the tax reform debate, President Reagan and Chairman Rostenkowski and Senator Packwood, then chairman of the Finance Committee, all supported tax reform, the idea to lower rates, and at the same time make sure that we had a more efficient economy where investments would be placed based upon good business judgment rather than tax incentives. So we also favor efficiency in the Tax Code.

I might just point out that the important issue over the next few months is the issue of getting the deficit under control. In fact, this week we in the House of Representatives will be voting on a balanced budget amendment. I presume it will pass, although at this time I understand there is some uncertainty as to what form it will take.

Back in 1983, Democrats essentially passed a $500 billion deficit reduction package based over a 5-year period. Back in 1990, with the assistance and leadership of President Bush, we reduced the budget deficit by $500 billion. At this time, we have the deficit on an annualized basis about 23 percent of the total GDP in this country.

Many economists say that that is a sustainable deficit, one that we can live with to promote growth in the economy, but we know that the deficit will be rising in years ahead mainly because of entitlement programs which many people have taken off the table in terms of spending cuts. So Democrats want to work with the American public, the business community, and our colleagues.

On the matter of how we are going to pay for these tax cuts, over the next 10 years, according to Treasury Department numbers, the 13 tax cuts in the Contract With America will cost $725 billion—$215 billion will be the cost over the next 5 years and $725 billion will be the cost over the next decade.

The cost increased from years 6 to 10 because that is when the capital cost recovery and that is when the issue of the capital gains tax kicks into place. So we want to make sure that if in fact we embark upon these tax cuts, we have spending cuts in place, certain spending cuts in place before we embark upon these tax incentives.

Let me mention, the Chairman had mentioned when we were debating the Kennelly amendment on the adoption of the rules that he is going to use discretionary spending cuts to pay for tax cuts. In the past, as the Chairman and other members know, we had a tradition in our committee that only revenue offsets would occur within this committee; that is, entitlement spending cuts would occur for tax cuts themselves.

The danger we face when we use discretionary spending cuts is, let's say that we want to cut the space program $3.5 billion over 5 years and then we give a tax cut of $3.5 billion over 5 years to replace that spending cut. The tax cut will continue on from years 6 to 10 into the definite future. The spending cut will end at the end of 5 years and that means that we will really not pay for it

even though, under our budget rules, there will be a revenue neutral package. That is the danger of using discretionary spending cuts and we ought to be aware of this as we embark upon this quest.

Let me conclude by making one additional observation. There is always a fear, and we hope to hear from witnesses over the next 5 days on this, that the combination of the neutral cost recovery and the capital gains provisions will lead to tax shelters.

As you know, the reason the American public and President Reagan supported the issue of tax reform in 1986 was because tax shelters became a way of life, they became a way of avoiding the Tax Code, converting ordinary income into capital income. We need to make sure that this doesn't happen in this series of tax cuts.

Ultimately, the American public will want interest rate stability and interest rate reduction, but a business individual and a corporation makes judgments based upon how they should invest their capital. It is not just capital gains or capital cost recovery; it is a business climate and it is interest rates. That is what determines how people make business decisions. So we must make sure that we don't do damage to the economy which, at this particular point in time, is running at a reasonably even pace.

So we look forward to working with the Chairman and members of the other side of the aisle and certainly with the business community on achieving capital recovery and growth in the economy.

Thank you, Mr. Chairman.

Chairman ARCHER. Would our first panel of witnesses please take their seats at the witness table. Mr. Bloomfield, Dr. Sinai, Mr. Cohen.

Without objection, any other opening statements may be entered by individual members in the record.

[The opening statement of Mr. Ramstad follows:]

OPENING STATEMENT OF HON. JIM RAMSTAD

Mr. Chairman, thank you for compiling another excellent panel of witnesses for today's hearing on the "Contract With America."

I am extremely pleased that today's hearing focuses on the critical issue of savings and investment. Clearly, Americans must be relieved of the heavy Federal tax burden they now shoulder and be encouraged to put more of their income into savings.

We are all too familiar with the alarming data concerning our Nation's saving rate. The U.S. household saving rate compares miserably to that of our partners in the Group of Seven industrialized nations (G–7). In 1993, the U.S. household saving rate was just half that of the next lowest G–7 member, at 4.4 percent.

The Contract With America directly attacks this national problem by allowing Americans to keep more of what they earn and by encouraging them, through tax policy, to save more of their earnings.

Today's hearing will give us an opportunity to ask some of the leading experts on these matters how the provisions in the Contract will affect the ability and propensity of the American family to save more.

I thank you all for being here and I look forward to your testimony.

Chairman ARCHER. Gentlemen, again, welcome.

Mr. Bloomfield, you are our first witness. As president of the American Council for Capital Formation, we are delighted to have you with us this morning. I note in reviewing your testimony that you have also prepared special reports for this hearing, questions and answers on capital gains, questions and answers on IRAs, and

the impact of the alternative minimum tax on investment and economic growth. I found these reports to be very useful and commend them to my colleagues.

You may proceed. You probably know the rules of the committee, that we would like you to keep your oral testimony to 5 minutes or less. Any lengthier testimony in writing may be submitted for the record.

STATEMENT OF MARK A. BLOOMFIELD, PRESIDENT, AMERICAN COUNCIL FOR CAPITAL FORMATION; ACCOMPANIED BY MARGO THORNING, PH.D., CHIEF ECONOMIST

Mr. BLOOMFIELD. Mr. Chairman, thank you. For the record, I am Mark Bloomfield, president of the American Council for Capital Formation, and I am accompanied by Dr. Margo Thorning, our chief economist.

Today history has come full circle. Almost 17 years ago, July 25, 1978, a member of this committee with bipartisan support offered a proposal to index capital gains for inflation. It passed the committee. Unfortunately, it did not become law. Today it is in the Chairman's mark. The author of that proposal in 1978 was Congressman Bill Archer and the chairman today is Chairman Bill Archer. We congratulate you, Chairman Archer, and urge its enactment. It is long overdue.

Today I would like to make three points. First, we have a very serious savings and investment problem. U.S. savings and investment today lags behind those of our major competitors and our historic past. We need to do something about our low savings and investment.

Second, current tax policy is impeding savings and investment. The basic point here is that we tax savings and investment as if it were a sin rather than the important determinant of economic growth, higher living standards and better jobs for our citizens. Let me illustrate.

In our international survey of the taxation of personal savings, we found that the United States ranks at the top of 12 countries that most harshly tax personal savings, capital gains interest, and dividends. In our international comparison of the tax treatment of investment in machinery and equipment that is technologically innovative and that is crucial for economic growth as well as pollution control equipment, we again found that the United States taxes investment much more harshly than our competitors.

Although the Tax Reform Act of 1986 reduced corporate and individual tax rates, it unfortunately increased capital costs by eliminating the investment tax credit, lengthening depreciation lives, creating the comprehensive corporate alternative minimum tax and increasing capital gains tax rates. These are the issues that the Contract now seeks to redress.

Third, the GOP Contract. There are three savings and investment provisions that are an important step in reducing the bias against capital formation, provided that the Contract does so in such a manner as to be revenue neutral in the aggregate and does not increase the deficit.

Neutral capital cost recovery (NCRS). While true expensing would be preferable, NCRS is a positive step toward real expensing for investment and it ameliorates some of the negative impact of the alternative minimum tax on new investment.

IRAs. We believe IRAs are a very useful tool to increase our dismally low personal savings rate. Let me respond to the criticisms of IRAs. Do IRAs result in new savings? I think the answer is yes. The weight of available evidence suggests that IRAs generated a significant amount of savings that otherwise would not have taken place.

Second, can we afford expanded IRAs? Again. I think the answer is yes. Harvard Professor Larry Summers, who now serves as the Under Secretary of the Treasury explained, under current law, the government loses 25 cents for each dollar of IRA contribution. If more than one quarter of new saving going to IRAs represents new savings, IRAs will increase private saving by more than their revenue cost.

Capital gains tax reductions. Treasury Secretary Robert Rubin suggested that the President could sign a capital gains tax cut if it met three criteria: That it made economic sense, that it was fair and that it did not lose revenue. Let me expand. First, it would make economic sense if it reduces our high capital costs, if it prevents the taxation of inflationary gains, and if it encourages entrepreneurship.

Second, it would be fair if it applies to all income brackets and all sectors of the American economy, to Main Street as well as Wall Street, to middle-class investors as well as farmers, to new entrepreneurs as well as retiring businessmen, and to individuals and corporations.

Third, it should not reduce total tax revenues and should in fact be a revenue raiser because of the unlocking of existing assets and important macroeconomic consequences. On all three counts, I suggest the capital gains proposals in the Contract measure up to Secretary Rubin's criteria and therefore should be enacted into law.

Conclusion. The pendulum may be about to swing from the tax policies of the last decade, especially the substantial increase in the economic tax burden on savings and investment and back toward progrowth policies. When historians in years ahead judge this committee, let its legacy be that it was the savings and investment Committee on Ways and Means.

Thank you.

[The prepared statement and attachments follow:]

ACCF

AMERICAN COUNCIL FOR CAPITAL FORMATION

Statement of
Mark A. Bloomfield, President
American Council for Capital Formation
before the House Committee on Ways and Means
January 24, 1995

ACCF STATEMENT

My name is Mark A. Bloomfield. I am president of the American Council for Capital Formation (ACCF). I am accompanied by Dr. Margo Thorning, our chief economist. The ACCF represents a broad cross section of the American business community, including the manufacturing and investment sectors, Fortune 500 companies and smaller firms, individuals, and associations. Our board of directors includes cabinet members of prior Republican and Democratic administrations, former members of Congress, prominent business leaders and public finance experts. We appreciate this opportunity to present testimony on the impact of the tax provisions in the Republican "Contract With America."

To encourage a constructive debate on the Contract's saving and investment proposals, our affiliated public policy think tank, the ACCF Center for Policy Research, has prepared three special reports for today's hearing: "Questions and Answers on Capital Gains," "Questions and Answers on IRAs," and "The Impact of the Alternative Minimum Tax on Investment and Economic Growth."

We commend the emphasis the GOP Contract places on the need to increase saving and investment. The saving and investment proposals: the Neutral Cost Recovery System (NCRS), capital gains tax reductions, and expansion of Individual Retirement Accounts (IRAs) in the GOP contract will, if enacted, go a long way toward addressing the burdens on capital formation imposed by the Tax Reform Act of 1986 (TRA). Almost ten years after the enactment of the TRA, it is clear that U.S. tax policies toward saving and investment must be revised if we are to increase real wages for U.S. workers and retain our leading role in world affairs. We also applaud Chairman Archer and members of this committee for their commitment—which we share—to enacting the Republican Contract in such manner as to be revenue neutral in the aggregate, thus not increasing the federal deficit.

TRENDS IN U.S. CAPITAL FORMATION

Investment spending in the United States in recent years compares unfavorably with that of other nations as well as our own past experience. From 1973 to 1991, gross nonresidential investment as a percent of Gross Domestic Product (GDP) was lower for the United States than for any of our major competitors (see Table 1). The U.S. saving rate averaged 4.8 percent over the 1973-1991 period, compared to 19.1 percent in Japan and 10.7 percent in West Germany. Even more disturbing is the fact that net annual business investment in this country has in recent years fallen to only half the level of the 1960s and 1970s. Net private domestic investment averaged 7.4 percent of GDP from 1960 to 1980; since 1991 it has averaged only 3.0 percent (see Table 2).

Reflecting the reduced share of GDP being invested each year, the U.S. capital stock has also grown more slowly. In the three decades prior to 1980, the total capital stock grew at 4.0 percent per year; in the 1980s and 1990s, the rate fell to 2.7 and 1.4 percent respectively (see Table 3). The stock of equipment, which many experts regard as critical for strong productivity growth, has increased only about half as fast since 1980 as in previous decades. Industrial equipment stocks, which grew at an average rate of 4.3 percent over the 1950-1979 period, increased by just 1.2 percent annually in the 1980s and 0.1 percent since 1990.

LINK BETWEEN INVESTMENT, PRODUCTIVITY INCREASES, AND ECONOMIC GROWTH

The importance of investment in plant and equipment for economic growth is emphasized in a new book by Harvard Professor Dale Jorgenson. Professor Jorgenson's book, *Productivity: Postwar U.S. Economic Growth*, analyzed economic growth between cyclical peaks in the business cycle over the 1948-1979 period. Allocating increases in output to three sources, growth

in the capital stock labor, supply, and multifactor productivity, Professor Jorgenson found that increases in the capital stock contribute most to increases in output (see Figure 1).[1]

In 1979, the output of the civilian economy stood at almost three times the level of output in 1948. Capital and labor inputs together contributed 2.6 percent per year to the output growth rate of 3.4 percent from 1948 to 1979; capital's share was 1.5 percent compared to 1.1 percent for labor. Thus, these two inputs accounted for more than three-fourths of output growth, Professor Jorgenson stated. By contrast, multifactor productivity increases (efficiency gains) during this period contributed 0.8 percent per year, or only 24 percent of output growth. Growth in capital input is the most importance source of growth in output, growth in labor input is the next most important source, and multifactor productivity growth plays a subordinate role, Professor Jorgenson concluded.

Studies by Harvard Professors Bradford De Long and Lawrence H. Summers, now on leave at the U.S. Department of the Treasury, concluded that investment in equipment is perhaps the single most important factor in economic growth and development. Their research provided strong evidence that for a broad cross section of nations, every 1 percent of GDP invested in equipment is associated with an increase in the GDP growth rate itself of one-third of one percent—a very substantial social rate of return.

Investment's key role in advancing technological progress and productivity growth is also stressed in recent research by New York University Professor Edward N. Wolff. He argued that U.S. labor productivity growth rates are depressed by the recent slower growth in the capital-to-labor ratio—from a peak of 2.0 percent per year in the 1950s to 1.2 percent per year in the 1972-1992 period. He emphasized that the effects of the decline in U.S. capital-labor growth are perhaps even more pernicious than they appear at first glance. First, an increasing capital-labor ratio will increase labor productivity through capital deepening. Second, there appears to be an important and significant interaction effect between capital investment and technological advance.

Thus, a slowdown in capital formation may doubly hurt labor productivity growth—directly by slowing down the rate of capital deepening and indirectly by slowing down the rate of technological advance. His research also shows that U.S. labor productivity growth lags behind our competitors; OECD countries outstripped the United States during much of the 1950-1990 period. He noted that countries such as Japan and Germany, which experienced strong productivity growth in the 1970s and 1980s, showed significant gains in their capital-to-labor ratios. Our competitors' gains in capital-to-labor ratios are a direct result of their higher levels of investment.

Implications of Lagging Investment and Slow Growth in Labor Productivity for Current and Future Living Standards

Real family income in the United States has been nearly stagnant since the mid-1970s and in recent years has actually fallen. For example, real median household income was $39,869 in 1989; income has declined in each subsequent year, and in 1993, stood at $36,959. These trends have not only made it harder to maintain living standards but have also jeopardized our future economic health and our ability to remain the principal leader in international affairs. In addition, looming in the future is the need to finance the retirement of the baby boom generation. Research by Stanford Professor B. Douglas Bernheim, commissioned by the ACCF Center for Policy Research, our public policy think tank, shows that current saving by members of the baby boom generation is seriously inadequate. The typical baby boom household saves at only one-third the rate required to finance a retirement standard of living comparable to that enjoyed before retirement.

[1]Jorgenson's analysis uses *multifactor* productivity, which relates output to inputs of both labor and capital. The traditional productivity measure commonly found in popular articles is *labor* productivity, which relates output to labor input alone.

Tax Policy and Capital Costs

The user cost of capital is the pretax return on a new investment that is required to cover the purchase price of the asset, the market rate of interest, inflation, risk, economic depreciation, and taxes. This capital cost concept is often called the "hurdle rate" because it measures the return an investment must yield before a firm will be willing to start a new capital project.

Economists are in broad agreement that capital costs are affected by tax policy. For example, Stanford Dean John B. Shoven estimated that about one-third of the cost of capital is due to taxes. In other words, hurdle rates are 50 percent higher than they would otherwise be due to the tax liability on the income produced by the investment. Thus, the higher the tax on new investment, the less the investment that will take place. Although TRA substantially reduced corporate and individual income tax rates, the legislation's capital cost recovery provisions raised effective tax rates and capital costs for productive and pollution-control assets. Capital costs increased because of the loss of the investment tax credit, lengthening of depreciable lives for many assets, creation of the corporate alternative minimum tax (AMT), and increases in the capital gains tax.

The corporate AMT has an especially pernicious effect on the cost of capital. TRA created a comprehensive AMT system separate from, but parallel to, the regular tax system. Under the AMT regime, taxable income is modified by an intricate series of "adjustments" to income, including depreciation. A high level of investment is a major reason firms become AMT taxpayers. Depreciation allowances for firms paying the AMT generally are much less favorable than for those for firms paying the regular corporate income tax (see Table 4). Today, a significant proportion of large U.S. companies pay the AMT rather than the regular income tax. Yet a high level of investment is exactly what is needed for increasing economic growth; thus, AMT reform should be given high priority. (For additional background, see "The Impact of the Alternative Minimum Tax on Investment and Economic Growth," a special report prepared by the ACCF Center for Policy Research for this hearing.)

The impact of TRA on U.S. industry can be illustrated by the following example relating to the present value of the capital cost recovery allowance when a corporation purchases new equipment. For example, the present value of the deductions for investment in modern and competitive continuous casting equipment for steel production under the strongly pro-investment tax regime in effect from 1981 to 1985 was close to 100 percent, according to a study by Arthur Andersen & Co. prepared especially for today's testimony. In contrast, under current law the present value of the capital cost recovery allowance for that same investment today is only 81 percent for a corporation paying the regular income tax. And if a corporation is subject to the corporate AMT, as many major steel companies are, the present value is only 59 percent (see Table 4).

The Arthur Andersen study also shows that the United States lags behind many of our major competitors in capital cost recovery for equipment that is technologically innovative, is crucial to U.S. economic strength, or helps prevent pollution. Capital cost recovery provisions for pollution-control equipment are much less favorable now than prior to TRA's passage. For example, the present value of cost recovery allowances for wastewater treatment facilities used in pulp and paper production was approximately 100 percent prior to TRA. Under regular TRA income tax, the present value for wastewater treatment facilities dropped to 81 percent; for AMT payers, the figure became 63 percent. Scrubbers used in the production of electricity fared even worse. Prior to TRA, the present value was 90 percent. Today, the present value is only 55 percent; for AMT taxpayers the figure drops to 42 percent. As is true in the case of productive equipment, loss of the investment tax credit and lengthening of depreciable lives both raise effective tax rates.

According to estimates by Dr. Joel Prakken of Laurence H. Meyer & Associates, the user cost of capital for most types of productive equipment would now be about 15 percent lower had TRA not been enacted (see Figure 2).

THE REPUBLICAN CONTRACT AND U.S. ECONOMIC GROWTH

Reforming and restructuring the U.S. federal tax system to reduce the multiple taxation of saving and investment inherent in the income tax—and promoting investment and higher living standards—is high on policymakers' 1995 agenda. The saving and investment proposals in the "Contract With America" will, if enacted, go a long way toward addressing the burdens on saving and investment imposed by TRA.

- *Neutral Capital Cost Recovery (NCRS)*

The Republican Contract's proposal to increase depreciation deductions to allow the theoretical equivalent of expensing—i.e., immediate write-off—for property with recovery classes of ten years or less, and to index longer-lived property for inflation will be important steps forward in reducing the bias against saving and investment for firms paying the regular income tax.

Under NCRS, the present value of capital cost recovery allowances of, for example, assets used to produce continuous casting equipment for steel production, rises from 81 percent under current law to 95 percent, not far below the equivalent to expensing (see Table 4). Firms paying the AMT also fare much better under NCRS. For example, the present value of depreciation allowances rises to 93 percent for equipment used for producing continuous casting equipment, compared to 59 percent under current law.

However, short-lived equipment comes closer to the ideal of expensing under NCRS than do assets with recovery classes longer than ten years. For example, net present value for scrubbers used in electricity plants would rise from 55 percent under current law to only 69 percent under NCRS (Table 4). Thus NCRS does not provide a "level playing field" among assets with short and long lives. Another possible drawback to NCRS is that cash flow for short-lived assets is reduced in the early years of an assets' life due to the switch from 200 percent declining balance method of depreciation to the 150 percent method. However, the fact that NCRS is voluntary and can be elected on an asset-by-asset basis should minimize this concern for companies that tend to give more weight to cash flow compared to net present value's in evaluating investment projects.

The ACCF has long advocated expensing as the optimal way of leveling the playing field for all types of assets. While true expensing, which would allow in the first year a complete write-off for the purchase price of an asset is preferable in many ways to NCRS, such an expansive change in tax policy may not be affordable at present.

In sum, NCRS is a positive move toward real expensing for investment and ameliorating much of the AMT's negative impact on new investment.

- *Capital Gains Tax Reductions*

The GOP "Contract With America" contains three capital gains incentives. First, individual and corporate taxpayers could exclude 50 percent of their capital gains from taxable income. The new effective capital gains tax rates would be 7.5 percent, 14 percent, 15.5 percent, 18 percent, and 19.8 percent for individuals, depending on the tax bracket. Corporations would be subject to a top effective capital gains tax rate of 17.5 percent. Second, the basis (the original cost) of capital assets would be indexed for inflation occurring after 1994. Third, individual taxpayers could deduct losses on sales of principle residences.

Capital gains tax reform should satisfy three criteria. First, it should make economic sense by lowering the excessively high cost of U.S. capital, reducing the bias against high-risk capital, and ameliorating the taxation of inflationary gains. Second, it should be fair to all income groups and sectors of the U.S. economy: Main Street and Wall Street, middle-class investors and farmers, new entrepreneurs and retiring businessmen, and individual investors and businesses alike. Third, it should not reduce total tax revenues and, in fact, it might be a revenue-raiser because it would unlock existing capital gains and would have important macroeconomic consequences.

On all three counts, the capital gains proposal in the Republican Contract measures up and should be enacted. (This is further documented in "Questions and Answers on Capital Gains," a special report prepared by the ACCF Center for Policy Research for this hearing.)

To those who favor a truly level playing field over time for individual and business decisions to save and invest, stimulate economic growth, and create new and better jobs, capital gains (and other forms of saving) should not be taxed at all. This view was held by top economists in the past and is held by many mainstream economists today.

This is primarily because the income tax hits saving more than once—first when income is earned and again when interest and dividends on the investment financed by saving are received, or when capital gains from the investment are realized. The playing field is tilted because the individual or company that saves and invests pays more taxes over time than if all income were consumed and no saving took place. Taxes on income that is saved raise the capital cost of new productive investment for both individuals and corporations, thus dampening such investment. As a result, future growth in output and living standards is impaired.

Low capital gains taxes not only treat savers more fairly but also help hold down capital costs. Public finance economists refer to the tax on capital gains as a tax on retained income, which funds a large part of business investment. The higher the capital gains tax, the more difficult it is for management to retain earnings (rather than pay out dividends) to fund real investment in productive projects. Research by Stanford Dean John Shoven, Ohio State Professor Patric Hendershott, and Dr. Allen Sinai, chief global economist at Lehman Brothers and a highly respected economic forecaster, indicates that a cut in the capital gains tax rate to a range of 15 to 20 percent would reduce the cost of capital by 4 to 8 percent.

Favorable tax treatment of capital gains is especially important in encouraging the "start-up" of new but risky enterprises, which provide significant dynamism and growth to the U.S. economy. Much of that start-up money comes from friends and relatives of the entrepreneur. Most of their return is likely to be in appreciated stock; thus, low capital gains taxes makes them more willing to risk their savings.

Dr. Sinai's research in the past has shown that when macroeconomic "feedback" effects as well as unlocking of unrealized capital gains are estimated, a substantial reduction in capital gains taxes results in new and better jobs, as well as increased capital formation, stronger economic growth, and federal tax revenues that are significantly larger than under current law.

Specifically, capital gains tax reductions would:

- raise real and nominal gross national product,
- increase capital spending and capital formation,
- increase employment,
- raise stock prices,
- increase household net worth,
- lower the cost of capital for business and increase business profits,
- shift business financing from debt to equity,
- draw a larger portion of household investment in to equities,
- shift the financing of business activity away from debt to equity, and
- induce portfolio allocations by households toward equity.

- *Individual Retirement Accounts*

Individual Retirement Accounts (IRAs) were developed in the 1970s to encourage individuals to save for retirement. The 1981 tax cut expanded IRAs so that any wage earner could contribute up to $2,000 annually to an IRA; a couple with two wage-earners could contribute $4,000. A couple with a nonworking spouse could contribute $2,250. Contributions were tax deductible and taxes on funds accumulating in an IRA were deferred until withdrawn. Individuals had to be 59 1/2 years of age to withdraw funds from IRA accounts without penalty.

TRA curtailed IRAs so that contributions are not fully deductible except for workers without employer pensions, families with annual incomes under $40,000, and individuals with annual incomes under $25,000. These income limits are not indexed.

The Republican "Contract With America" offers a new "American Dream Savings Account" (ADS) which allows a nondeductible annual contributions of up to $4,000 for a married couple ($2,000 for an individual) and provides indexation for inflation. If the ADS were held for five years, the taxpayer could withdraw funds without penalty for retirement, first-time home purchases, and college or medical expenses.

IRA reform enjoys bipartisan support. For example, President Clinton has also proposed such reform, expanding tax-deductible IRAs as part of his "Middle-Class Bill of Rights" and permitting the use of the money before retirement to pay for the purchase of a first home, education, catastrophic health costs, or the care of an elderly parent. The Administration proposal raises the current tax-deductible IRA income limit from $40,000 (phasing out at $50,000) to $80,000 (phasing out at $100,000). The Administration proposal also allows individuals the option of the "back-loaded IRA" in which after-tax saving is put into an IRA but the proceeds are exempt from tax when withdrawn.

Prominent public finance economists and scholars such as former Council of Economic Advisers Chairman Martin Feldstein, Treasury Undersecretary Lawrence H. Summers, and Professors David A. Wise of Harvard University, James M. Poterba of Massachusetts Institute of Technology, Steven F. Venti of Dartmouth College, Jonathan Skinner of the University of Virginia, and Richard A. Thaler of Cornell University have concluded that IRAs—especially tax-deductible IRAs—do in fact result in new saving.

Nearly a dozen scholarly studies, using a variety of data sources and employing several different statistical approaches, have examined whether targeted saving vehicles such as IRAs and 401(k)s affect saving. For example, Professor Venti's recent testimony before a Senate Finance Subcommittee examined saving data from a Survey of Income and Program Participation for three different age groups (families reaching age 60 to 64 in 1984, 1987, and 1991). Professor Venti found a striking increase in saving the longer the family has been exposed to the targeted retirement programs—IRAs, 401(k)s, and Keoghs (see Table 5).

The growth in IRA and 401(k) asset balances is astounding, Professor Venti noted. The typical member of the youngest family—those with nine years of exposure to targeted retirement saving programs—has nearly three times the targeted retirement assets of the oldest cohort. There is a comparable increase in total assets as well. In contrast, among families without IRAs, 401(k)s, and Keoghs, the youngest families have only about 75 percent of the financial assets of the older families ($1,691 vs. $2,247). Professor Venti concluded that since total financial assets, including balances in IRAs and 401(k)s, were much larger for the younger cohort (the families with the longest exposure to IRAs) in 1991 than for the older cohort in 1984, targeted retirement saving programs did stimulate new saving over the period.

Another reason that IRAs can be an important tool in increasing the low U.S. saving rate is that they encourage the self-control required to abstain from consumption. According to Professor Thaler, IRAs help people save by making it more difficult to "get to" the money than if it were left in an open bank savings or checking account. Professor Thaler explains that households allocate funds, implicitly or explicitly, into categories, or "mental-accounts." Some funds—for example those in cash or a checking account—are designated for current consumption. Others—for example those in a savings account—are for "rainy days" or "special occasions." Self-control and mental-accounts come together because the latter vary in how "tempting" they are to invade. Money in a person's wallet is more tempting to spend than money in the checking account, which in turn is more tempting than the savings account. Less tempting are funds explicitly set aside for retirement, such as money in an IRA plan. Once this concept is factored in, IRAs can increase saving even if (as some critics charge) all the money put into IRAs would have been saved anyway. By putting funds into a less accessible account, the IRA increases long-term saving. (For additional background on IRAs, see "Questions and Answers on IRAs," a special report prepared by the ACCF Center for Policy Research for this hearing.)

CONCLUSION

The pendulum may be about to swing away from the tax policies of the last decade, especially the substantial increase in the economic tax burden on saving and investment, and back toward progrowth policies. The hard fact is that we can no longer afford the luxury of tax policies that reward consumption, discourage saving and investment, overregulate American business, and penalize economic growth.

The Republican Contract's tax reform proposals for neutral capital cost recovery, capital gains tax reductions, and IRA expansion have started a dialogue that is likely to result in a substantial reduction in the bias against saving and investment in the U.S. tax code. These provisions would help move the United States toward a tax system that is more neutral toward productive capital formation and pave the way for more fundamental tax restructuring.

Table 1 Saving and Investment as a Percent of Gross Domestic Product, 1973-1991

	United States	Canada	Japan	France	West Germany	United Kingdom
SAVING						
Net saving[1]	4.8%	8.1%	19.1%	8.8%	10.7%	4.7%
Personal saving[2]	5.9%	7.7%	11.9%	6.9%	8.2%	3.2%
Gross saving (net saving plus consumption of fixed capital)[3]	16.6%	19.7%	32.8%	21.2%	22.9%	16.2%
INVESTMENT						
Gross nonresidential fixed capital formation	13.9%	15.3%	24.1%	15.0%	14.7%	14.3%
Gross fixed capital formation	18.4%	21.7%	30.3%	21.1%	20.6%	18.0%

[1]*The main components of the OECD definition of net saving are: personal saving, business saving (undistributed corporate profits), and government saving (or dissaving). The OECD definition of net saving differs from that used in the National Income and Product Accounts published by the Department of Commerce, primarily because of the treatment of government capital formation.*
[2]*Personal saving is comprised of household saving and private unincorporated enterprise.*
[3]*The main components of the OECD definition of consumption of fixed capital are the capital consumption allowances (depreciation charges) for both the private and the government sector.*

Source: Derived from National Accounts, Vol. II, 1973-1985 and 1979-1991, Organization for Economic Cooperation and Development (OECD), 1987 and 1993 eds. Prepared by the American Council for Capital Formation Center for Policy Research, February 1994.

Table 2 Flow of U.S. Net Saving and Investment (percent of GDP in current $)

	Average 1960-1980	Average 1981-1985	Average 1986-1990	Average 1991-1994[1]
Net private domestic saving	8.2%	7.2%	5.1%	5.2%
State and local government surpluses	0.4%	1.2%	0.9%	0.4%
Subtotal of private and state saving	8.6%	8.4%	5.9%	5.6%
Less: federal budget deficit	-1.0%	-4.1%	-3.2%	-3.6%
Net domestic saving available for private investment	7.6%	4.3%	2.7%	1.9%
Net inflow of foreign saving[2]	-0.4%	1.2%	2.4%	1.1%
Net private domestic investment	7.2%	5.5%	5.1%	3.0%
Personal saving	5.1%	5.6%	3.4%	3.4%
Net business saving[3]	3.1%	1.6%	1.7%	1.8%

[1]*In the 1960-80 period the United States sent more capital abroad than it received; thus net inflow was negative during this period.*
[2]*Net business saving = gross private saving - personal saving - corporate and noncorporate capital consumption allowance.*
[3]*The 1994 figures included in this average reflect only the first two quarters.*

Source: Department of Commerce Bureau of Economic Analysis, National Income Accounts. Update prepared by the American Council for Capital Formation Center for Policy Research, October 1994.

Table 3 Growth in the Net Capital Stock by Type (average annual growth rates in 1987 dollars)

	1950-59	1960-69	1970-79	1980-89	1990-93	1993 level (billions of 1987 $)
Total	3.6	4.5	3.8	2.7	1.4	4979.5
Equipment	4.1	5.0	4.9	2.6	2.3	2359.7
Information processing	8.8	8.9	8.9	9.3	7.3	747.7
Equipment less information processing	3.8	4.7	4.4	1.0	0.3	1612.1
Industrial[1]	5.0	4.3	3.6	1.2	0.1	754.6
Structures	3.3	4.2	2.8	2.8	0.6	2619.7

[1]*Industrial equipment includes fabricated metal products, engines and turbines, metal working machinery, special industry machinery, general industrial (including materials handing, equipment, and electrical transmission), distribution, and industrial apparatus.*

Source: "Fixed Nonresidential Private Capital, by Type of Equipment and Structures," Department of Commerce, Bureau of Economic Analysis, July 21, 1994. Chart prepared by the American Council for Capital Formation Center for Policy Research, September 1994.

Table 1 NCRS and [illegible] Relative to Current Law for Selected Depreciable Property [illegible] Equipment

	Computer Chips	Telephone Switching Equipment	Factory Robots	Crank-shafts	Continuous Casting for Steel Production	Engine Blocks	Wastewater Treatment for Chemical Production	Wastewater Treatment for Pulp and Paper Equipment	Scrubbers Used in Electricity Plants
United States									
1985 Law	100.1	100.1	100.1	100.1	100.1	100.1	100.1	100.1	89.7
MACRS[1]	85.2	85.2	80.8	80.8	80.8	80.8	85.2	80.8	54.5
AMT[2]	81.1	78.4	68.8	64.6	59.0	60.8	70.0	62.7	41.5
NCRS[3]	95.4	95.4	94.9	94.9	94.9	94.9	95.4	94.9	68.9
AMT-NCRS[4]	95.4	95.2	94.2	93.8	93.0	93.3	94.3	93.5	61.1
Brazil	75.7	74.8	74.7	74.7	88.3	74.7	74.7	74.7	79.4
Canada	76.9	75.9	74.0	73.8	74.2	73.6	85.3	85.3	85.3
Germany	83.6	83.0	82.7	83.9	82.2	83.9	71.8	69.7	68.9
Japan	87.1	86.2	83.4	83.9	81.4	83.7	84.6	83.7	82.4
Korea (w/3% ITC)	88.7	84.3	82.6	80.1	77.7	79.6	95.2	93.9	92.2
Singapore	91.7	91.7	91.7	91.7	91.7	91.7	91.7	91.7	91.7
Taiwan	83.9	78.0	79.0	64.3	63.5	63.7	147.0	147.0	147.0

Notes: [1]*MACRS = Modified Accelerated Cost Recovery System (Current Law)*
[2]*AMT = Alternative Minimum Tax (Current Law)*
[3]*NCRS = Neutral Cost Recovery System Proposal in Republican Contract for regular tax payers*
[4]*AMT-NCRS = AMT Reform in NCRS Proposal in Republican Contract for AMT payers*

Source: Stephen R. Carrick and Gerald M. Godshaw, "AMT Depreciation: How Bad is Bad," in *Economic Effects of the Corporate Alternative Minimum Tax* (Washington, D.C.: American Council for Capital Formation Center for Policy Research, September 1991); and unpublished data incorporating the AMT provisions of OBRA 1993. Updated by Arthur Andersen LLP, Office of Federal Tax Services, Washington, D.C., January 1995.

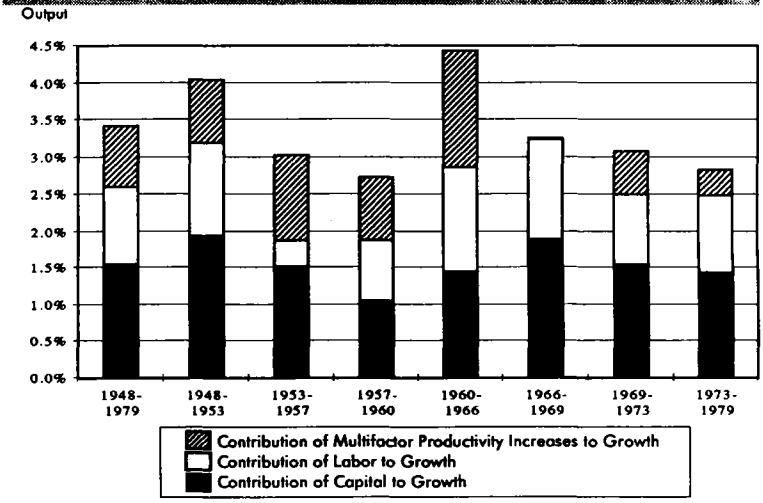
Table 2 Financial Security Saving by Families

	Families reaching age 60-64 in:		
	1984	1987	1991
Percent of families with targeted retirement saving	38	41	42
Approximate years of exposure to plans	2	5	9
Targeted retirement assets	$7,575	$13,119	$21,613
Total financial assets	$29,847	$34,013	$45,019
Percent of families without targeted retirement saving	62	59	58
Total financial assets	$2,247	$1,982	$1,691

Note: The data on saving are median asset balances in 1991 dollars.

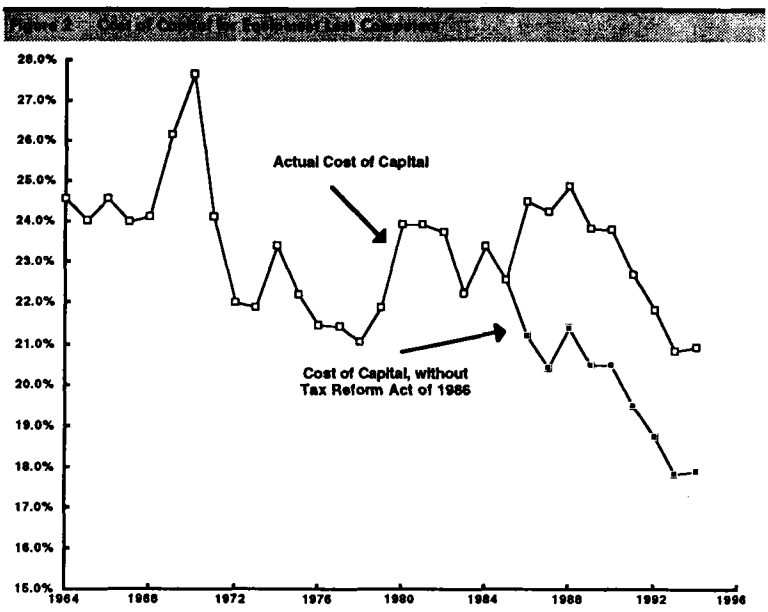
Source: Steven F. Venti, "Promoting Saving for Retirement Security," testimony presented to the Senate Finance Subcommittee on Deficits, Debt Management, and Long-Term Growth, December 7, 1994.

Figure 1 [illegible]



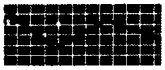
[1]The endpoints for each period are years in which a cyclical peak occurred. The growth rate is the average annual growth rate between cyclical peaks.

Source: Dale Jorgenson. *Productivity, Vol. I: Postwar U.S. Economic Growth.* (Cambridge, Mass.: MIT Press, 1995). Chart prepared by the ACCF Center for Policy Research, January 1995.



Note: The cost of capital is defined as the user cost of capital; it includes economic depreciation. Personal tax rates are not factored into the calculations.

Source: Joel Prakken, Laurence H. Meyer and Associates, unpublished data, August 1994.



AMERICAN COUNCIL FOR CAPITAL FORMATION
CENTER FOR POLICY RESEARCH

SPECIAL REPORT

January, 1995

Questions and Answers on Capital Gains

Q. *Does the United States Need a Capital Gains Tax Cut?*

A. Yes. To those who favor a truly "level playing field" over time for individual and business decisions to save and invest, stimulate economic growth, and create new and better jobs, capital gains (and other forms of saving) should not be taxed at all. This view was held by top economists in the past and is held by many mainstream economists today.

This is primarily because the income tax hits saving more than once, first when income is earned and again when interest and dividends on the investment financed by saving are received, or when capital gains from the investment are realized. The "playing field" is tilted because the individual or company that saves and invests pays more taxes over time than if all income is consumed and no saving takes place. Taxes on income that is saved raise the capital cost of new productive investment for both individuals and corporations, thus dampening such investment. As a result, future growth in productivity and living standards is impaired.

Low capital gains taxes not only treat savers more fairly but also help hold down capital costs. Public finance economists refer to the tax on capital gains as a tax on retained income, which funds a large part of business investment. The higher the capital gains tax, the more difficult it is for management to retain earnings (rather than pay out dividends) for real investment in productive projects.

Favorable tax treatment of capital gains is especially important in encouraging the "start-up" of new but risky enterprises, which provide significant dynamism and growth to the U.S. economy. Much of that start-up money comes from friends and relatives of the entrepreneur. Their return will be in appreciated stock and thus low capital gains taxes makes them more willing to risk their savings.

The unfairness of taxing capital gains is significantly increased in those cases in which gains are "phantom earnings" brought on by inflation. Indexation of capital gains taxes would obviate this.

Although the economy is expanding, worries about the future appear to be multiplying. A cut in the capital gains tax to a top marginal rate of, say, 15 to 20 percent would by no means act as an economic panacea. However, it would surely give a strong boost to values of capital assets (e.g., real estate and the stock market), encourage investment by both mature and new businesses, and constitute fairer taxation of peoples' savings.

Q. *Will Capital Gains Tax Cuts Increase U.S. Job Growth and Economic Growth?*

A. Yes. Dr. Allen Sinai, chief global economist at Lehman Brothers and a highly respected economic forecaster, argues that when macroeconomic "feedback" effects as well as unlocking of unrealized capital gains are estimated, a substantial reduction in capital gains taxes results in stronger economic growth, increased capital formation, and federal tax revenues that are significantly larger than under current law.

His estimates show that cuts in capital gains taxes:

- raise real and nominal gross national product,
- increase capital spending and capital formation,
- raise stock prices,
- increase household net worth,
- lower the cost of capital for business and increase business profits, and
- increase employment.

A capital gains tax reduction would also shift the financing of business activity away from debt to

For more information on capital gains issues, please contact the American Council for Capital Formation Center for Policy Research, 1750 K Street, N.W., Suite 400, Washington, D.C. 20006-2300; 202/293-5811.

equity, and induce portfolio allocations by households toward equity to take account of changes in expected after-tax returns on stocks and bonds.

Q. *How Do Capital Gains Affect Capital Costs?*

A. The cost of capital is the pretax return of the new investment needed to cover the purchase price of an asset, the market rate of interest, inflation, taxes, and the return required by the investors. Capital costs are an important factor in determining which investments firms will make and how much investment occurs. High capital costs mean that only those projects with the greatest expected return will be undertaken because only they will yield a return large enough to satisfy investors, resulting in less overall investment and an aversion toward higher risk projects.

Research by Stanford's Dean of the College of Arts and Sciences, Professor John Shoven, Ohio State Professor Patric Hendershott, and Dr. Allen Sinai of Lehman Brothers indicates that a capital gains tax rate in the range of 15 to 20 percent would reduce the cost of capital by 4 to 8 percent.

Q. *Aren't Cuts in Capital Gains Tax Rates Simply Another Version of "Trickle-Down" Economics that Won't Help Working Americans?*

A. No. The econometric studies of Dr. Allen Sinai demonstrate that a cut in capital gains tax rates will begin quickly to promote jobs, growth, and investment. This is because the tax cut would lower business capital costs, increase start-ups of new companies, and raise the value of equities and real estate. This is precisely the sort of economic environment in which "working Americans" prosper.

Perhaps the best anecdotal answer to those who argue that high taxes on capital gains hurt working Americans comes from a New Jersey painting contractor who (as quoted in the *Washington Post*) was "trying to scare up some work..."

> "...you're looking at a poor man who thinks the capital gains tax [cut] is the best thing that could happen to this country because that's when the work will come back. People say capital gains is for the rich, but I've never been hired by a poor man."

Q. *Still, isn't it True that Most of the Direct Benefits of a Capital Gains Tax Cut Go to the Rich?*

A. No. The facts are that many middle-class taxpayers realize a capital gain every once in a while but are counted as permanently rich under IRS statistics. But when those tax payer returns are adjusted to exclude their temporary capital gains and include only their wage and salary income, it becomes clear that middle- class taxpayers are major beneficiaries of lower capital gains tax rates. A special Treasury study covering 1985 shows that nearly one-half of all capital gains were realized by taxpayers with wage and salary income of less than $50,000. In addition, three-fourths of all returns with capital gains were reported by taxpayers with wage and salary income of less than $50,000. The issue of counting as wealthy the middle-class person who occasionally realizes a capital gain which artificially inflates his income in a given year has been studied by the Joint Committee on Taxation. A panel analysis for the year 1979-1983, by the JCT, found that 44 percent of taxpayers reporting gains realized a gain in only one out of five years.

It is true that many upper-income people have large capital gains. By realizing them, they pay more taxes, making revenue available to finance government programs which benefit lower-income recipients.

Q. *How Do Capital Gains Rates Affect "Start-Up" Companies?*

A. Capital gains taxation has a particularly powerful impact on the entrepreneurial segment of the U.S. economy—making possible new technological breakthroughs, new start-up companies, and new jobs. Starting new businesses involves entrepreneurs, informal investors, venture capital pools, and a healthy public market. All are sensitive to after-tax rates of return, which is why the level of capital gains taxation is important.

Foremost is the entrepreneur. By taxing his potential capital gains at a higher rate, either the pool of qualified entrepreneurs will decline or investors will have to accept a lower rate of return. In either case, the implications for the U.S. economy are clearly negative. To be successful, the entrepreneur needs

capital. Fledgling start-ups depend heavily on equity finance from family, friends, and other informal sources. Professors William Wetzel and John Freear of the University of New Hampshire, in a survey of 284 new companies, found taxable individuals to be the major source of funds for those raising $500,000 or less at a time. The point to be stressed is that individuals providing start-up capital for these new companies pay capital gains taxes and are sensitive to the capital gains tax rate.

Small businesses and entrepreneurs face higher capital costs than Fortune 500 companies. For them, a significant capital gains tax differential can make a big difference.

Q. *Can We "Afford" a Capital Gains Tax Cut?*

A. Yes. Critics of lower capital gains taxes argue that such cuts will reduce federal revenues and thus add to the budget deficit, absorb national saving, and raise interest rates and capital costs. Both economic analysis and experience effectively refute this view.

There is actually little difference between congressional estimates of capital gains tax cuts and those of the Treasury. For example, when President Bush proposed a 30 percent exclusion for capital gains in 1989, the congressional Joint Committee on Taxation (JCT) estimated a "static" loss over 1990-1995 of $100 billion. However, induced realizations—the "unlocking" effect—and depreciation recapture would have recouped almost 90 percent of the loss, according to the JCT, and 110 percent as estimated by the Treasury. [This arithmetic accounts for only one behavioral response—the "unlocking" effect—and the Treasury recoups almost all of the revenue loss. There is no revenue accounting for lower capital costs and increased economic activity. This impact would be substantial.]

Experience indicates that lower capital gains taxes have a positive impact on federal revenues. The most impressive evidence involves the period from 1978 to 1985. During those years the marginal federal tax rate on capital gains was cut from almost 50 percent to 20 percent—but, total individual capital gains tax receipts increased from $9.1 billion to $26.5 billion.

Research by experts at the prestigious National Bureau of Economic Research indicates that the "maximizing" capital gains tax rate—i.e., the rate that would bring in the most Treasury revenue—is somewhere between 9 and 21 percent.

Q. *How Do Our Competitors Treat Capital Gains?*

A. Our international competitors recognize the contribution a capital gains tax differential can make to new risk capital, entrepreneurship, and new job creation.

The United States taxes capital gains more harshly than almost any other industrial nation. A survey of twelve industrialized countries shows that the U.S. capital gains tax rate on long-term gains on portfolio securities exceeds that of all countries except Australia and the United Kingdom, and these two countries index the cost basis of an asset (see Table 1). Germany, Japan, and South Korea exempt or tax only lightly capital gains on portfolio stock.

Not only do virtually all industrialized countries tax individual capital gains at lower rates than the United States; they also accord more favorable treatment to corporate capital gains.

Q. *What Should a Sensible Capital Gains Tax Cut Look Like?*

A. Capital gains tax reform should satisfy three criteria. First, it should make economic sense by lowering the excessively high cost of U.S. capital, reducing the bias against high-risk capital, and ameliorating the taxation of inflationary gains.

Second, it should be fair to all income groups and sectors of the U.S. economy: Main Street and Wall Street, middle-class investors and farmers, new entrepreneurs and retiring businessmen, and individual investors and businesses.

Finally, although there is controversy about the revenue consequences of the capital gains tax reduction, a very strong and credible case can be made that this initiative, with its important macroeconomic consequences, will not reduce total tax revenues and, in fact, is a revenue-raiser.

Q. *Isn't Indexing the Best Way to Lower the Capital Gains Taxes?*

A. Indexing is a very good idea because it adjusts for inflation, but taken alone it is a far from complete solution to the problem. A traditional capital gains tax exclusion is also needed.

Indexing for inflation will not offset much of the negative effects on the cost of capital caused by the

very high capital gains taxes resulting from the Tax Reform Act of 1986.

Q. *What Is the Capital Gains Tax Proposal in the GOP "Contract With America?"*

A. The GOP "Contract With America" contains three capital gains incentives:

- *Fifty Percent Capital Gains Deduction*—The "Contract With America" would substantially cut the tax rate on capital gains by allowing taxpayers to exclude one-half of the amount of their net capital gains. Currently, capital gains are taxed at the same rate as ordinary income, subject to a cap of 28 percent. Thus, there is a modest capital gains differential for the upper tax rate brackets, but principally because the 1993 tax law raised income tax rates. The Contract would halve the effective capital gains tax rate for lower- and middle-income taxpayers. The new effective capital gains tax rates would be 7.5 percent, 14 percent, 15.5 percent, 18 percent, and 19.8 percent for individuals, depending upon the individual's

Table 1 International Comparison of Capital Gains Taxes and Personal Saving Rates

Country	Capital Gains Maximum Individual Tax Rate[1]		Personal Saving Rate[2]
	Short-term	Long-term	1975-1991
United States	28.0%	31.3%[3]	6.8%
Japan	1% of sale price or 20% of net gain.	1% of sale price or 20% of net gain.	17.3%
Australia	48.3%	48.3%; asset cost is indexed.	9.3%
Belgium	Exempt	Exempt	14.7%
Canada	23.80%	23.80%	12.5%
France	18.1%	18.1%	15.6%
Germany	53.0%	Exempt	12.7%
Hong Kong	Exempt	Exempt	N/A
Italy	25.0%	25.0%	19.8%
Netherlands	Exempt	Exempt	2.9%
Sweden	25.0%	25.0%	1.4%
United Kingdom	40%; asset cost is indexed.	40%; asset cost is indexed.	9.8%

[1] Reflects top marginal rates on portfolio securities gains.
[2] Organization for Economic Cooperation and Development. Net household saving as a percent of disposable income. *OECD Economic Outlook* 52, December 1992, Table R 12, p. 212.
[3] While the top statutory rate is 28.0%, the actual top marginal rate for an individual faced with reduced itemized deductions and phasing out of personal exemptions is 31.3% for a family of four.

Prepared by the American Council for Capital Formation Center for Policy Research.

tax bracket. Corporations would be subject to a top effective capital gains tax rate of 17.5 percent.

- *Capital Gains Indexation*—The "Contract With America" would end the current practice of taxing individuals and corporations on capital gains due to inflation. Currently, taxpayers must pay capital gains taxes on the difference between an asset's sales price and its "basis" (the asset's original purchase price, adjusted for depreciation and other items), even though the increase in value may be due to inflation. The Contract would increase the basis of most capital assets to account for inflation occurring after 1994. Taxpayers would be taxed only on the real—not inflationary—gain.

- *Loss on the Sale of a Home*—The "Contract With America" would treat a loss on the sale of a principal residence as a capital loss. Currently, if a home-owner sells his or her home at a loss, that loss is not deductible (even though gains on future residence sales may be taxable). The Contract would allow taxpayers to deduct the loss on the sale of a principal residence. This loss would be subject to the capital loss limitation rules, which allow a net capital loss (determined after netting capital gains and capital losses) to offset up to $3,000 annually of ordinary income, with the unused portion of the loss carried forward into succeeding years.

Q. *What Is a Capital Gain?*

A. A capital gain or loss is the difference between the selling price of an asset and its basis (cost). The basis (cost) is the purchase price of the asset, including any brokerage fee. For example, if corporate stock is purchased for $2,000 and later sold for $2,500 (net of broker commissions), the capital gain is the difference between the $2,000 purchase price and the $2,500 received from the sale, or $500. If the asset purchased is a physical asset, such as a building, and the owner had made improvements, then the tax basis is the purchase price plus the cost of the improvements. If the asset depreciates over time, the basis is the original sale price reduced by the decline in value from depreciation.

The distinction between capital assets and other forms of property is the most important concept in the law relating to the taxation of capital gain. Under the Code, any property is a "capital asset" unless it is covered by one of numerous exceptions. The theme running through the exceptions is that capital gains treatment is appropriate only for income resulting from the appreciation in value of investment property or property used in a trade or business. Thus, there are exceptions that deny capital gain treatment for income from personal efforts, income from property not attributable to appreciation (such as interest, dividends, royalties, and rent), and the ordinary profits of business operations.

The primary assets that typically yield capital gains are corporate stock and business and rental real estate, according to a recent report by the Senate Budget Committee. Corporate stock accounts for from 20 percent to 50 percent of total realized gains, depending on the state of the economy and the stock market. There are also gains from assets such as bonds, partnership interests, owner-occupied housing, timber, and collectibles, but all of these are relatively small as a share of total capital gains.

Q. *What Is the Current Federal Capital Gains Tax Rate?*

A. Gains on the sale of capital assets held for more than a year are limited to a maximum tax rate of 28 percent under the federal individual income tax, even though rates on ordinary income go up to 39.6 percent (or even higher in some cases). Also, gain on the sale of property used in a trade or business is treated as a long-term capital gain if all gains for the year on such property exceed all losses for the year. Qualifying property used in a trade or business generally is depreciable property or real estate that is held more than a year, but not inventory.

Benefits of the 28 percent maximum tax rate are limited to individuals with tax rates above 28 percent—that is, those in the 31 percent bracket, the 36 percent bracket, or the 39.6 percent bracket. For 1994, a taxpayer filing a joint return would have to have taxable income of $91,850 before the 31 percent tax rate applied (single taxpayers would have to have $53,500). Taxable income would have to be $140,000 before the 36 percent rate applied, and $250,000 before the 39.6 percent rate applied.

Under current law, capital gains net of capital losses realized by an individual are taxed at a top

Table 2 History of Capital Gains Tax Rates

Years	Holding Period (%)	Individuals: Top Marginal Rate (%)	Individuals: C-G[a] Rate (%)	Individuals: Diff.[b]	Corporations: Top Marginal Rate (%)	Corporations: C-G[a] Rate (%)	Corporations: Diff.[b] (%)
1942-43	6 mos.	88.0	25.0	63.0	40.0	25.0	15.0
1944-45	6 mos.	94.0	25.0	69.0	40.0	25.0	15.0
1946-50	6 mos.	91.0	25.0	66.0	38.0	25.0	13.0
1951	6 mos	87.2	25.0	62.2	50.8	25.0	25.8
1952-53	6 mos.	88.0	26.0	62.0	52.0	26.0	26.0
1954	6 mos.	87.0	26.0	61.0	52.0	26.0	26.0
1955-63	6 mos.	87.0	25.0	62.0	52.0	25.0	27.0
1964	6 mos.	77.0	25.0	52.0	50.0	25.0	25.0
1965-69	6 mos.	70.0	25.0	45.0	48.0	25.0	23.0
1970	6 mos.	70.0	29.5	40.5	48.0	28.0	20.0
1971	6 mos.	70.0	32.5	37.5	48.0	30.0	18.0
1972-76	6 mos.	70.0	35.0[c]	35.0	48.0	30.0	18.0
1977	9 mos.	70.0	35.0	35.0	48.0	30.0	18.0
1978-10/31/78	1 yr.	70.0	35.0	35.0	48.0	30.0	18.0
11/1/78-6/9/81	1 yr.	70.0	28.0	42.0	46.0	28.0	18.0
6/10/81-6/22/84	1 yr.	50.0	20.0	30.0	46.0	28.0	18.0
6/23/84-86	6 mos.	50.0	20.0	30.0	46.0	28.0	18.0
1987	6 mos.	38.5	28.0	10.5	40.0	34.0	6.0
1988	1 yr.	33.0[d,e]	33.0[d,e]	0	34.0	34.0	0
1990	1 yr.	31.0[f]	28.0[f]	3.0	34.0	34.0	0
1993	1 yr.	39.6	28.0	11.6	35.0	35.0	0
Rep. Contract Proposal[g]	1 yr.	39.6	19.8	19.8	35.0	17.5	17.5

[a] Maximum capital gains tax rate.
[b] Differential between marginal income tax rate and capital gains rate.
[c] Interplay of minimum tax and maximum tax on earned income results in a marginal rate of 49.125%.
[d] Statutory maximum of 28% but "phaseout" notch increases rate to 33%.
[e] Interplay of all "phaseouts" can increase marginal rate to 49.5%.
[f] The Budget Act of 1990 increased the statutory rate to 31.0%, and capped the marginal rate on capital gains at 28.0%. Until 1996, however, some taxpayers will face effective marginal rates of more than 34.0% due to the phase out of personal exemptions and itemized deductions.
[g] The Republican Contract provides: (1) a 50 percent capital gains deduction for individuals and corporations, (2) indexation of the basis of capital assets to eliminate gains due to inflation, and (3) a provision to treat the loss on the sale of a home as a capital loss. The 50 percent capital gains deduction means that capital gains tax rates would be 7.5%, 14.0%, 15.5%, 18.0% and 19.8% for individuals.

Prepared by the American Council for Capital Formation Center for Policy Research.

marginal federal tax rate of 28 percent in taxable income. Net losses are included up to a maximum of $3,000. Net capital losses in excess of $3,000 are carried over to later taxable years. This constraint limits the ability of investors to time the realization of gains and losses so as to minimize taxes.

Corporate capital gains are taxed at a rate of 35 percent, the rate applied to ordinary corporate income.

Q. *What Is the History of Capital Gains Taxes in the United States?*

A. Although the original 1913 Income Tax Act taxed capital gains at ordinary rates, legislation in 1921 provided for an alternative flat-rate tax for individuals of 12.5 percent for gain on property acquired for profit or investment. This treatment was to minimize the influence of the high progressive rates on market transactions. Over the years, many revisions in this treatment have been made. In 1934, a sliding-scale treatment was adopted (where lower rates applied the longer the asset was held). This system was revised in 1938. In 1942, the sliding-scale approach was replaced by a 50 percent exclusion for all but short-term gains (held for less than six months), with an elective alternative tax rate of 25 percent (see Table 2). The alternative tax affected only individuals in tax brackets above 50 percent.

In 1978, a 60 percent exclusion for individuals was introduced and the alternative rate for corporations was lowered to 28 percent. In 1981, the maximum tax rate on capital gains was reduced to 20 percent; the corporate gains tax remained at 28 percent.

The Tax Reform Act of 1986, which lowered overall tax rates and included only two tax rate brackets (15 percent and 28 percent), provided that capital gains would be taxed at the same rate as ordinary income.

In 1990, a 31 percent rate was added to the rate structure for ordinary income. There had, however, been considerable debate over proposals to reduce capital gains taxes. Since the new rate structure would have increased capital gains tax rates for many taxpayers from 28 percent to 31 percent, a separate capital gains rate cap of 28 percent was maintained. The 28 percent cap was continued when the 1993 Omnibus Budget Reconciliation Act added a top rate of 36 percent and a ten percent surcharge on very high incomes, producing a maximum rate of 39.6 percent on ordinary income.

Q. *Do States Also Tax Capital Gains?*

A. Yes. Of the 42 states which tax capital gains, the majority apply this tax to the gain reported on the federal tax return. The Tax Reform Act of 1986, which eliminated the 60 percent exclusion for capital gains income, dramatically increased state capital gains taxes. As noted in a recent op-ed in the *Washington Times*:

> ...State capital gains taxes add another layer of impediment to investment and entrepreneurship, thereby further hampering economic growth and job creation...
>
> Even though a state capital gains tax rate of 4.5 percent, for example, as levied in Connecticut, is less than the national state average of 5.4 percent, it can turn out to be much more daunting after inflation is factored into the equation. For example, if one considers inflation on a venture capital investment of $50,000 made in 1987 and sold for $70,000 in 1993, Connecticut's real capital gains tax rate jumps to 11 percent..
>
> In a state with a much higher capital gains tax rate, such as New York, where the top rate is 7.875 percent, the real rate on such an investment jumps to over 19 percent.

The combined burden of federal and state taxes on capital gains makes it more difficult to raise capital for the start-up and entrepreneurial activity companies which are the source of much economic vibrancy, innovation, and job creation.

Q. *Is Capital Gains a Partisan Issue?*

A. No. A reduction in capital gains taxation has not been a partisan issue in the past and should not be a partisan issue now. Capital gains tax reductions enjoyed bipartisan support from the tax-writing committees in all the major debates on this issue for nearly two decades. The real issues are economic: U.S. productivity growth, competitiveness, and job creation. As to fairness, past capital gains cuts have benefited the public generally by strengthening the U.S. economy. In fact, capital gains tax reductions in the Republican "Contract With America" is one of the most progressive measures to be considered by the Ways and Means Committee in many years. It raises large sums from upper-income taxpayers to fund programs for low income Americans. A number of prominent Democrats have championed lower capital gains taxes over the years. ❖

AMERICAN COUNCIL FOR CAPITAL FORMATION
CENTER FOR POLICY RESEARCH

SPECIAL REPORT

January, 1995

Questions and Answers on IRAs

Q. What is an Individual Retirement Account?

A. Individual Retirement Accounts (IRAs) were developed in the 1970s to encourage individuals to save for retirement. The 1981 tax act expanded IRAs so that any wage earner could contribute up to $2,000 annually to an IRA; a couple with two wage-earners could contribute $4,000. A couple with a nonworking spouse could contribute $2,250. Contributions were tax deductible and taxes on funds accumulating in an IRA were deferred until the funds were withdrawn. Individuals had to be 59 1/2 to withdraw funds from IRA accounts without penalty.

The Tax Reform Act of 1986 curtailed IRAs so that IRA contributions are not fully deductible except for workers without employer pensions, families with annual incomes under $40,000 and individuals with annual incomes under $25,000. These income limits are not indexed.

Q. Do IRAs increase saving?

A. Yes. Prominent public finance economists and scholars, including former Council of Economic Advisers Chairman Martin Feldstein, Harvard Professor Lawrence Summers, now on leave as U.S. Treasury Undersecretary for International Affairs, and Professors David A. Wise of Harvard University, James M. Poterba of Massachusetts Institute of Technology, Steven F. Venti of Dartmouth College, Jonathan Skinner of the University of Virginia, and Richard A. Thaler of Cornell University, have concluded that IRAs—especially tax deductible IRAs—do result in new saving.

Nearly a dozen scholarly studies, using a variety of data sources and employing several different statistical approaches, have examined whether targeted saving vehicles such as IRAs and 401(k)s impact saving. For example, Professor Steven Venti's recent testimony before a Senate Finance Subcommittee examined saving data from a Survey of Income and Program Participation for three different age groups (families reaching age 60 to 64 in 1984, 1987 and 1991).[1] Professor Venti found a striking increase in saving the longer the family has been exposed to the targeted retirement programs—IRAs, 401(k)s, and Keoghs (see Table 1).

The growth in IRA and 401(k) asset balances is astounding, Professor Venti noted. The typical member

Table 1 Financial Assets Saved by Families

	Families reaching age 60-64 in:		
	1984	1987	1991
Percent of families with targeted retirement saving	38	41	42
Approximate years of exposure to plans	2	5	9
Targeted retirement assets	$7,575	$13,119	$21,613
Total financial assets	$29,847	$34,013	$45,019
Percent of families without targeted retirement saving	62	59	58
Total financial assets	$2,247	$1,982	$1,691

Note. The data on saving are median asset balances in 1991 dollars.

For more information on IRA issues, please contact the American Council for Capital Formation Center for Policy Research, 1750 K Street, N.W., Suite 400, Washington, D.C. 20006. 202/293-5811.

Table 2 Flow of U.S. Net Saving and Investment (percent of GDP in current $)

	Average 1960-1980	Average 1981-1985	Average 1986-1990	Average 1991-1994[1]
Net private domestic saving	8.1%	7.2%	5.1%	5.2%
State and local government surpluses	0.7%	1.2%	0.9%	0.4%
Subtotal of private and state saving	8.8%	8.4%	5.9%	5.6%
Less: federal budget deficit	-1.0%	-4.1%	-3.2%	-3.6%
Net domestic saving available for private investment	7.8%	4.3%	2.7%	1.9%
Net inflow of foreign saving[2]	-0.4%	1.2%	2.4%	1.1%
Net private domestic investment	7.4%	5.5%	5.1%	3.0%
Personal saving	5.2%	5.6%	3.4%	3.4%
Net business saving[3]	2.9%	1.6%	1.7%	1.8%

[1]*The 1994 figures included in this average reflect only the first three quarters.*
[2]*In the 1960-80 period the United States sent more capital abroad than it received, thus net inflow was negative during this period.*
[3]*Net business saving = gross private saving - personal saving - corporate and noncorporate capital consumption allowance.*

Source: Department of Commerce Bureau of Economic Analysis, National Income Accounts. Update prepared by the American Council for Capital Formation Center for Policy Research, December 1994.

of the youngest family—those with the nine years of exposure to targeted retirement saving programs—has nearly three times the targeted retirement assets of the oldest cohort. There is a comparable increase in total assets as well. In contrast, among families without IRAs, 401(k)s, and Keoghs, the youngest families have only about 75 percent the financial assets of the older families ($1,691 vs. $2,247). Professor Venti concluded that since total financial assets, including balances in IRAs and 401(k)s, are much larger for the younger cohort in 1991 than for the older cohort in 1984, targeted retirement saving programs did stimulate new saving over the period.

Q. *Why does the United States need more saving?*

A. The U.S. personal saving rate dropped from 5.2 percent of GDP in 1960-1980 to 3.4 percent in 1991-1994 (see Table 2). Saving makes possible the productivity-enhancing investment that is critical to raising real wages for both skilled and unskilled workers. Investment in the United States averaged 7.4 percent of GDP from 1960 to 1980, but since 1991 it has averaged only 3.0 percent, and is unlikely to increase unless U.S. domestic saving increases. The downward trend in U.S. net private domestic investment must be reversed if real incomes are to increase. U.S. family income has been nearly stagnant since the mid-1970s and in recent years family income has actually fallen. For example, real median household income was $39,869 in 1989; income has declined each year to $36,959 in 1993.

In addition, looming in the future is the need to finance the retirement of the "baby boom" generation. Research suggests this generation's saving rate is only one-third the amount needed for secure retirement.

Q. *Who uses IRAs?*

A. Most contributions to IRAs are made by middle-income families, according to Professor Venti. At the IRA program's peak in 1986, about 16 percent of tax filers contributed to an IRA and about 29 percent of all families with a head of household under age 65 had positive IRA assets balances. Of course, households that had low incomes or had a young household head were less likely than wealthier or older households to have an IRA. However, at the peak of the program 75 percent of all IRA contributions were accounted for by families with annual incomes less than $50,000.

IRA participation is also closely related to age. Nearly 50 percent of all families in the 55-65 age interval had an IRA account. Thus even though less than one-third of all families have an IRA at a single point in time, over their lifetimes at least half of all families could be expected to participate in an IRA program.[2]

Q. *Do other countries use IRAs?*

A. Many industrial countries, including Canada, Australia, France, the United Kingdom, the Netherlands, and Belgium, encourage saving through IRA-type programs. Most of these countries permit larger IRA contributions than does the United States, and most allow a tax deduction for the IRA. For example, Canada permits taxpayers covered by an employer's pension plan to contribute $3,500 per year to a Registered Retirement Saving Plan (RRSP); persons without an employer pension plan could contribute up to $13,500 in 1994.

Canada's generous RRSP plan may help explain why that country has a higher personal saving rate than the United States (9.6 percent of disposable income over the 1986-1994 period, compared to 4.7 percent for the United States). Other countries with IRA-type saving programs also have personal saving rates which exceed that of the United States. For example, the personal saving rate was 6.3 percent in Australia, 12.5 percent in France, and 9.1 percent in the United Kingdom over the 1986-1994 period.

Q. *What are the leading proposals for IRA expansion?*

A. IRAs enjoy strong bipartisan support.

- The Republican Contract With America offers a new "American Dream Savings Account" (ADS) which allows a nondeductible annual contribution of up to $4,000 for a married couple ($2,000 for an individual); the annual IRA contribution would be indexed for inflation. If the ADS were held for five years, the taxpayer could withdraw funds without penalty for retirement, first-time home purchases, college, or medical expenses.
- President Clinton has proposed expanding tax-deductible IRAs and permitting the use of the money before retirement to pay for the purchase of a first home, education, catastrophic health costs, or for the care of an elderly parent. The administration proposal raises the current tax-deductible IRA income limit from $40,000 (phasing out at $50,000) to $80,000 (phasing out at $100,000). The administration proposal also allows individuals the option of the "back-loaded IRA" in which after-tax saving is put into an IRA but the proceeds are exempt from tax when withdrawn.
- IRAs have also enjoyed bipartisan support over the years. For example, outgoing Treasury Secretary Lloyd Bentsen is a long-time IRA supporter and cosponsored several bills with Senator Bill Roth (R-DE) to reinstate deductible IRAs while he was chairman of the Senate Finance Committee. Senators Roth and Breaux (D-LA) have introduced similar legislation (S12) in the 104th Congress. Treasury Undersecretary Summers also believes deductible IRAs will help increase the U.S. saving rate.

Q. *Should IRA contribution limits on nonworking spouses be raised?*

A. Yes. Under current law, a family with two wage-earners can contribute up to $4,000 per year to an IRA. In contrast, a couple with one wage-earner can make a total IRA contribution of only $2,250. Over 40 years, the couple in which both spouses work outside the home can contribute $70,000 more to an IRA than can the single-income couple. At a 6 percent return on investment, the first couple would earn almost $300,000 more in savings for its retirement needs than the single-income couple, despite the fact that the retirement needs of both couples would be approximately the same. Changing the current treatment of nonworking spouses who wish to establish IRAs would promote fairness and recognize the retirement needs of the non-wage earning spouse—goals shared by Republicans and Democrats.

Q. *Can we "afford" expanded IRAs?*

A. Yes. As Dr. Summers commented:

> The weight of the available evidence suggests that IRAs generated a significant amount of saving that would otherwise not have taken place. If [deductible] IRAs were reinstated under current law, the government would lose about twenty-five cents for each one dollar of contribution., If more than one-fourth of the money contributed to IRAs represents new saving, IRAs will increase private saving by more than their revenue cost. If this condition is met, the case for reinstating IRAs is clear. Even if it is not, there is still a strong case for saving incentives given that the restoration of IRAs would be likely to come at

the expense of other tax breaks rather than at the expense of larger deficits.[3]

Q. *How do IRAs reinforce the self-control needed for saving?*

A. The importance of self-control is usually ignored in the formulation of a national savings policy. According to Professor Thaler, IRAs help people save by making it more difficult to "get to" the money than if it were left in a bank savings or checking account. Professor Thaler explains that households allocate funds, implicitly or explicitly, into categories, or mental accounts. Some funds, for example those in cash or the checking account, are designated for current consumption. Others, for example those in the savings account, are for "rainy days" or "special occasions." Self-control and mental accounts come together because mental accounts vary in how "tempting" they are to invade. Money in your wallet is more tempting to spend than money in the checking account, which in turn is more tempting than the savings account. Less tempting are funds explicitly set aside for retirement, such as money in an IRA plan. Once this concept is factored in, IRAs can increase saving even if (as some critics charge) all the money put into IRAs would have been saved anyway. By putting funds into a less accessible account, the IRA increases long-term saving.[4]

Q. *Do Americans want to see IRAs expanded?*

A. Yes. Support for additional saving incentives has remained high for several years. Two nationally representative polls, one conducted in December 1990 and one in late-December 1992, demonstrated remarkable stability in the public's opinions concerning saving. According to the poll conducted in 1992 by the Opinion Research Corporation:

- The vast majority of Americans (77 percent) feel it is important for the government to make it a national priority to increase personal saving.
- Nearly nine in ten Americans (88 percent) believe that it is important for them to increase their personal saving rate.
- Seventy-four percent of Americans would save a larger proportion of their income if the government provided them with tax incentives to save more.

In light of this strong support for additional saving incentives, it is not surprising Americans want the 104th Congress to put expanded IRAs at the top of its agenda. According to a post-election survey conducted by the Luntz Research Companies, expanded IRAs are the single most popular tax proposal "on the table."

Q. *Won't Americans just shift money from existing accounts if IRA limits are raised?*

A. No. American families simply do not have the money to keep shifting assets from other accounts into their IRAs, according to a new study by Capital Research Associates.[5] The study classified families by the age of the "family head" and found, specifically, that families headed by individuals 44 years of age and below have median net financial assets of just $700. Even families on the verge of retirement, headed by individuals aged 55 to 64, have median net financial assets of only $6,880. Those families with the highest level of median net financial assets, $10,000, are headed by individuals aged 65 to 74. Overall, the median level of net financial assets for all U.S. families amounts to approximately $1,000, the analysis concluded, thus suggesting that American families cannot simply shift assets from other accounts to IRAs. ❖

Notes

1. Steven F. Venti, "Promoting Saving for Retirement Security," testimony presented to the Senate Finance Subcommittee on Deficits, Debt Management, and Long-Term Growth, December 7, 1994.

2. Venti, "Promoting Saving for Retirement Security."

3. Lawrence H. Summers, "Stimulating Personal Saving" in *The U.S. Savings Challenge: Policy Options for Productivity and Growth*, ed. by Charls E. Walker, Mark A. Bloomfield, and Margo Thorning (Boulder, Colo.: Westview Press, 1990) p. 170.

4. Richard H. Thaler, "Self-Control, Psychology and Savings Policies," testimony presented to the Senate Finance Subcommittee on Deficits, Debt Management, and Long-Term Growth, December 7, 1994.

5. Joseph M. Anderson, "The Wealth of U.S. Families in 1991 and 1993," (Chevy Chase, Md.: Capital Research Associates, December 1994). The study was commissioned by Merrill Lynch and Co.

AMERICAN COUNCIL FOR CAPITAL FORMATION
CENTER FOR POLICY RESEARCH

SPECIAL REPORT

November, 1994

The Impact of the Alternative Minimum Tax on Investment and Economic Growth

by Margo Thorning*

Q. *What is the Corporate Alternative Minimum Tax?*

A. The Tax Reform Act of 1986 created a comprehensive alternative minimum tax (AMT) system that exists separate from, but parallel to, the regular tax system. Under the AMT scheme, taxable income is modified by an intricate series of "adjustments" and by "preference items" to arrive at alternative minimum taxable income. Depreciation allowances for firms paying the alternative minimum tax are generally much less favorable than those for firms paying the regular corporate income tax. The corporate minimum tax rate is 20 percent, while the top minimum tax rate for individuals is 28 percent.

There are three main reasons why corporations can become AMT payers: (1) a high level of investment in assets such as equipment and structures, and/or (2) low taxable income due to cyclical downturns, strong international competition, or other factors, and/or (3) low real interest rates.

Q. *How Does the AMT Affect Investment Spending?*

A. A study by Prakken, Varvares, and Meyer (PVM) argues that the AMT has the potential to reduce investment spending in one of two ways.[1] First, AMT-filers pay a higher average tax rate and consequently generate less internal cash flow than they would under the regular tax. This, in turn, may curb investment by firms with impeded access to capital markets. Second, the AMT affects the marginal tax rate on capital, and hence may discourage investment by raising what in neoclassical investment theory is known as the rental price of capital (or the "cost of capital"). The "rental price" is defined as the annual cost (interest plus depreciation) per unit of capital, after adjusting for the real purchase price of capital and allowing for corporate taxes, including deductions for depreciation and interest.

PVM's results show that firms permanently on the AMT face capital costs significantly higher than firms that pay the regular corporate income tax. PVM's econometric simulations show that if all firms were to face the AMT indefinitely (the worst case scenario), the result would be to reduce the level of output by approximately $60 billion annually relative to the case in which all firms paid the regular income tax. Ultimately, the equipment/output ratio would fall by 3 percent. In absolute terms, the stock of equipment would be 3.9 percent lower.

Q. *How Does the AMT Affect U.S. Cost Recovery Compared to Our Competitors?*

A. Research by Arthur Andersen and Co. shows that U.S. firms paying the AMT recover their investment costs for new equipment much more slowly than do companies in major competitor nations. For example, the present value of cost recovery allowances for U.S. steel firms using continuous casting equipment is only 57.7 percent compared to 79.3 percent in Germany and 88.3 percent in Brazil (see Table 1).

[1]Joel L. Prakken, Chris P. Vavares and Laurence H. Meyer, "Investment, Economic Growth and the Corporate Alternative Minimum Tax," *Tax Policy for Economic Growth in the 1990s*, American Council for Capital Formation Center for Policy Research, 1993.

*Margo Thorning is the Director of Research for the ACCF Center for Policy Research, the education and research affiliate of the American Council for Capital Formation. Its mandate is to enhance the public's understanding of the need to promote economic growth through sound tax, regulatory and environmental policy. For further information, contact the ACCF Center for Policy Research, 1750 K Street, N.W., Suite 400, Washington, D.C. 20006; 202/293-5811.

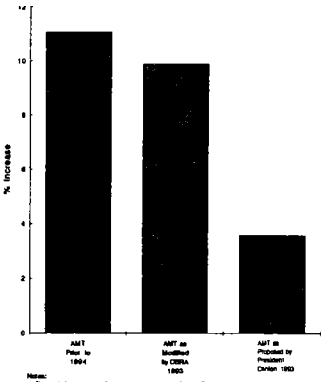
Q. *How Does the AMT Affect Taxes for Firms that Purchase Pollution-Control Equipment?*

A. Capital cost recovery provisions for pollution-control equipment are much less favorable now than prior to TRA's passage. For example, the present value of cost recovery allowances for wastewater treatment facilities used in pulp and paper production was 98.0 percent prior to TRA. Under regular TRA income tax, the present value dropped to 78.5 percent, while for AMT payers, the figure is 62.1 percent. Scrubbers used in the production of electricity fared even worse. Prior to TRA, the present value was 86.8 percent. Today, the present value is only 50.8 percent; for AMT taxpayers the figure drops to 41.5 percent. As is true in the case of productive equipment, loss of the investment tax credit and lengthening of depreciable lives both raise effective tax rates.

Q. *Didn't the Changes to the AMT in the 1993 Budget Act "Fix" the Problems Faced by Capital Intensive Firms?*

A. While the repeal of the adjusted current earnings (ACE) adjustment to depreciation contained in OBRA 1993 was a positive step, the capital cost disadvantage faced by firms on the AMT remains (see Figure 1). AMT firms with assets depreciated over seven years face capital costs 10 percent higher than for firms on the regular corporate income tax. Had the reform proposed by the Clinton administration been enacted, AMT firms' capital cost disadvantage would have fallen to less than 4 percent. ❖

Figure 1 Increase in Cost of Capital for Equipment Incurred by AMT Firms Compared to Firms Paying the Regular Income Tax under Prior Law, OBRA 1993 Changes and President Clinton's Original 1993 Reform Proposal



Notes:
Depreciation systems for an asset depreciated over 7 years under regular law.
AMT prior to 1994: 150% declining balance recovered over 15 year period.
Clinton's AMT: 120% declining balance recovered over 7 year period.
OBRA 1993: 150% declining balance recovered over 13 year period.

Explanation:
A firm on the current AMT faces a cost of capital 9.87 percent higher than a firm paying the regular income tax; the Clinton-House AMT proposal would have reduced the capital cost disadvantage to 3.8 percent for an AMT firm.

The analysis assumes that firms are permanently on the AMT. The capital cost calculations use the precise return required by tax elevator and are net of economic depreciation.

Source: Capital cost calculations by Laurence H. Meyer & Associates; chart prepared by ACCF Center for Policy Research, December 1993.

Table 1 International Comparison of the Present Value of Equipment Used to Make Selected Manufacturing Products and Pollution-Control Equipment (as a percent of cost)

	Computer Chips	Telephone Switching Equipment	Factory Robots	Crank-shafts	Continuous Casting for Steel Production	Engine Blocks	Wastewater Treatment for Chemical Production	Wastewater Treatment for Pulp and Paper Equipment	Scrubbers Used in Electricity Plants
United States									
1985 Law	98.0	98.0	98.0	98.0	98.0	98.0	98.0	98.0	86.8
MACRS	83.4	83.4	78.5	78.5	78.5	78.5	83.4	78.5	50.8
AMT	80.8	78.1	68.3	64.1	57.7	60.3	69.4	62.1	41.5
Brazil	75.7	74.8	74.7	74.7	88.3	74.7	74.7	74.7	79.4
Canada	73.4	72.2	70.3	70.1	70.5	69.9	82.8	82.8	82.8
Germany	80.7	80.1	79.8	81.1	79.3	81.1	67.6	65.5	64.6
Japan	78.8	77.5	73.5	74.4	70.9	74.1	75.2	74.2	72.9
Korea(w/ 3% ITC)	86.2	81.3	79.6	76.9	74.4	76.5	94.2	93.1	91.8
Singapore	90.1	90.1	90.1	90.1	90.1	90.1	90.0	90.0	90.0
Taiwan	80.6	73.7	75.1	58.4	57.7	57.9	144.1	144.1	144.1

Source: Stephen R. Corrick and Gerald M. Godshaw, "AMT Depreciation: How Bad is Bad." *Economic Effects of the Corporate Alternative Minimum Tax*, published by the American Council for Capital Formation Center for Policy Research (Washington, D.C.: September 1991); and unpublished data incorporating the AMT provisions of OBRA 1993.

Chairman ARCHER. Thank you.

Our next witness is Dr. Allen Sinai, managing director and chief global economist, Lehman Brothers, Boston, Mass. We are pleased to have you with us.

STATEMENT OF ALLEN SINAI, PH.D., MANAGING DIRECTOR AND CHIEF GLOBAL ECONOMIST, LEHMAN BROTHERS, BOSTON, MASS.

Mr. SINAI. Thank you. I am pleased to be here. After 4 years of an economic upturn and now a near full employment economy, extending and preserving the business expansion without rising inflation is a major challenge for economic policy. So what economic policies might increase saving, stimulate productive investment, raise productivity growth, and increase the potential supply of the economy should take center stage.

It is in this context that the American dream savings account, other provisions in the American Dream Restoration Act and of the tax reductions in the Job Creation and Wage Enhancement Act of the Contract With America are examined. All more or less as objectives increased savings, higher investment, greater capital formation, more entrepreneurship, and improved family welfare.

On this basis, some tax changes, for example, the $500-per-child tax credit under 18 for families with incomes up to $200,000 and other refundable tax credits for child adoption and family care of dependent senior citizens do not score well. These are principally consumption stimuli as opposed to savings stimuli.

Some of the tax proposals in the Contract do well on the criteria of savings, investment, productivity growth, entrepreneurship, and increased potential output, but none would be beneficial under full employment if the Federal budget deficit were to rise significantly.

Of the tax reductions considered, those with greatest potential economic effects on savings and investment I believe are capital gains tax reduction, neutral cost recovery, and the ADS account. Preliminary results from some quantitative work that we have done on proposed capital gains tax reductions are provided in the testimony.

I want to focus on some of the conclusions. First, many of the tax reductions in the Contract With America are very positive for saving, investment, productivity and entrepreneurship, but in most cases the macroeconomic impact is relatively small, perhaps only marginal. That is true for the increased small business deductions, property expenses, increased estate and gift tax exemptions, and the greater deductibility of expenses for home offices.

They all have a positive saving and entrepreneurship effect, but too small to make much of a difference in the overall economy. With funding for the total of all the tax reductions perhaps difficult on economic and political grounds, it would be wise to choose among them, skinnying down the costs and reducing the funding requirements.

Also, given that the economy is near full employment, I would suggest that only those tax reductions that increase potential supply should be used. And those prime candidates are the capital gains tax reductions, neutral cost recovery, and the ADS.

Some of the quantitative results we find from capital gains tax reductions and simulating it with our large-scale model of the U.S. economy include the following. The capital gains tax reductions, as proposed, do stimulate economic growth, do raise economic activity compared to what otherwise would occur, do create extra jobs, 1.4 million jobs over the 5-year period of the program, and they do raise national saving at least initially. If these capital gains tax reductions were financed by reductions in government spending, then national savings would be permanently raised by this combination, that is, reduced capital gains and reduced government spending.

Taking account of feedback effects on the economy from the tax reductions of the stimulative effect and increased capital gains realizations—here I don't mean unlocking; just realizations from a better economy and a better stock market—the revenue losses for the capital gains tax reduction net is estimated at $62 billion over 5 years.

If one adds the unlocking of unrealized capital gains to that, and unlocking is now well accepted as a real phenomenon by the academics who study it, and by those of us who work in the business world, the capital gains tax reductions are the only tax proposal of all that has a shot at paying for itself over the horizon in which they are applied.

Now, the neutral cost recovery accelerated depreciation also could be beneficial for stimulating investment, capital formation, and productivity, but it would not have the broad-based effects and potential for revenue feedback of the capital gains tax reductions. It would be less cost effective ex-post than reducing capital gains taxes.

The ADS account or enhanced IRAs very likely would be quite popular, with many new accounts created in financial institutions for them, but the net effect on overall savings is questionable, with mixed results from studies on this topic. I think, though, the particular form of the proposal this time, the ability to draw tax free for certain purposes could provide a stronger incentive to current saving and the savings rate than past types of IRAs and so it should be considered.

In an economy so near full employment, it is important to raise productivity, savings, investment, and potential supply through increased savings and investment of all the measures for reducing taxes in the Contract With America. Capital gains tax reduction has the lead on this score.

Thank you.

[The prepared statement and attachments follow:]

Saving and Investment in a Full Employment Economy:
The *Contract With America* Tax Reductions

by Allen Sinai*

Introduction and Summary

After four years of an economic upturn and now a near full employment economy, extending and preserving the business expansion without accelerating inflation has become the major challenge for economic policy.

In almost all cyclical episodes, once the economy reaches full employment, booming spending and heavy borrowing, spiraling inflation, speculative excesses in the financial and real economy, and upward spiraling interest rates eventually lead to financial instability, credit crunches, declines in real economic activity and a full-fledged recession.

What economic policies might lower consumption and increase saving, stimulate productive investment, raise productivity growth, increase the potential output, or aggregate supply, of the economy take center stage in a full employment economy, since a side effect from strong and rapid growth in such a situation can be accelerating and unwanted inflation.

Economic policies that previously might have been appropriate no longer are so at or near full employment. Instead, monetary and fiscal policies must be designed to slow the demand-side of the economy and raise the supply-side so as to balance the growth of aggregate demand and aggregate supply.

Against a given backdrop of monetary policy, tax and spending policies that shift consumption to saving, induce productive investment and capital formation, raise productivity growth, and provide incentives for entrepreneurship are to be preferred.

It is in this context that the American Dream Savings Account (ADS Account), other provisions in the American Dream Restoration Act, and some of the tax reductions in the Job Creation and Wage Enhancement Act of the *Contract With America* are examined.

All, more or less, have as objectives increased savings, higher investment, greater capital formation, more entrepreneurship, and improved family welfare. Presumably, if any of these goals were achieved, productivity could improve and also the potential output, or supply, of the economy. Also, the revenue loss, or cost for each proposal must be assessed, since under the Omnibus Budget Reconciliation Acts of 1990 and 1993 and Budget Enforcement Act of 1990, tax reductions have to be paid for by spending reductions, other outlay cuts, or higher taxes elsewhere.

On this basis, some tax changes not considered here, for example, the $500 tax credit per child under 18 for families with incomes up to $200,000, the $5,000 refundable tax credit for child adoption, and $500 credit for family care of dependent senior citizens do not score well. The same applies to the Administration's scaled-down proposal for a child tax credit of $500 in families with incomes of $75,000 and under. These tax reductions would tend to stimulate consumption more than savings or potential supply, and because of large revenue losses would require substantial and possibly politically difficult reductions in federal government spending and outlays. *In a full employment economy, any sizeable net fiscal stimulus or deficit-financed reductions of taxes should be avoided.*

Some of the tax proposals in the *Contract With America* do well on criteria of savings, investment, productivity growth, entrepreneurship and increased potential output. *None* would be beneficial in a fully employed economy *if* the federal budget deficit were to rise significantly. Sizeable deficit-financed tax reductions of any kind are the wrong action to take at full employment, inviting the very result economic policy must try to avoid—potentially higher inflation, speculative excesses in spending, borrowing and financial investments, a weaker dollar, tighter monetary policy, spiraling interest rates, and eventually an economic downturn.

Of the tax reductions considered in the American Dream Restoration Act and Job Creation and Wage Enhancement Act, those with the greatest potential economic effects on saving and investment are capital gains tax reductions, neutral cost recovery, and the ADS Account.

Preliminary results from macroeconometric model analysis of the proposed capital gains tax reductions are provided, since this policy change probably would have the greatest macroeconomic impact. The effects on the economy, inflation, cost of capital, savings, capital spending, employment, productivity, potential output, the federal budget deficit, and federal government tax receipts, on ex-ante (static) and ex-post (dynamic) bases, are considered (Appendix Tables 3-5).

Here, dynamic refers to capital gains realizations and full macroeconomic feedback effects of the capital gains tax reductions. Estimates of increased capital gains realizations that occur because of the lower capital gains tax, a better stock market, and increased saving are superimposed on the model-based macroeconomic results to assess more fully the dynamic, or ex-post, revenue losses. Estimates of a "taxpayer effect" or "unlocking"—the realization of previously unrealized capital gains and payment of additional taxes because of the new capital gains tax reductions—are taken from Joint Tax Committee (JTC) and Office of Tax Assessment (OTA) figures used in the evaluation of capital gains tax reduction proposals made by the Bush Administration. The capital gains tax proposals this time are greater in scope, a larger reduction in the effective capital gains tax rate and through the addition of indexing for inflation.

* Chief Global Economist and Director, Lehman Brothers Global Economics.

The results are presented without and with equivalent reductions in spending and/or transfers to offset the ex-post or dynamic loss of revenues from the tax reductions. Monetary policy is not changed from a baseline situation.

The Baseline Forecast (January 1995) parameters that underlie the model simulation are shown in Table 1 of the Appendix, essentially a near-balanced growth path for the economy that reflects economic forces in place now to slow the demand-side of the economy in-line with potential supply. This Baseline scenario shows a reduction of inflation pressure as the economy slows, permitting tax reductions to occur with less chance of an inflationary effect.

Some conclusions, briefly:

- Many of the tax reductions in the *Contract With America* (Table 2, Appendix) are very positive for saving, investment, productivity, entrepreneurship and potential output. But, in most cases the macroeconomic impact would be relatively small, and perhaps only marginal. This is true for increased small business tax deductions for property expenses, increased estate and gift tax exemptions then indexed for inflation, and the greater deductibility of expenses for home offices. All have a saving or entrepreneurship effect, but too small to make much of a difference in the overall economy.

  The Modify Marriage Penalty provision, at a $10 billion cost, would be designed to correct a socially undesirable subsidy. Raising social securities earnings limits to $30,000, phasing out the social security tax increase recently passed into law, and tax incentives for private long-term care insurance are more consumption-oriented than for savings and investment.

- If all provisions were enacted, the tax reductions could be very costly, some $193.3 billion over five years, according to House of Representative estimates, adding sizably to the federal budget deficit unless offset by spending or outlay reductions. With reductions in defense outlays (other than already programmed in prior legislation), social security, net interest and much of Medicare and Medicaid "off the table," savings to finance all the tax cuts could be hard to find or politically difficult. A balanced budget amendment could not be passed quickly enough to fund the aggregate of tax reductions, many of which are designed to be implemented on January 1, 1995 or in January 1996.

- With funding for all the tax reductions difficult on economic and political grounds, it would be wise to chose among them, skinnying-down costs and reducing the funding requirements. Also, given that the economy is near full employment, only those tax reductions that increase potential supply should be used.

- The prime candidates are thus capital gains tax reductions, neutral cost recovery, or the new ADS Account, an essentially enhanced IRA.

- The capital gains tax reductions were simulated in the Sinai-Boston large-scale macroeconometric model of the U.S. economy, a 50% exclusion for gains on assets held at least one year and indexing for inflation over the holding period of the asset.

  These proposals would have the greatest macroeconomic effects of the various savings-investment oriented tax reductions, stimulating economic activity, increasing jobs, increasing capital spending and capital formation, for a time improving national savings, increasing entrepreneurship, and raising the potential output of the economy without generating higher inflation (Table 3, Appendix).

  - According to the Sinai-Boston Model, over the five-year period from 1995 to 1999, real GDP would be $26.3 billion higher per year and real economic growth up 0.1 percentage point per annum compared with a situation of no capital gains tax reductions. A considerable increase in business capital spending is estimated, 2.1% a year relative to the Baseline, with about two-thirds of the additional spending in equipment. 283,000 jobs a year or about 1.4 million over the five-year period would be gained. Productivity growth would be up 0.1 percentage points a year and potential output by $4.4 billion per year.

  - National savings would not change much, principally because of a net, after feedback, rise in the federal budget deficit of $12.3 billion per annum. But, business savings would move sharply higher, by $10.2 billion per year (Table 4).

  - The stronger economy stems from a lower cost of capital with the reductions in capital gains taxes, increased business and personal saving, higher business spending on plant and equipment, the increased stock prices and higher household net worth as investors shift funds away from other investments into stocks, increased hiring and new jobs, and wealth, income, and profits effects on spending, saving, and purchases of financial assets. Short-term interest rates would move somewhat higher assuming no change in monetary policy. But, long-term interest rates likely would drop somewhat from positive wealth and income effects.

  - With the increased capital formation, entrepreneurship measured by new business incorporations and reductions in government operations, productivity would increase and so would the potential output of the economy. This supply-side effect, although very modest, would tend to limit any inflationary effect of the tax reductions. The balanced nature of the economy before the tax reductions in terms of demand and supply are part of the lack of any inflationary effect. The unemployment rate would move down by 0.1 percentage point per year.

- Taking account of the feedback effects from the tax reductions, increased capital gains realizations and stronger economy, ex-post, or dynamic estimates of revenue losses total $61.9 billion, or $12 billion per year (Table 5).

  Assuming that some "unlocking" occurs, an effect that is almost universally agreed upon, the net cost of the capital gains tax cuts is even less, with a possibility that the effects would go a long way toward fully paying for the initial loss of ex-ante tax receipts. Unlocking estimates can very considerably, however, so that a precise estimate of the net cost in reduced tax receipts cannot be made at this point.

- Financing the capital gains tax reductions with reduced government spending and/or outlays weakens the macroeconomic effects, but does not wipe them out (Table 6). Growth, jobs, investment, entrepreneurship and employment all rise, as does consumption. National saving increases substantially, however, because of the reductions in spending/outlays (Table 7). The combination, capital gains tax reductions and cutbacks in government spending and outlays to match the ex-post revenue losses, about $62 billion over five years, produces an economy that, on balance, grows faster, creates more jobs, generates more capital formation and raises productivity without any pickup on inflation. Increased savings and investment tilt the economy away from consumption.

- Neutral cost recovery, or accelerated depreciation, also could be beneficial for stimulating investment, capital formation and productivity, but without the broad-based effects and potential for induced revenue feedback of the capital gains tax reductions. It would be less cost effective, ex post, than reducing capital gains taxes.

- The ADS Account, or enhanced IRA, very likely would be quite popular, with many new accounts created in financial institutions for them. But, the net effect on overall saving is questionable, with mixed results from studies on this topic.

  Most likely, a considerable switching of savings from other vehicles to the ADS Accounts would occur, a plus for financial institutions but not necessarily reducing consumption and raising saving relative to disposable income. The ability to draw, tax-free, on the ADS Account for purposes of education, medical costs, insurance for long-term care, and retirement could provide a powerful incentive to current saving, however, with this proposal having a better chance of increasing the personal savings rate than previous types of IRAs.

In summary, the tax reductions proposed in the *Contract With America* have much to be commended, with many aimed at and contributing to increased savings, investment, productivity, entrepreneurship, and higher potential output. These are all good supply-side dimensions, whose beneficial effects would be buttressed if financed by reductions in the operation of the federal government, headcount reduction, consolidation, outsourcing, privatization of certain functions and reductions in entitlements. Consumption spending also would be increased, relatively more under some measures than others. Family tax credits do not score well on supply-side considerations and are principally a stimulus to consumption.

Of all the tax reductions considered, the most beneficial, in a balanced way, to both the demand-side and supply-sides of the economy at potentially least net cost, is the 50% exclusion of capital gains from taxation, effectively having the capital gains tax rate at all personal and corporate income tax levels, and the indexing of capital gains to inflation.

Econometric model simulations with the Sinai-Boston Model of the U.S. Economy also show significantly positive effects on economic activity, real economic growth, capital spending for equipment and plant, jobs, and national saving if the capital gains tax reductions are financed by equivalent cuts in spending and/or outlays.

The tax on inflation-generated capital gains has long been considered a distortion that would be corrected on indexing. The stimulation to the supply- and demand-sides of the economy through an effective halving of capital gains tax rates is tolerable for an economy near full employment, given the savings-investment dimensions of the capital gains tax reductions.

On several criteria for judging changes in taxes—allocative efficiency, economic growth, savings and investment, international competition and fairness—capital gains tax reduction wins on almost all. The one exception is equity, because higher income families tend to hold more of the assets that could be subject to capital gains.

In an economy so near full employment, it is important to raise productivity and potential supply through increased saving and investment. Of all the measures for reducing taxes in the *Contract With America*, capital gains tax reductions lead on this score.

Appendix
Charts and Tables

Chart 1
The "Output Gap"
(Bils. 87 $s)

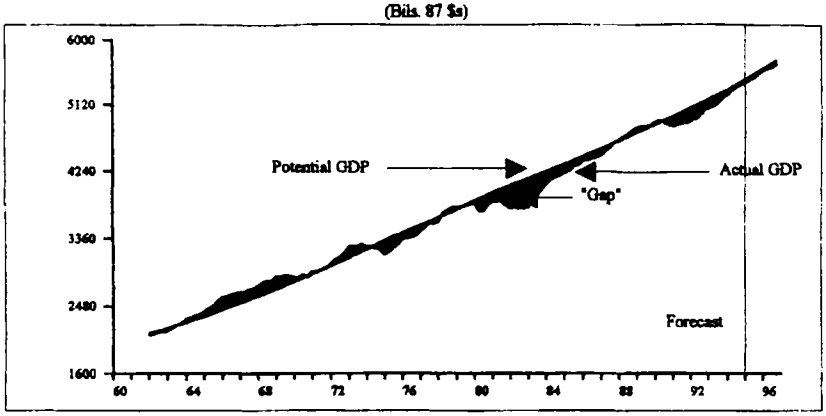


Chart 2
Manufacturing Capacity Utilization (Percent)

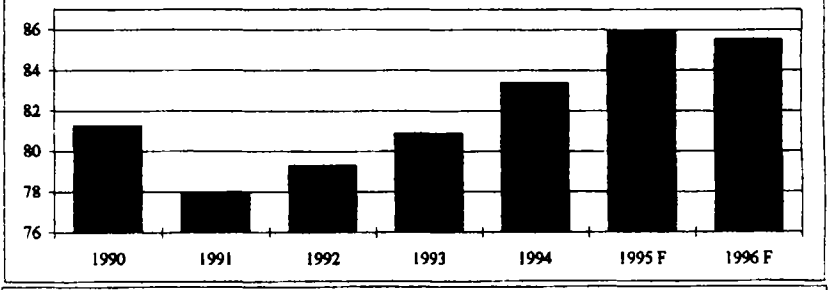


Chart 3
Unemployment Rate
(Percent)

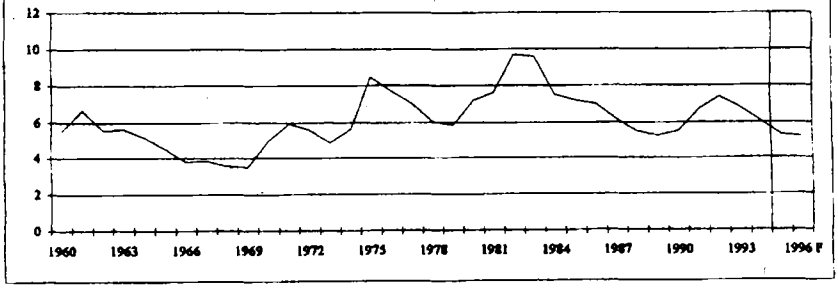


Table 1
Baseline Forecast Parameters*
Economic Assumptions (Calendar Years, Except Where Noted)

	1993	1994	1995	1996	1997	1998	1999
Real GDP (% chg., 4th qtr./4th qtr.)	3.1	4.0	2.7	2.5	2.0	2.8	2.1
GDP Deflator (% chg., 4th qtr./4th qtr.)	1.8	2.6	3.4	2.9	3.2	2.6	2.5
Unemployment Rate (%)	6.8	6.1	5.3	5.2	5.6	5.5	5.7
91-Day Treasury Bill Rate	3.0	4.3	6.3	5.9	4.6	4.9	4.5
10-Year Treasury Note Rate (%)	5.9	7.1	7.7	7.2	7.0	7.5	6.9

Source: Lehman Brothers Global Economics (LBGE).
*January forecast, LBGE.

Table 2
Tax Reductions in the *Contract With America**
(Bils. of $'s)

Acts and Provisions	5-Year Cost or Savings (-)
Reinforcing Families	
Tax Incentives for Adoption	0.9
Dependent Care Tax Credit for Seniors	8.0
American Family Tax Relief in American Dream Restoration Act	
$500 Per Child Tax Credit	107.0
Modify Marriage Penalty	10.0
American Dream Savings Account (Super IRA or ADS Account)	-4.7
Senior Citizens' Reforms	
Raise Social Security Earnings Limit to $30K	6.8
Phase-Out Clinton Social Security Tax Increase	17.0
Tax Incentives for Private Long-Term Care Insurance	1.3
Economic Growth/Regulatory Reform (Job Creation and Wage Enhancement Act)	
Cut Capital Gains Rate (50% Exclusion/Index for Inflation)	56.0
Neutral Cost Recovery	-19.5
Small Business Expensing	3.5
Raise the Estate and Gift Tax Exclusion	6.5
Restore Tax Deductions for Home Offices	0.5
Total	193.3

*House Budget Committee, Republican Staff Estimates, October 1994.

Table 3
Macroeconomic Effects of a Capital Gains Tax Cut*
50% Exclusion for Long-term Capital Gains and Indexing for Inflation - All Taxpayers
(Changes from Baseline, Fiscal Years)

	1995	1996	1997	1998	1999	Avg. Per Yr.
Real GDP - Level						
(Bils. 87 $'s)	5.3	21.5	29.1	34.0	41.4	26.3
(Pct. Chg.)	0.1	0.4	0.5	0.6	0.7	0.5
Real GDP-Growth (Pctg. Pts.)	0.1	0.3	0.1	0.1	0.1	0.1
Business Capital Spending						
Total (Bils. 87 $'s)	2.2	11.5	18.8	23.3	27.9	16.7
(Pct. Chg.)	0.3	1.5	2.4	2.8	3.2	2.1
Plt. (Bils. 87 $'s)	1.0	5.2	7.6	8.4	9.3	6.3
(Pct. Chg.)	0.6	3.2	4.4	4.7	5.0	3.6
Equip. (Bils. 87 $'s)	1.2	6.3	11.2	14.8	18.6	10.4
(Pct. Chg.)	0.2	1.1	1.8	2.3	2.7	1.6
Capital Formation - Stocks						
Plt. (Bils. 87 $'s)	0.3	3.8	10.4	17.9	25.7	11.6
(Pct. Chg.)	0.0	0.1	0.4	0.7	0.9	0.4
Equip. (Bils. 87 $'s)	0.4	4.5	12.9	23.8	36.7	15.7
(Pct. Chg.)	0.0	0.2	0.4	0.8	1.1	0.5
Consumption						
(Bils. 87 $'s)	3.9	17.0	26.2	30.4	33.9	22.3
(Pct. Chg.)	0.1	0.5	0.7	0.8	0.8	0.6
Real Net Exports						
(Bils. 87 $'s)	-1.5	-10.3	-19.4	-22.9	-23.4	-15.5
Inflation - GDP Deflator						
(Pctg. Pts.)	-0.0	-0.0	0.1	0.0	-0.0	0.0
Employment and Unemployment						
Payroll (Mils.)	-0.028	0.251	0.428	0.404	0.361	0.283
Unemp. Rate (%)	-0.0	-0.1	-0.2	-0.2	-0.2	-0.1
Productivity Growth (Pctg. Pts.)	0.1	0.1	0.1	0.2	0.2	0.1
Potential GDP						
(Bils. 87 $'s)	0.2	1.5	4.0	6.8	9.7	4.4
(Pct. Chg.)	0.0	0.0	0.1	0.1	0.2	0.1
Interest Rates (%)						
90-day T-Bill	0.02	0.09	0.14	0.16	0.18	0.12
30-year Treas.	-0.11	-0.11	-0.08	-0.08	-0.09	-0.10
AAA-Equiv. Corp. New Issue	-0.12	-0.16	-0.12	-0.11	-0.13	-0.13
Aftertax Return on Equity	0.96	1.31	1.35	1.41	1.47	1.30
Cost of Capital (%)						
Pretax Equity	-0.74	-1.03	-1.08	-1.15	-1.22	-1.04
(Pct. Chg.)	-5.1	-7.2	-7.6	-7.9	-8.3	-7.2
Aftertax Wted. Avg. Cost - Debt & Equity	-0.27	-0.36	-0.39	-0.42	-0.46	-0.4
(Pct. Chg.)	-2.7	-3.7	-3.9	-4.1	-4.3	-3.7
S&P500						
(Pct. Chg.)	0.3	1.0	1.2	1.4	1.7	1.1
Exch. Rate						
(Pct. Chg.)	0.0	0.2	0.5	0.1	-0.2	0.1
Household Net Worth						
(Bils. $'s)	24.5	104.0	187.6	262.9	334.8	182.7
(Pct. Chg.)	0.1	0.4	0.7	0.9	1.1	0.7
Fed. Bdgt. Def. (NIPA)						
(Bils. $'s)	-11.8	-11.5	-10.5	-12.7	-15.0	-12.3
Personal Savings						
(Bils. $'s)	5.8	6.4	1.9	-3.7	-6.6	0.8
Business Savings						
(Bils. $'s)	6.6	10.4	10.8	11.1	12.1	10.2
National Savings						
(Bils. $'s)	0.8	6.1	3.0	-4.7	-8.9	-0.7
National Savings Plus Earnings from Higher Realizations (Bils. $'s)	--	--	--	--	--	--

* Macroeconometric model simulation with the Sinai-Boston Model of the U.S. Economy. Policy changes effective January 1, 1995.

Table 4
National Savings*
50% Exclusion for Long-term Capital Gains and Indexing for Inflation - All Taxpayers
(Changes from Baseline, Fiscal Years)

	1995	1996	1997	1998	1999	Avg. Per Yr.
National Saving	0.8	6.1	3.0	-4.7	-8.9	-0.7
Personal Saving	5.8	6.4	1.9	-3.7	-6.6	0.8
Business Saving	6.6	10.4	10.8	11.1	12.1	10.2
Government Surplus or Deficit (-) (NIPA)	-11.6	-10.6	-9.7	-12.1	-14.5	-11.7
Federal	-11.8	-11.5	-10.5	-12.7	-15.0	-12.3
State and Local	0.3	0.9	0.8	0.6	0.5	0.6

* Macroeconometric model simulation with the Sinai-Boston Model of the U.S. Economy. Policy changes effective January 1, 1995.

Table 5
Federal Tax Receipts*
50% Exclusion for Long-term Capital Gains and Indexing for Inflation - All Taxpayers
(Changes from Baseline, Fiscal Years)

	1995	1996	1997	1998	1999	Cum. 1995-99
Total Receipts	-12.1	-12.5	-11.1	-12.4	-13.8	-61.9
Personal	-7.6	-9.0	-8.8	-9.9	-11.4	-46.6
Ordinary	0.3	2.1	3.4	3.7	4.2	13.7
Capital Gains	-7.8	-11.1	-12.1	-13.6	-15.6	-60.3
Corporate	-4.5	-5.3	-5.3	-5.7	-5.8	-26.6
Ordinary	0.7	2.0	2.4	2.7	3.4	11.1
Capital Gains	-5.1	-7.2	-7.7	-8.4	-9.2	-37.7
Excise	0.0	0.2	0.3	0.4	0.4	1.4
Social Insurance	-0.1	1.5	2.7	2.8	2.9	9.9
Ex-Ante (Static) Revenue Loss	-25.1	-36.3	-39.8	-43.8	-48.8	-193.8
Personal**	-14.8	-22.1	-24.8	-27.6	-30.9	-120.2
Corporate**	-10.3	-14.2	-15.0	-16.2	-17.8	-73.5
Exclusion**	-24.8	-34.8	-37.0	-39.4	-42.4	-178.4
Indexing**	-0.3	-1.5	-2.8	-4.4	-6.4	-15.4
Taxpayer Effect (Increased Realizations, LBGE)	10.2	15.7	16.6	17.6	19.1	79.2
Economic Feedback Effect (Increased Tax Receipts from Macroeconomic Feedback - LBGE)	2.9	8.1	12.1	13.8	15.9	52.8
Ex-Post (Dynamic) Revenue Loss						
With Increased Realizations (LBGE)	-12.1	-12.5	-11.1	-12.4	-13.8	-61.9
With "Unlocking" Estimates						
Personal						
JCT (1)	-9.1	6.4	3.3	2.5	-0.4	2.7
OTA (1)	-9.3	6.8	7.3	4.6	2.8	12.2
Pers. and Corp. (Corp. Est. LBGE)						
JCT (1)	-7.2	9.2	4.8	4.2	-2.1	8.9
OTA (1)	-7.4	9.6	8.8	6.3	1.1	18.4

* Macroeconometric model simulation with the Sinai-Boston Model of the U.S. Economy. Policy changes effective January 1, 1995.
** LBGE Estimate.
(1) JCT - Joint Committee on Taxation, 1990 estimate of Bush Administration capital gains proposal, no indexing.
OTA - Office of Tax Analysis, 1990 estimate of Bush Administration capital gains proposal, no indexing.

Table 6
Macroeconomic Effects of a Capital Gains Tax Cut*
50% Exclusion for Long-term Capital Gains and Indexing for Inflation - All Taxpayers
Dynamic Revenue Losses Financed by Lower Federal Government Outlays**
(Changes from Baseline, Fiscal Years)

	1995	1996	1997	1998	1999	Avg. Per Yr.
Real GDP - Level						
(Bils. 87 $'s)	-4.8	12.5	23.6	27.5	36.8	19.1
(Pct. Chg.)	-0.1	0.2	0.4	0.5	0.6	0.3
Real GDP-Growth (Pctg. Pts.)	-0.1	0.3	0.2	0.1	0.1	0.1
Business Capital Spending						
Total (Bils. 87 $'s)	0.8	9.8	17.7	22.6	27.8	15.7
(Pct. Chg.)	0.1	1.3	2.3	2.8	3.2	1.9
Plt. (Bils. 87 $'s)	0.7	4.8	7.5	8.5	9.5	6.2
(Pct. Chg.)	0.4	2.9	4.4	4.8	5.1	3.5
Equip. (Bils. 87 $'s)	0.1	5.0	10.2	14.1	18.3	9.5
(Pct. Chg.)	0.0	0.9	1.7	2.2	2.7	1.5
Capital Formation - Stocks						
Plt. (Bils. 87 $'s)	0.2	3.3	9.6	17.2	25.2	11.1
(Pct. Chg.)	0.0	0.1	0.4	0.6	0.9	0.4
Equip. (Bils. 87 $'s)	-0.1	2.7	10.3	20.8	33.6	13.5
(Pct. Chg.)	-0.0	0.1	0.4	0.7	1.0	0.4
Consumption						
(Bils. 87 $'s)	-0.8	7.9	19.0	25.0	30.6	16.3
(Pct. Chg.)	-0.0	0.2	0.5	0.6	0.8	0.4
Real Net Exports						
(Bils. 87 $'s)	1.1	-1.8	-12.0	-18.6	-19.8	-10.2
Inflation - GDP Deflator						
(Pctg. Pts.)	-0.0	-0.1	0.0	0.0	-0.1	-0.0
Employment and Unemployment						
Payroll (Mils.)	-0.139	0.037	0.304	0.302	0.294	0.160
Unemp. Rate (%)	0.0	-0.0	-0.1	-0.1	-0.2	-0.1
Productivity Growth (Pctg. Pts.)	0.1	0.2	-0.0	0.2	0.2	0.1
Potential GDP						
(Bils. 87 $'s)	0.1	1.2	3.6	6.7	9.8	4.3
(Pct. Chg.)	0.0	0.0	0.1	0.1	0.2	0.1
Interest Rates (%)						
90-day T-Bill	-0.03	0.03	0.10	0.11	0.13	0.07
30-year Treas.	-0.14	-0.18	-0.15	-0.15	-0.17	-0.16
AAA-Equiv. Corp. New Issue	-0.16	-0.22	-0.20	-0.19	-0.20	-0.20
Aftertax Return on Equity	0.95	1.31	1.35	1.40	1.46	1.30
Cost of Capital (%)						
Pretax Equity	-0.74	-1.03	-1.09	-1.16	-1.22	-1.05
(Pct. Chg.)	-5.2	-7.2	-7.6	-8.0	-8.3	-7.3
Aftertax Wtd. Avg. Cost - Debt & Equity	-0.28	-0.38	-0.41	-0.44	-0.48	-0.4
(Pct. Chg.)	-2.8	-3.8	-4.1	-4.3	-4.5	-3.9
S&P500						
(Pct. Chg.)	0.2	1.1	1.7	2.0	2.4	1.5
Exch. Rate						
(Pct. Chg.)	-0.2	-0.3	0.2	0.1	-0.3	-0.1
Household Net Worth						
(Bils. $'s)	9.5	58.7	132.2	208.2	284.2	138.5
(Pct. Chg.)	0.0	0.2	0.5	0.7	1.0	0.5
Fed. Bdgt. Def. (NIPA)						
(Bils. $'s)	-3.5	-1.4	1.6	1.8	2.7	0.2
Personal Savings						
(Bils. $'s)	0.2	4.0	4.3	-2.4	-5.4	0.1
Business Savings						
(Bils. $'s)	4.6	9.3	10.7	11.8	13.8	10.0
National Savings						
(Bils. $'s)	1.1	12.7	17.8	12.3	12.5	11.3
National Savings Plus Earnings from Higher Realizations (Bils. $'s)	–	–	–	–	–	–

* Macroeconometric model simulation with the Sinai-Boston Model of the U.S. Economy. Policy changes effective January 1, 1995.
** Reduction of outlays is split between two-thirds purchases and one-third transfers. No reduction in non-defense infrastructure spending.

Table 7
National Savings*
50% Exclusion for Long-term Capital Gains and Indexing for Inflation - All Taxpayers
Dynamic Revenue Losses Financed by Lower Federal Government Outlays**
(Changes from Baseline, Fiscal Years)

	1995	1996	1997	1998	1999	Avg. Per Yr.
National Saving	1.1	12.7	17.8	12.3	12.5	11.3
Personal Saving	0.2	4.0	4.3	-2.4	-5.4	0.1
Business Saving	4.6	9.3	10.7	11.8	13.8	10.0
Government Surplus or Deficit (-) (NIPA)	-3.6	-0.6	2.8	2.9	4.1	1.1
Federal	-3.5	-1.4	1.6	1.8	2.7	0.2
State and Local	-0.1	0.8	1.2	1.1	1.4	0.9

* Macroeconometric model simulation with the Sinai-Boston Model of the U.S. Economy. Policy changes effective January 1, 1995.
** Reduction of outlays is split between two-thirds purchases and one-third transfers. No reduction in non-defense infrastructure spending.

Table 8
Federal Tax Receipts*
50% Exclusion for Long-term Capital Gains and Indexing for Inflation - All Taxpayers
Dynamic Revenue Losses Financed by Lower Federal Government Outlays**
(Changes from Baseline, Fiscal Years)

	1995	1996	1997	1998	1999	Cum. 1995-99
Total Receipts	-15.3	-16.9	-14.0	-15.2	-15.9	-77.2
Personal	-8.8	-10.7	-9.8	-11.0	-12.3	-52.6
Ordinary	-0.8	0.5	2.4	2.8	3.4	8.3
Capital Gains	-8.0	-11.2	-12.3	-13.8	-15.7	-60.9
Corporate	-5.6	-6.0	-5.5	-5.7	-5.3	-28.1
Ordinary	-0.4	1.2	2.2	2.7	3.9	9.7
Capital Gains	-5.2	-7.3	-7.8	-8.4	-9.3	-37.9
Excise	-0.0	-0.0	0.2	0.3	0.3	0.6
Social Insurance	-0.9	-0.1	1.3	1.3	1.4	2.9
Fed. Govt. Outlays	-12.1	-12.5	-11.1	-12.4	-13.8	-61.9
Purchases - Ex-Post	-8.1	-8.3	-7.4	-8.3	-9.2	-41.3
Transfers - Ex-Post	-4.0	-4.2	-3.7	-4.1	-4.6	-20.6
Ex-Ante (Static) Revenue Loss	-25.1	-36.3	-39.8	-43.8	-48.8	-193.8
Personal***	-14.8	-22.1	-24.8	-27.6	-30.9	-120.2
Corporate***	-10.3	-14.2	-15.0	-16.2	-17.8	-73.5
Exclusion***	-24.8	-34.8	-37.0	-39.4	-42.4	-178.4
Indexing***	-0.3	-1.5	-2.8	-4.4	-6.4	-15.4
Taxpayer Effect (Increased Realizations, LBGE)	10.2	15.7	16.6	17.6	19.1	79.2
Economic Feedback Effect (Increased Tax Receipts from Macroeconomic Feedback - LBGE)	-0.4	3.7	9.2	11.0	13.8	37.3
Ex-Post (Dynamic) Revenue Loss						
With Increased Realizations (LBGE)	-15.3	-16.9	-14.0	-15.2	-15.9	-77.2
With "Unlocking" Estimates						
Personal						
JCT (1)	-12.3	2.0	0.4	-0.3	-2.5	-12.6
OTA (1)	-12.5	2.4	4.4	1.8	0.7	-3.1
Pers. and Corp. (Corp. Est., LBGE)						
JCT (1)	-10.4	4.8	1.9	1.4	-4.2	-6.4
OTA (1)	-10.6	5.2	5.9	3.5	-1.0	3.1

* Macroeconometric model simulation with the Sinai-Boston Model of the U.S. Economy. Policy changes effective January 1, 1995.
** Reduction of outlays is split between two-thirds purchases and one-third transfers. No reduction in non-defense infrastructure spending.
*** LBGE Estimate.
(1) JCT - Joint Committee on Taxation, 1990 estimate of Bush Administration capital gains proposal, no indexing.
OTA - Office of Tax Analysis, 1990 estimate of Bush Administration capital gains proposal, no indexing.

Chairman ARCHER. Thank you, Dr. Sinai.

Our last witness on this panel is Sheldon Cohen, former Commissioner of the Internal Revenue Service.

Welcome to the committee.

STATEMENT OF SHELDON S. COHEN, PARTNER, MORGAN, LEWIS & BOCKIUS, WASHINGTON, D.C., AND FORMER COMMISSIONER OF THE INTERNAL REVENUE SERVICE

Mr. COHEN. Thank you, Mr. Chairman. I am Sheldon Cohen, a partner in the Washington law firm of Morgan, Lewis & Bockius and speak for myself not for my law firm or for any of its clients. I am pleased at the opportunity to talk with you today.

I want to talk a bit about a tax system on which these changes will be imposed and how these changes might improve or deteriorate the administration of the tax laws. I think that is an important element here because we have a very fine tax system with a very low cost of administration. Indeed, our tax system as a whole collects about 29 and a fraction percent of our GDP as against 35 or more percent for any developed country. Our cost is much less than Germany, Japan, et cetera.

One of the things that we have to be careful of is that we keep it as a perceived fair system; that is, the taxpayers around the country must understand that they are being treated fairly. I believe you need a progressive system to do that or slightly progressive, and that is what we have today. It can be better, but beauty is in the eyes of the beholder there.

We have to be careful how we use those resources, that we don't skew economic planning by use of the tax system. Many of us would not vote for centralized economic planning in this country, and yet many of the same people would suggest tax deductions, tax credits, et cetera, which have the net effect of economic planning.

I prefer that the system work whereby lawyers, accountants, and businesspeople make decisions on the merits of the economy, the economic return from that investment, and that taxes be a cost at the end of the line that doesn't enter into the first decision that you make. One reason that I would avoid some of the credits and so forth that have been suggested is because they do come first.

The first decision will be made, can I get a tax benefit. We have had a great deal of that over the past number of years. The Tax Court has been full of cases, jammed with cases that revolve around tax benefits and very little economic benefit, and I think we have to avoid that.

The problem with refundable credits is that they will produce an action. You are putting a job on an agency that is an audit agency and you are putting a job that basically is a social work job. If you gave HHS $x billion and told them to give benefits to every child in the United States, you would put an obligation on HHS to audit more than eight-tenths of 1 percent of those people.

The IRS presently audits eight-tenths of 1 percent of all the people and it is on a sliding scale; the higher the income, the higher the percentage, so if you get into $30,000, $40,000, $50,000 brackets, you are talking one-tenth of 1 percent or less. I question whether you would put such a program in any agency with that little degree of supervision.

When we get over to the home office deduction, for example, I can understand a lot of people's unhappiness with the tight rule, but that tight rule was written in 1986 in exchange for rate reduction. If we break the package, we break the package. The difficulty is that back before 1986, everybody had in their apartment or house a room with a desk and that was their home office. I would hesitate to go back to that because once you loosen those rules, they basically become unenforceable.

The so-called neutral cost recovery system allows a very fast recovery of more than one's basis. We are back again to making decisions based on the tax benefits. If most of us remember the excessive rental property that was produced as a result of the depreciation benefits of 10 or 15 years ago, we produced a real estate debacle in effect by throwing benefits at real estate that were beyond what was needed.

I am not an economist, I am only a tax lawyer, but I see the way my clients make decisions, see the way other clients make decisions, and if they see a benefit, they go for it and they tend to push other considerations to the side. They go for the immediate benefit, so I worry about the "administrability" and decisionmaking that would result, particularly when you throw that together with capital gains at the disposition end.

When we get to capital gains, capital gains is a religion. Mr. Bloomfield believes in it and I don't. We have debated this a number of years and we like each other and don't get mad at each other. We have a capital gains tax break—in effect, we have one now, a 28 percent rate against a nominal rate of 39.6 percent, and there ought to be some benefit there. Whether that is enough, Mark and I would again debate that, and you might debate that. But throw it together with indexing and you have an interesting goulash.

Those people who go for indexing are the same people who say that we have too many regulations in the United States. You are going to get a thick book of how to apply indexing. It is not a simple concept, not easy to do. Recordkeeping will not be easy.

One can try to design a lot of rough and ready rules. They will either be too beneficial or too detrimental, I don't know which, but even if you write restrictive rules, the big six accounting firms, large law firms will be able to do it; the small businessman, the people that you ought to give the benefits to will not be able to do it. They will do it wrong and cause problems for themselves and the IRS. So I would ask you to go slow and think about the administratability of those provisions as well as the benefits that they might give.

My own view is that the best thing that you could do for capital formation is to reduce the deficit. A dollar's worth of deficit reduced is a dollar's worth of savings. The United States ran a very large capital surplus during the Korean war because it ran the Korean war basically on a balanced budget.

I am proud to say that I am the last Commissioner of the IRS to preside over a balanced budget. My last year in office was the last year the United States had a balanced budget.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF SHELDON S. COHEN
BEFORE THE
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES
January 24, 1995

Mr. Chairman and distinguished members of the Committee:

My name is Sheldon S. Cohen. I am a partner in the law firm of Morgan, Lewis & Bockius in the D.C. office. It is my pleasure to appear before you today to present my personal views on some of the tax proposals contained in the "Contract with America." My comments will reflect my opinions regarding our Federal tax system and the principles that I believe are vital to the support and maintenance of the system. My views have evolved over many years of working in the area of taxation on both sides of the table: within the IRS as one of the drafters of the 1954 Code under President Eisenhower, and as Chief Counsel and Commissioner of Internal Revenue in the Johnson administration as well as in private practice as an attorney frequently representing clients. I speak here for myself, not for my firm or any of its clients. You might be interested to note that I was Commissioner of the IRS the last time the United States had a balanced budget, (fiscal 1969).

In light of all the recent criticism about our tax system, it is interesting to note that we have the finest tax system with the lowest cost of collection of any of the developed countries of the world. (Indeed, our overall tax collection, state, local and federal, is lower than any of the other developed countries.) In order for our self-assessment tax system to function well, it must be perceived by the taxpayers as a fair system. In my experience, fairness requires that an individual's tax burden be based on his or her ability to pay. This, in turn, requires a reasonably progressive rate structure. The rate structure does not make a tax system complex. It is deductions and credits, which require careful definition, that make the system complicated. Moreover, perceived fairness of the system cannot be maintained if taxpayers believe that, somehow, there are loopholes available to well advised taxpayers which enable them to escape their fair share of the tax burden. An overly complex system contributes to the perception of unfairness. Confidence in the system is a fragile balance. We should do nothing to lessen compliance with our tax laws as they are the sinews which hold government together. I have been all over the world working with developing countries to improve their systems; they all envy ours.

Experience has taught me that the tax system should not direct the utilization of our nation's resources. Commercial and financial transactions should be driven by economic and business considerations, not by tax considerations. It is interesting that many of those who do not believe in centralized government economic planning will suggest a tax deduction or credit which has the effect of imposing a centralized economic plan. As a practicing tax lawyer, I, and many of my brethren, have spent too much time and energy addressing client concerns, not about the legal or economic aspects of the investment, but about the size of the tax "write-offs." Memories are still fresh of the collapse of the rental real estate market, caused, in part, by overdevelopment facilitated by depreciation deductions that made the availability of tenants almost an afterthought. Let us not return to the days of the "tax shelter society."

We all know that the integrity and efficiency of the IRS is the cornerstone of an effective tax system. I think it is counter-productive to use the IRS as the administrative institution to implement and administer a broad range of social policies. These burdens are ill suited to the skills needed by

tax administrators and cause a diversion of resources away from the Service's important traditional functions. I have said before this Committee in the past, when it was controlled by the other party, that you can accomplish almost any program by use of the tax system. Thus, if you push this too far you could abolish many departments of the government and use the IRS to hand out agricultural subsidies, child care benefits, veterans benefits, business incentives and on and on. All this would, of course, bring down the system. With each added item, the IRS becomes less effective and the Code a jumble of conflicting provisions. We must be careful not to go too far afield with the tax system.

I approach the "Contract with America" with these principles and opinions in mind.

A number of the social programs that are contained in the Contract with America are funded through a technique referred to as the refundable tax credit. These programs are: (i) the $500 per child refundable tax credit; (ii) the $5,000 refundable tax credit for adoption expenses; and (iii) the $500 refundable tax credit for elderly care.

Some of these social programs may be worthy in purpose and address the concerns of many Americans. Perhaps there is room for discussion regarding the effectiveness of these programs and the precise targeting of the benefits. I might target them at one group in society while some of you seem to direct these benefits at everyone -- at a greater cost. My concerns, however, deal with the problems of administering and auditing these benefit programs within our present system of tax administration and enforcement.

No doubt the refundable tax credit technique has appealing features; after all, the IRS already administers other deductions, credits and refundable tax credits, and almost everyone files a tax return. I assume the authors believe that it is relatively simple to reduce tax liability by the amount of the credit, or to request a refund to the extent the amount of refundable credit exceeds tax liability. I submit, however, that notwithstanding the asserted ease of administration, the refundable tax credit technique forces the IRS into the business of administering social programs for which it does not have the skill or experience. This will result in high cost administration coupled with a low level of accountability from the beneficiaries of the programs. It will also denigrate the existing tax administration since new resources are not provided.[1/]

The $500 credit is given to everyone except for the upper one percent of taxpayers. I suspect that many people earning over $100,000 would enjoy the credit but do not in my judgment have need of it. How much lower than $100,000 the limit should be is a judgment call.

The Congress would, I believe, insist that a social work agency have strict accountability before paying out benefits under a program such as one providing a $5,000 payment to defray adoption expenses. Yet, upon the receipt of a tax return claiming a tax credit for adoption expenses, it is likely that the IRS would accept a reduced tax payment or authorize cash disbursement to the taxpayer. It does not have the staff to check on this or if it attempts to use existing staff it will be at the expense of revenue agents who are in sorely short supply

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1/ I would remind the Committee of the furor caused by the proposal of candidate George McGovern in 1972 that there be a grant of $1,000 to every man, woman and child in America to alleviate poverty. I opposed that idea on administrability, as well on other grounds.

now. I'm sure that even the $500 child credit will create more incentive for cheating. After all, by listing one more child, I get a check for $500 and the IRS has the burden of checking on me.

The IRS is not the kind of agency to oversee or enforce a social program utilizing refundable tax credits. At present, the IRS examines a very limited number of returns (substantially less than 1%). Moreover, most of the returns filed by persons qualifying for the benefits provided under these tax credit programs are not ordinarily selected for audit. The number of audits tends to be higher for the complex high income returns and lesser for simpler low income returns. It is unlikely that Forms 1099 or other similar verification will be available to prevent the payment of tax benefits in cases involving taxpayer mistakes or fraud. Indeed, we see a high incidence of mistakes and fraud on the earned income tax credit now. I believe these new proposed programs would engender similar cheating. If the verification burden falls on the IRS personnel, then resources that would normally be assigned to audits of complex high income returns, will be diverted to monitoring social welfare programs -- an inefficient use of resources by any standard.

It is likely that the IRS will have problems monitoring taxpayer compliance under other provisions of the Contract with America. For example, under an American Dream Saving Account ("ADSA"), penalty free withdrawals would be allowed after five years for the purchase of a first home, higher education expenses, or medical expenses. Again, the compliance issue centers on difficulties of verification. For example, if the ADSA account requires the financial institution to issue a Form 1099 (or similar information return) upon a purported penalty-free withdrawal event, verification of the bona-fides of the withdrawal would require an audit of the return. The limits on the number of returns that can be selected for audit would either prevent any meaningful verification of ADSA withdrawals or would divert the IRS from auditing other, higher priority returns. In any event, there is no evidence from our prior experience with IRAs that this program would markedly increase savings in this country.

Any expansion of the home office deduction is likely to expand the possibility of taxpayer abuse in this area of the tax law that traditionally has been the subject of abuse. That was the reason the Congress toughened these rules in 1986. Many of us can remember when it seemed that every home in America had a room with the mandatory desk and bookcase that, presumably, was set aside for some business activity or another and for which tax deductions were taken. (As I recall, the Congress in 1986, with the Reagan Administrations concurrence, traded the lowering of tax rates for the elimination of deductions).

Speaking of the bad old days, I would like to address the neutral cost recovery system and the capital gains preferences as provisions that have the potential for tax shelter activity and for directing investment on the basis of tax benefits rather than pre-tax economic return.

The neutral cost recovery system provides special tax incentives for investment in short-lived tangible assets based on an indexing system that exceeds the inflation rate. As a result, the amount of depreciation over the life of some assets will exceed the cost of the assets. These special tax incentives likely will cause taxpayers to modify their behavior by making investment decisions based on tax considerations rather than on economic considerations (particularly when coupled with the capital gains proposal). As I have stated, a well-ordered tax system should not cause this result. We have only recently seen the backlog of the shelter cases in the Tax Court and Appeals

Division of IRS fall off. These suggested new shelters will again cause disruption.

The long-standing debates continue over the fairness, cost and economic efficacy of preferential treatment for capital gains. Some in the debate center their ideas on the use of preferential rates; others on the use of an indexing system. The provisions in the "Contract with America" contain both types of preferences. There may be some merit on either side of the debate. This area has become one of religious belief. There is no certainty on either side of the argument. If I had to choose, my personal choice is for no special capital gain preference but I can see the idea of a simple and modest capital gain preference -- somewhat as we have in present law (where the maximum capital gains rate on individuals is 28% as against a nominal high rate of 39.6%).

Simplicity is not the hallmark of an indexing system. Incredible complexity is almost certain to accompany any system that can be applied to the variety of special situations we can all envision. Such complexity is likely to present a costly burden to the IRS and a bewildering array of rules to the average taxpayer.[2/] One of the concerns of the Contract is the excessive rules and regulations with which it contends we all live. The contract provisions on indexation would markedly increase the volume of regulations needed to implement such a complex provision. Moreover, I would be deeply troubled by tax policy concerns over the results of indexing assets without indexing the debt incurred to acquire those assets. If I buy a machine with 100% debt, why do we index the machine, but not the debt. I pay off the debt with depreciated dollars. I prefer no indexing but if we go for the complexity, we need it to work fairly.

While some aspects of the capital gains preference issue are debatable, there should be absolutely no question that large differences between the tax treatment of ordinary income and capital gains spawn tax planning activity designed to convert ordinary income into capital gains and to shift the benefits of capital gains to high-bracket taxpayers. The results of this planning may be lucrative for the players and their tax advisors but is costly to the economy and destructive to the tax system. Moreover, a revival of the gamesmanship surrounding capital gains conversions will force me to brush up on the collapsible corporation rules, a painful exercise I would prefer to avoid.

My comments, today, are offered in the hope that the work of this Committee will strengthen the integrity of the Federal tax system. The American taxpayers deserve and expect a tax system that is fair, administrable and economically neutral. I hope that goal can be achieved through your work. I would be glad to assist you and your staff to achieve such a goal.

2/ I have often discerned that taxpayers only complain about complexity when the rules are ones they do not like; they do not seem to mind complex provisions which are beneficial.

Chairman ARCHER. Thank you, Mr. Cohen.

If we make judgments as to which provisions are to be put in the Tax Code strictly based on difficulty of administration, would you suggest to this committee that we abolish the foreign source income tax provisions in the current Tax Code?

Mr. COHEN. I think those rules are terribly complex and I would try to make them more simple. The difficulty is that anything that is so complex that it takes a special category of people like me who administer them, you have perceived unfairness.

Now, you have a variety of provisions in the law that are terribly complex and were put there to ameliorate some problem or other. It would be better if we could do it some other way. I am not saying that you shouldn't do anything that makes the law more complex but that you must think carefully when you make the law complex because the compliance rate in the United States is in the 80th percentile now.

When I was in office 25 years ago, it was the 90th percentile. When you think about 1 percentage slip in compliance, you are talking about more revenue than you are talking about in most of these measures.

Chairman ARCHER. Well, I would simply submit to you that we looked very carefully at foreign source income on several occasions and, at the end of those deliberations, we made it more complex. That did not seem to deter this committee from doing that. I would also submit that the complexity of the foreign source income provisions would make indexing look very, very simple.

Dr. Sinai, let me inquire of you, because you are reputed amongst many sources in this country as having one of the best models for looking at capital gains and its impact on the economy. I am curious as to whether you have done any rough tabulation on the capital gains provision that is in the Contract With America and, if so, could you tell us what impact you believe it would have on revenues?

Mr. SINAI. The tax reductions are unique, as you know, because of the unlocking effect and the effect potentially on the stock market, also on the economy, I would submit, and what that means for the induced tax revenues to the government. I don't know of any other tax that is quite like this. So what we gained when we simulated this is that our economic activity is greater, economic growth is stronger.

We do generate and increase business savings and personal saving. I am now talking about a situation where we wouldn't finance this with cuts in government spending, and we increase productivity and potential output. That brings some extra revenues in and a somewhat better stock market increases realizations and then, at the lower tax rate, more taxes come into the government. Net-net, the particular proposal that is in the Contract With America, after these feedback effects, without making an assessment of the full unlocking effect, cost $62 billion over 5 years. That is about $12 billion a year. We haven't done our own independent estimates of unlocking.

I don't think the proposal has been evaluated yet in terms of what the unlocking effects would be, but there is a vast majority of opinion, academic and otherwise, that says there really is

unlocking. So that $62 billion cost has to be, I think, reduced once you add the effect of unlocking. Whether it would fully pay for itself or not, I don't know. It depends on the unlocking numbers used.

But I could cautiously say that a capital gains tax reduction has the best shot of any tax of perhaps paying for itself, all things considered. When we have looked at the model simulations, what it does to saving, investment, and the economy, and though it is not a big potatoes thing in a $6.8 trillion economy, it is a big enough thing that it really does move the economy in the direction that you talked about in your opening comments, Chairman Archer.

So I have to be of all—if I have to pick one of what is being talked about here, this would be the one that at this time in our economy I would favor.

Chairman ARCHER. I am a little reluctant to ask you the next question, but I am going to do it anyhow.

Mr. SINAI. I appreciate your comments about the model.

Chairman ARCHER. I would like you, if you are willing to do so, to characterize yourself to this committee as to whether you believe yourself to be a liberal, moderate, or conservative economist.

Mr. SINAI. Yes. That is an interesting question, Mr. Chairman. I think it is in the eyes of the beholder. I suspect that in my research and my opinions, sometimes I strike people as being liberal, sometimes conservative and maybe most of the time they can't understand what I am talking about. So I don't really put myself in either of those.

And with all due respect to Democrats and Republicans, both of whom I provide advice and information to, I am happy to do so as a citizen of the country, I am independent politically and that independent doesn't mean I am a Perot supporter. The research drives me so I would refuse to be labeled any of those. If someone, because I have said what I just said about capital gains, thinks I am conservative, that is for them to say. I wouldn't say it.

Chairman ARCHER. You think of yourself as being mainstream?

Mr. SINAI. I think of myself as being evidential. In forecasting, there is no doubt I can change my mind at any time.

Chairman ARCHER. Let me ask you and Mr. Bloomfield a question that has troubled me over the years. We talk a great deal about incentives for new savings and I believe that that is very, very important. I think all three of you probably agree that that is important, but very rarely do we hear anyone speak of existing savings.

Are not existing savings important, particularly if they are given flexibility to seek their highest and best use in the marketplace? In fact, are they not on a par with new savings inasmuch as new savings merely become mixed in an existing savings pool as soon as they are saved and become a part of existing savings?

Mr. SINAI. Well, Mr. Chairman, I think what you say is true in a qualitative sense and in a practical sense. It is not always so fungible. It is not easy for the forms in which savings are held to be moved from one use to another. But, generally, markets will do in terms of incentives what you think.

On the margin, what will move markets more, of course, are the marginal funds flows. That is often why there is stress on that.

Mr. BLOOMFIELD. Mr. Chairman, I would add that one of the critical factors, particularly with capital gains, is the lock-in effect and to the extent to which you have a capital gains tax cut, you will have a lot of unlocking. And I think that would be helpful for small business and others that are looking for capital. That capital may never be unlocked without a capital gains tax cut.

I would also like to comment about the revenue implications of capital gains that Dr. Sinai talked about. Dr. Sinai looked at the macroeconomic impact of capital gains. In his testimony, you will see that he estimates that a capital gains cut creates about 1 million jobs over 5 years and it has a significant impact on investment which is critical to long-term economic growth.

Harvard Professor Dale Jorgenson, who will be here I think 2 days from now, just published a book indicating that the most important factor for long-term capital growth is capital stock. I think that what you have in capital gains is a tremendous impact on investment, which is important for long-term economic growth.

In other words, Dr. Sinai talked about the macroeconomic impact of capital gains. There are two other aspects that affect the revenue impact. One is the historical data. If you look at the historical data and you look at the period when we did have a capital gains experiment which was the period 1978 to 1985, what happened in that period?

In 1978, capital gains receipts were $9 billion, in 1985 they were $27 billion. That cannot be explained only by economic growth and the stock market. What would apply is higher capital gains revenue at lower rates.

The second example that I would like to use in terms of historical data is the period subsequent to the 1986 tax bill. What happened with the 1986 tax bill, of course, was a tremendous unlocking in 1985. In 1985, capital gains receipts were $49.7 billion, and they have not recovered to that level. They dropped in 1986 under the new regime to $32 million, and now capital gains receipts are only $29 billion. I think that says something about capital gains receipts and tax rates because, in the period 1987 to 1992, there was an increase in the economy and inflation.

Let me finally comment about the whole question of unlocking and revenue estimates. This may sound contrarian, but there is not that much of a difference of opinion among economists, I am talking about the Joint Committee on Taxation and the Treasury, about unlocking. Let me give you an example.

When the Bush proposal for a 30-percent exclusion was before the committee, the static revenue loss of the Bush proposal was $100 billion. The Joint Committee on Taxation estimated that unlocking alone over 5 years would recoup 90 percent of that static revenue loss. The Treasury Department assumed that unlocking would recoup 110 percent of the revenue loss. So if you look at the amount in the aggregate, unlocking almost does it.

As you go through revenue estimates, we have a Treasury revenue estimate of the capital gains provisions of the Contract, we have Dr. Sinai's revenue estimates which show that with macroeconomic feedback, that after 5 years you do have a revenue impact which is positive in addition to the jobs created. But the Joint Committee numbers we haven't seen yet.

I would suggest that, since unlocking is not a macroeconomic argument but a very technical argument about how much unlocking you are going to get, as you look at the revenue estimates, you probably will have a range from A to D where D might be a revenue loss in the range of $50 billion and A would be a revenue loss in the range of about $2.5 billion. This committee might line up those revenue estimates and understand that these are very, very technical and they are also very, very credible numbers. These are not far out things.

In that sense, the unlocking is something which is a mainstream argument, something we should look at carefully. I think even before you get in the macroeconomic analysis of the revenue impact, you are going to be pretty close to avoiding a big revenue loss.

Chairman ARCHER. Thank you very much.

Mr. Stark.

Mr. STARK. Thank you, Mr. Chairman. I would just note that in Dr. Sinai's testimony, I think he emphatically points out that none of these tax proposals would be beneficial in a fully employed economy if budget deficits were to rise significantly.

It is interesting to note that in his testimony, he has a total tax reduction 5-year cost of $193 billion. And the Senate Budget Committee came out with a 5-year tax cost of $188 billion. Not bad.

The Senate's proposal to pay for this would cut nondefense discretionary spending by $252 billion, and most of that I suspect would be to cut entitlements with the exception of Social Security by $580 billion, arguably cuts to the lowest income people in the country.

So I ask my friend, Sheldon Cohen, in your experience and reviewing what we have done and the number of taxpayers and whether they are rich or very low or middle income, how would you assess the distribution of these cuts? Would most of them go to the upper 2 percent of Americans, 1 percent, 5 percent, half of the American taxpayers?

Mr. COHEN. I was rather surprised that, for example, the $500-per-child credit went all the way up to $250,000. You are talking there about a fraction of 1 percent of the population. If you got down to $100,000, you would be talking about the upper 2 percent of the population so that those benefits flow across the board.

When you are talking about the depreciation, capital gains combination where the big money is, those cuts go predominantly to the upper 5 to 10 percent of the population. Most of the capital gains activity in the United States is in the upper 5 percent of the population.

Mr. STARK. Where do you find the largest amount of the entitlements excluding Social Security? You take most of that out of Medicare, but those would go to the seniors, 40 percent of those are poor.

Mr. COHEN. Older people would be lucky if they had $40,000 income, so you are talking about the average income in the United States is in the low thirties, so you're certainly talking well below the average.

Mr. STARK. So it would be a fair estimate to say that what this plan would do is give $188 billion of incentives or rewards or bonuses to those at least in the richest 10 percent and at the same

time taking three times as much away from the lowest 40 percent of people in income, those people below arguably $30,000 a year; is that a fair assumption?

Mr. COHEN. Yes, sir.

Mr. STARK. How would your model deal with that, Dr. Sinai?

Mr. SINAI. I think capital gains tax reductions benefit higher income families compared with lower income families. The cuts you describe would do the same; it would be an increase in the inequity of income distribution that has happened over the last 10 or 12 years.

If one weights very highly that particular dimension of capital gains tax reduction, you have to be against it. I understand and respect that view. That is one of the criteria by which we judge tax changes.

On the other criteria——

Mr. STARK. We could do it other ways. If capital gains is very important, we could pay for it by distributing the cuts more to those upper-income people as well, could we not?

Mr. SINAI. Yes. The other dimensions of capital gains tax reduction, growth, the ability to compete internationally on cost of capital grounds, we have the highest capital gains taxes of any of the countries on the list. Many of them have no capital gains taxes. The jobs effect, these are the dimensions that are also very important and each individual weights them differently.

My judgment is, capital gains tax reduction wins on four out of five criteria, even admitting for the effect you talk about. So I think it is a good thing to do. The tax cuts you describe sound large to finance, $188 billion over 5 years. We did in the model do simulations where we cut spending and some transfers by $190 billion, the amount of the static revenue losses, and I could provide those results to you.

Mr. STARK. In your testimony, you show $193 billion in cuts.

Mr. SINAI. That is the static revenue loss.

Mr. STARK. The Senate showed $188 billion.

Mr. SINAI. We are very close. We have done model simulations of both cutting spending and transfers by $190 billion to see what it does and what was reported in the testimony would cut spending and transfers by $62 billion, which was the ex-post revenue loss. I would be happy to provide the former to the committee as well.

[The following was subsequently received:]

Table 9
Macroeconomic Effects of a Capital Gains Tax Cut*
50% Exclusion for Long-term Capital Gains and Indexing for Inflation - All Taxpayers
Dynamic Revenue Losses Financed by Lower Federal Government Outlays**
(Changes from Baseline, Fiscal Years)

	1995	1996	1997	1998	1999	Avg. Per Yr.
Real GDP - Level						
(Bils. 87 $'s)	-14.3	-1.9	7.3	7.9	16.3	3.1
(Pct. Chg.)	-0.3	-0.0	0.1	0.1	0.3	0.0
Real GDP-Growth (Pctg. Pts.)	-0.3	0.2	0.2	0.0	0.1	0.1
Business Capital Spending						
Total (Bils. 87 $'s)	-0.5	7.3	14.7	19.4	24.6	13.1
(Pct. Chg.)	-0.1	1.0	1.9	2.4	2.8	1.6
Plt. (Bils. 87 $'s)	0.4	4.2	6.9	8.1	9.3	5.8
(Pct. Chg.)	0.2	2.5	4.1	4.5	5.0	3.3
Equip. (Bils. 87 $'s)	-0.9	3.1	7.8	11.3	15.3	7.3
(Pct. Chg.)	-0.2	0.5	1.3	1.8	2.3	1.1
Capital Formation - Stocks						
Plt. (Bils. 87 $'s)	0.1	2.6	8.5	15.6	23.4	10.0
(Pct. Chg.)	0.0	0.1	0.3	0.6	0.9	0.4
Equip. (Bils. 87 $'s)	-0.6	0.7	6.5	15.1	25.9	9.5
(Pct. Chg.)	-0.0	0.0	0.2	0.5	0.8	0.3
Consumption						
(Bils. 87 $'s)	-3.9	-0.6	5.5	7.2	10.9	3.8
(Pct. Chg.)	-0.1	-0.0	0.1	0.2	0.3	0.1
Real Net Exports						
(Bils. 87 $'s)	3.0	6.8	1.6	-3.0	-2.9	1.1
Inflation - GDP Deflator						
(Pctg. Pts.)	-0.1	-0.2	-0.1	-0.0	-0.1	-0.1
Employment and Unemployment						
Payroll (Mils.)	-0.238	-0.222	0.013	-0.031	-0.071	-0.110
Unemp. Rate (%)	0.1	0.1	-0.0	-0.0	-0.0	0.0
Productivity Growth (Pctg. Pts.)	0.1	0.3	-0.0	0.1	0.2	0.2
Potential GDP						
(Bils. 87 $'s)	0.1	1.1	3.5	6.8	10.0	4.3
(Pct. Chg.)	0.0	0.0	0.1	0.1	0.2	0.1
Interest Rates (%)						
90-day T-Bill	-0.07	-0.05	0.01	0.01	0.01	-0.02
30-year Treas.	-0.18	-0.26	-0.27	-0.29	-0.32	-0.26
AAA-Equiv. Corp. New Issue	-0.20	-0.31	-0.32	-0.34	-0.37	-0.31
Aftertax Return on Equity	0.95	1.31	1.35	1.40	1.46	1.29
Cost of Capital (%)						
Pretax Equity	-0.75	-1.03	-1.09	-1.17	-1.24	-1.05
(Pct. Chg.)	-5.2	-7.2	-7.6	-8.0	-8.4	-7.3
Aftertax Wtcd. Avg. Cost - Debt & Equity	-0.29	-0.39	-0.43	-0.48	-0.53	-0.4
(Pct. Chg.)	-2.9	-4.0	-4.3	-4.6	-5.0	-4.2
S&P500						
(Pct. Chg.)	0.2	1.3	2.0	2.6	3.5	1.9
Exch. Rate						
(Pct. Chg.)	-0.5	-1.1	-0.5	-0.4	-0.8	-0.6
Household Net Worth						
(Bils. $'s)	5.0	29.8	66.1	102.3	143.4	69.3
(Pct. Chg.)	0.0	0.1	0.3	0.4	0.5	0.2
Fed. Bdgt. Def. (NIPA)						
(Bils. $'s)	2.4	12.1	22.6	27.8	33.1	19.6
Personal Savings						
(Bils. $'s)	-2.7	-2.0	-0.8	-6.3	-6.9	-3.8
Business Savings						
(Bils. $'s)	223.9	249.5	275.5	304.7	338.7	278.5
National Savings						
(Bils. $'s)	223.0	260.1	298.6	327.7	367.3	295.3
National Savings Plus Earnings from Higher Realizations (Bils. $'s)	–	–	–	–	–	–

* Macroeconometric model simulation with the Sinai-Boston Model of the U.S. Economy. Policy changes effective January 1, 1995.
** Reduction of outlays is split between two-thirds purchases and one-third transfers. No reduction in non-defense infrastructure spending.

Table 10
National Savings*
50% Exclusion for Long-term Capital Gains and Indexing for Inflation - All Taxpayers
Dynamic Revenue Losses Financed by Lower Federal Government Outlays**
(Changes from Baseline, Fiscal Years)

	1995	1996	1997	1998	1999	Avg. Per Yr.
National Saving	223.0	260.1	298.6	327.7	367.3	295.3
Personal Saving	-2.7	-2.0	-0.8	-6.3	-6.9	-3.8
Business Saving	223.9	249.5	275.5	304.7	338.7	278.5
Government Surplus or Deficit (-) (NIPA)	1.9	12.6	23.9	29.3	35.5	20.7
Federal	2.4	12.1	22.6	27.8	33.1	19.6
State and Local	-0.5	0.6	1.3	1.6	2.4	1.1

* Macroeconometric model simulation with the Sinai-Boston Model of the U.S. Economy. Policy changes effective January 1, 1995.
** Reduction of outlays is split between two-thirds purchases and one-third transfers. No reduction in non-defense infrastructure spending.

Table 11
Federal Tax Receipts*
50% Exclusion for Long-term Capital Gains and Indexing for Inflation - All Taxpayers
Dynamic Revenue Losses Financed by Lower Federal Government Outlays**
(Changes from Baseline, Fiscal Years)

	1995	1996	1997	1998	1999	Cum. 1995-99
Total Receipts	-18.1	-23.0	-21.8	-24.8	-26.7	-114.3
Personal	-9.8	-13.2	-13.0	-15.1	-17.2	-68.3
Ordinary	-1.7	-1.7	-0.5	-1.0	-1.1	-6.2
Capital Gains	-8.1	-11.4	-12.5	-14.1	-16.0	-62.1
Corporate	-6.6	-7.5	-7.1	-7.2	-6.2	-34.5
Ordinary	-1.4	-0.1	0.7	1.3	3.2	3.7
Capital Gains	-5.2	-7.3	-7.8	-8.5	-9.4	-38.3
Excise	-0.0	-0.0	0.2	0.3	0.3	0.6
Social Insurance	-0.9	-0.1	1.3	1.3	1.4	2.9
Fed. Govt. Outlays	-25.1	-36.3	-39.8	-43.8	-48.8	-193.8
Purchases - Ex-Post	-16.9	-24.2	-26.6	-29.2	-32.5	-129.4
Transfers - Ex-Post	-8.2	-12.1	-13.2	-14.6	-16.3	-64.4
Ex-Ante (Static) Revenue Loss	-25.1	-36.3	-39.8	-43.8	-48.8	-193.8
Personal***	-14.8	-22.1	-24.8	-27.6	-30.9	-120.2
Corporate***	-10.3	-14.2	-15.0	-16.2	-17.8	-73.5
Exclusion***	-24.8	-34.8	-37.0	-39.4	-42.4	-178.4
Indexing***	-0.3	-1.5	-2.8	-4.4	-6.4	-15.4
Taxpayer Effect (Increased Realizations, LBGE)	10.2	15.7	16.6	17.6	19.1	79.2
Economic Feedback Effect (Increased Tax Receipts from Macroeconomic Feedback - LBGE)	-28.3	-38.7	-38.4	-42.4	-45.8	-193.5
Ex-Post (Dynamic) Revenue Loss						
With Increased Realizations (LBGE)	-18.1	-23.0	-21.8	-24.8	-26.7	-114.3
With "Unlocking" Estimates						
Personal						
JCT (1)	-15.1	-4.1	-7.4	-9.9	-13.3	-49.7
OTA (1)	-15.3	-3.7	-3.4	-7.8	-10.1	-40.2
Pers. and Corp. (Corp. Est., LBGE)						
JCT (1)	-13.2	-1.3	-5.9	-8.2	-15.0	-43.5
OTA (1)	-13.4	-0.9	-1.9	-6.1	-11.8	-34.0

* Macroeconometric model simulation with the Sinai-Boston Model of the U.S. Economy. Policy changes effective January 1, 1995.
** Reduction of outlays is split between two-thirds purchases and one-third transfers. No reduction in non-defense infrastructure spending.
*** LBGE Estimate.
(1) JCT - Joint Committee on Taxation, 1990 estimate of Bush Administration capital gains proposal, no indexing.
OTA - Office of Tax Analysis, 1990 estimate of Bush Administration capital gains proposal, no indexing.

Mr. SINAI. You will get a much bigger gain in national savings, but by $190 billion of cuts out of the government side you are going to lose a lot of macrostimulus because it has negative effects. One issue is how much do you have to cut outlays to finance whatever estimate of the revenue losses you use.

Mr. STARK. Did you not find in your testimony that the dream savings accounts do little to increase overall savings but lead to switching existing savings into tax-deferred accounts?

Mr. SINAI. That is an opinion based on others' research. We have not quantitatively analyzed that. Years ago, I did an analysis of the IRAs in place at that time and came to the conclusion there was more switching in savings allocations than stimulus to saving. This one, because of the tax-free drawing on it for various advances could provide a bigger incentive to saving. It is different from the past IRAs. I don't think it will raise the savings rate very much, if at all, but that is an opinion. I haven't done the real research on that yet.

Chairman ARCHER. The gentleman's time has expired.

Mr. Crane.

Mr. CRANE. Thank you, gentlemen, for your testimony. Back when my son was a teenager, I remember one summer he had a job and I counseled him not to blow his paycheck at the end of the week on instant gratification but put something away for the proverbial day. He said, "That's nuts, daddy." I said, "What do you mean, George?" He said, "Daddy, if I blow it at the end of the week, they only get at it once."

I thought about that. I invest my saved dollar and invest in a public corporation. When they make a profit, it gets taxed a second time; dividend distribution, it gets hit a third time. I sell my stock and enjoy a capital gain and it gets hit a fourth time. And the ultimate obscenity in our code, in my estimation, is when you have the audacity to die and leave, then they come in and bash your bereaved spouse and loved ones.

I personally believe that we have one of the most reprehensible Tax Codes on the face of this Earth. It does violence to the values that I was brought up to believe in. I don't believe we should tax interest, dividends, or capital gains at all.

The fact of the matter is, if you have denied yourself instant gratification, why can't you put that dollar to work for the rest of that dollar's life and let it grow and develop interest? Hopefully that would put you in a position at some point to pass it on to a loved one when you shuffle off this mortal coil.

In that context, we have debated this question of reducing the capital gains tax. I remember in 1978, when Billy Steiger took the rate down to 28 percent and we got a lot of static revenue assessment about a revenue loss when it actually increased revenues. We heard that again in 1981.

When we took the rate back up in 1986, we had an executive session of the Ways and Means Committee over in H–137 and there was a fellow from Treasury sitting beside me who had scored this as a $25 billion revenue raiser over the next 5 years.

I said, "How can you come to that conclusion based on our experience?" He said, "You have to understand that this bill doesn't go into effect until January 1, 1987, but the fiscal year starts

October 1, 1986. We anticipate raising $20 billion of that between October 1 and December 31," which they did.

If you look at the figures, you had $326 billion in capital gains realizations in 1986 because of that anticipated hike. That then dropped the next year down to $144 billion. The actual Treasury revenues were $49.7 billion in 1986, and that dropped to $32 billion the next year. Looking at these figures causes me to ask a question. If your objective is to maximize revenue and maximize the creation of venture capital at the same time, I have heard reports that the ideal rate, assuming you feel determined to tax capital gains, should be between 9 and 12 percent. Have you got any material or do your studies indicate anything to confirm that?

Mr. BLOOMFIELD. Mr. Crane, the 9 to 11 percent rate is based on some work done at the National Bureau of Economic Research that Dr. Feldstein heads, and that is the result of work there. It is also the result of work done by Larry Lindsey, who now serves on the Federal Reserve Board. In prior years, he looked at the various economic models, and he looked at data, and that is sort of the rough range that he came up with, which was 9 to 11 percent. Now, obviously, with your proposal, you are at 19.8 percent, but you have indexing, so you are beginning to get down to that level.

What I am concerned about, that at some point if you do not have a significant capital gains tax cut, which you have, it is not worth doing, so I think you need to get to that range.

Mr. CRANE. You know something else, in that connection, I have a graph that goes back to the late eighties which indicates by quintiles the beneficiaries of the capital gains tax cuts. The graph shows that 75 percent of those beneficiaries of a capital gains cut are in the $50,000 and under bracket, and 90 percent of the beneficiaries have incomes under $100,000. The Treasury Department gave us these figures and I'm wondering if the panel would comment.

Mr. COHEN. Those are the beneficiaries, Mr. Crane, not the dollars.

Mr. CRANE. The beneficiaries, yes.

Mr. COHEN. But if you looked at the dollars, it skews the other way.

Mr. BLOOMFIELD. Well, Mr. Cohen, there is a point that Mr. Crane is making that is very legitimate and that is when the IRS looks, when the Joint Committee looks at income distribution, it assumes that the same taxpayer has a capital gain every year, which is distortionary. You take a person who earns $50,000 and his spouse earns $50,000 and they sell their business, they are a $200,000 taxpayer.

What CBO and others have done, they have always assumed that it was the same taxpayer. In fact, it is not. If you look at IRS statistics, you find out that 44 percent of all taxpayers realize a capital gain only once in 4 years.

If you look at the numbers you are talking about, Mr. Crane is correct. Half of all dollars of capital gains go to taxpayers with salary income of less than $50,000. If you look at filers, 75 percent of all returns that have capital gains have salary incomes of $50,000 or less. I am not disagreeing with the fact that I think Mr. Stark would make that a lot of upper-income people have capital

gains, but there is a heck of a lot of middle-class people who have capital gains, too.

Mr. CRANE. Could I make just one final comment, regarding the percentage of taxes paid by income groups, the top 10 percent in 1992 paid 57.5 percent of the total taxes, the top 50 percent paid 94.9 percent. The fact of the matter is these are the people who are paying the taxes, and I think they are entitled to some relief for doing the right thing.

Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Thomas.

Mr. THOMAS. Thank you very much.

One of the more frustrating things for me, especially last year in dealing with health care and in cosponsoring a super IRA bill along with then-Senator Bentsen and Roth and Jake Pickle as I continue to do, is the frustration in dealing with both the budget environment in which the world has to be looked at in 5-year increments and nothing exists beyond that, and as our colleague from California did, the penchant of examining tax policies through tax distribution charts in terms of who gets the benefit on a straight analysis of who benefits immediately.

Going back to my friend from Illinois' family analogy, if we sat around the table and talked about a distribution of family income on a distribution chart basis, my kids would want to claim far more than I let them claim, because I happen to think that the way in which I want to use the money has a superior calling than the way in which they want to use the money. Mr. Cohen, you are right. Paraphrasing the "Field of Dreams" in terms of tax breaks, if you give it, they will take it. I understand that, but my question is in terms of this whole business of deferred gratification. On an individual basis it is good for the soul, but I believe collectively it is good for society in ways that I would hope we could break out of the tax distribution models or the 5-year model.

You can deal with a Tax Code which people see as a higher good of building see-through office buildings, both literally or figuratively, or you can have a Tax Code which encourages people to put their own money away to take care of themselves at some future time. Frankly, they are both tax breaks if you look at them that way, but I happen to see a qualitative and a quantitative difference, and unfortunately it almost always has to get outside of the 5-year window or the distribution charts.

How do we break out of, or should we break out of, this conceptual framework of the 5-year budget window or the decision has to be made on a realtime basis in a distribution of tax benefits where people at the lower end of the income have to get the same deal as people at the upper end?

I will just throw it open to anybody who wants to respond.

Mr. SINAI. I don't know how you can design something that at the same time will give everybody equal benefit from some public policy change on taxation or spending. Where I come down is these days because we are close to full employment, is looking very positively at measures and actions in Washington that raise productivity growth and increase the rate of growth of potential output.

Now, that supply side growth of potential output, which has been very anemic for so many years and is now creeping up, estimated

now at 2½ percent a year, it used to be 3 percent a year, if we could pump that up and grow 3 percent a year, then the central bank would not next week be thinking about raising interest rates, which punishes everybody, upper and lower income families, so that, to me, gets out of this looking at it on the 5-year horizon and looking at it trying to make it work for everybody at the same time.

I do want to point out that the higher income families do save more, and if the goal is savings and investment, more will flow that way. I do want to point out also that a lot of other countries we compete with internationally have no capital gains taxes, that includes Germany, and Japan has a much lower one than we have, and there are other countries that index for inflation.

Your question on indexing, I do not see why that should be so difficult. If the United Kingdom and Australia can do it, I don't understand why we can't do it, either, so, you know, if we were back in 1981 and talking about a depressed economy and depressed growth, I might have a different view, but here we are talking about an economy close to full employment, so I am looking for saving, investment, productivity growth and an increase in potential outputs. If you finance by cutting the inefficient part of the Federal Government, starting on the operations side, you really get a very effective package.

Mr. BLOOMFIELD. Mr. Thomas, first of all, I want to congratulate you for your leadership again on promoting IRAs in this Congress. I might point out that yesterday Jonathan Skinner at the University of Virginia and Glen Hubbard at Columbia released a survey of the literature of the economic impact of IRAs, which I hope you will see soon.

But one of the interesting things they pointed out, which partly responds to your question, is that raising IRA contribution limits would increase long run national capital stock, $4 for every $1 lost in government tax revenue. Their work focuses on distributional tables, the first part of your question, and then also the revenue impact, and this gets into the debate that you have had, and I know the Joint Committee just prepared a pamphlet for the Finance Committee hearing today on do you do dynamic or do you do static revenue estimates. It seems to me that there is some fiscal discipline to starting at least in this round and focusing on traditional static analysis.

Having said that, however, I think we can put capital gains in a special category because of what Dr. Sinai referred to as the unlocking factor. We have on our board of directors of our public policy think tank people like John Shoven and Michael Boskin at Stanford; and Jim Poterba at MIT. We surveyed these mainstream NBER economists, and they are of the opinion that it might be very helpful to have alternative scenarios of the macroeconomic impact of tax policy done carefully because it is controversial. And it seems to me that that would be one way at getting at what Chairman Archer has referred to as accurate revenue estimates because we are concerned about the macroeconomic impact. The ultimate question on distribution is a job lost which could have been created because we tax savings and investment more than our competitors do.

Chairman ARCHER. If the gentleman would suspend, we have about 5 minutes to make this vote, and with apologies to our wit-

nesses, we will recess, vote, and come back right away and continue.

Mr. THOMAS. Mr. Chairman, I might just make a statement that as we sit here and berate the business leaders of America for thinking on a quarterly by-quarterly basis in terms of their investment and then turn around and do exactly the same thing on the Federal Government in terms of the societal needs, I just find it ironic that we don't realize that a 5-year increment is the same as a quarterly basis for business if we are making societal decisions. I will be back.

[Brief Recess.]

Chairman ARCHER. Will our guests please take their seats. Mr. Matsui.

Mr. MATSUI. Thank you, Mr. Chairman.

I would like to ask Mr. Sinai a question. In your testimony, you talked about the locking effect of the capital gains treatment, and the impression I had from you, that I think Mr. Bloomfield corrected, was that the Treasury Department's $60 billion revenue loss over 5 years did not take into consideration the fact that there would be more activity.

Did I misunderstand you?

Mr. SINAI. That is correct. I believe that is true. It does not take into account the effect of the lower capital gains tax on economic activity and saving and all the things I talked about, the macroeconomic effects.

When the economy gets stronger, you get induced revenues coming into the Federal Government on excise taxes, Social Security taxes, and ordinary income.

Mr. MATSUI. We are talking about two different things here. I think what Mr. Bloomfield said, and I don't mean to use him as a way of explaining your situation, but he correctly stated that back in 1990, I guess it was, when President Bush had a capital gains proposal, there was a difference between Treasury and Joint Tax, but both of them took into consideration the fact that it would be more economic activity, it was just a question of how much.

Mr. SINAI. I don't think they did. They just estimated what is called the unlocking effects, and they had two—small numbers, billions of dollars difference, and I do not believe they took into effect the——

Mr. MATSUI. That is not my understanding.

Mr. Bloomfield, because you were right in the middle of that, my understanding is that even—I mean, Joint Tax, they use dynamic scoring in terms of the provision itself, the specific provision itself. They don't use dynamic scoring in terms of the macroeconomic effect but they do use dynamic scoring in terms of the behavioral changes for the tax cut itself. If you could just answer yes or no on that.

Mr. BLOOMFIELD. Yes.

Mr. MATSUI. Dr. Sinai.

Mr. SINAI. What you just said is what I call unlocking, the taxpayer response, the unlocking response.

Mr. MATSUI. It does have an impact, right?

Mr. SINAI. Yes, it does have an impact.

Mr. MATSUI. OK. Then the larger issue is does this have an impact on the overall economy.

Mr. SINAI. Yes.

Mr. MATSUI. Now, let's take the first one first, the behavioral changes for the tax cut itself. Now, Mr. Bloomfield, you mentioned that Treasury had one point of view in 1990 and Joint Tax had another, it was a very small amount, but if you recall the difference was over a 3-year period about $35 billion. In other words, $10 billion difference a year.

I believe the President's proposal at that time had a $22 billion revenue gainer out of it over that period of time, and the Joint Tax had an $11 or $15 billion revenue loser over that period of time.

Now, the real problem I see is that a small almost imperceptible change in assumptions could create a massive problem for us if, in fact, we guessed wrong or we made assumptions that were incorrect.

Now, going back to 1981, because that is, frankly, where my start on this committee occurred, the danger I see is that we can use assumptions that even though they might be only a very small amount off could lead to massive budget deficits, and if you recall, I think you were even sitting in this Chamber here when Dave Stockman and Don Regan and the rest of them said that by 1983 we will have a balanced Federal budget with capital gains, with the investment tax credit, with all of these tax preferences that we gave to the entire private sector, and of course they paid for it, because in 1982 we tightened it up and in 1986 we went all the way the other direction and took all of them away, including the investment tax credit.

I think that is one of the dangers the private sector better be concerned about. They may get it for the next 2 years, but then the next 3 or 4 we may have a total shift in the other direction, but perhaps you can tell me why the assumptions are better in 1995 than they were in 1981.

Mr. BLOOMFIELD. Well, first of all, the most important point is that the unlocking part is so very sensitive to assumptions. I mean, everybody agrees on that.

Under the Bush proposal, as I recall, there was a revenue estimate over 5 years, and it was minus 12 on one side and minus 12 on the other, so whether it would be 35 or 20, it really doesn't make a difference because you raise the valid point you don't want to increase the deficit.

The point I am making, though, since it is so hard for the revenue estimator to come up with something concrete on what the perfect or the most accurate elasticity is, the members of this committee should know that this has nothing to do with supply side economics, this is the estimator's best guess at elasticities. One little change can throw the numbers off, and all I am saying is that you should have before you a range of A to D, and at least know that his number is not any more accurate, assume it is D, than what A would be.

Mr. MATSUI. That is not necessarily true, but let me just end by saying this, I think what you are saying is we should probably be a little cautious at the same time and maybe have a little more spending cuts than we have tax cuts in order to make sure that

in case we are wrong we might have a little margin of error, and let me just make one final comment, and all three of you or none of you can comment on this if you like.

Chairman Alan Greenspan testified before the House and Senate Budget Committees recently, and he stated "no model currently can be used to predict macroeconomic developments without substantial ad hoc adjustments." In other words, he is saying basically you can't make macroeconomic predictions on the effect of the economy on tax changes or even changes in many programs like education programs, which some might suggest might be able to raise productivity, thereby increasing the macroeconomic effects of this country.

Do you disagree with Chairman Greenspan, any of you?

Mr. SINAI. Certainly, I disagree with my friend, Alan Greenspan, a professional forecasting colleague before he came to the Federal Reserve. He said that for years. But for years he used himself econometric models in his own forecasting, so I think there is a large body of evidence that says you can have reliable inferences drawn from these models.

Mr. MATSUI. Mr. Chairman, I hate to ask you this, but can I just have one last question?

Chairman ARCHER. How long will the question and the answer be?

Mr. MATSUI. It will be very, very short. I hope it will be very short on their side. It will be very short on mine.

Mr. SINAI. I concur with you that as a business matter you would want to be conservative; you should be aware of static revenue estimates; you should be aware of the dynamic estimates when you include unlocking; you should be aware of the macroeconomic effects; and it is better to make sure you finance it adequately on the spending side and take a conservative approach to it.

Chairman ARCHER. Very quickly, Mr. Matsui.

Mr. MATSUI. Very quickly, Mr. Chairman.

Here is what the problem is, assuming for a minute you are correct that additional investment, by doing capital gains you unlock activity, more investments go because of the capital gains, but what about—here is what the problem is when you use the macroeconomic approach, what about the fact that these investments go to real estate or whatever it is instead of other areas because you are going to be moving capital from one area to another area, to the one that is most generous by way of a tax break, and so, you know, even though it might create activity in one area it may reduce activity in another. This is why the macroeconomic approach, dynamic scoring is so dangerous, frankly.

Mr. SINAI. Yes, the situation we are in now there is still mainly economic incentives for what you mentioned, real estate and capital gains tax reduction would not materially increase the subsidy to that asset class in a similar situation to the past.

I am absolutely convinced and I know the—I think the difficulty with dynamic scoring is the validity of the estimate, who does it and how they are used for political purposes. But I am absolutely convinced it is wrong to think in static terms because that isn't what happens after the fact. What happens after the fact is what happens to the economy, and the revenue results and what goes on in actual behavior, and as far as whether these things actually

make a difference in a model or not in a model, you have to talk to businesspeople, financial people, and from the grassroots anecdotal experience find out what they think about this. Over the years, I have tended to be persuaded that something like capital gains actually does have an effect. I notice all our competitors are doing it, lower rates or exemptions, and maybe there is something to be learned from that in terms of capital formation and productivity of countries like Japan.

Chairman ARCHER. The gentleman's time has expired.

I truly regret on these very important issues that we limit ourselves to 5 minutes, but if we didn't, we would never get through all of the members up here.

Mr. Herger.

Mr. HERGER. Thank you very much, Mr. Chairman, and I want to commend you, Mr. Chairman, on your opening remarks. Certainly the goal of our Contract With America and with the majority party on this committee, and I believe a majority of this committee on both sides, is to increase America's savings and be able to maximize our job creation.

And my question to you, Mr. Bloomfield, to get back to something that I think is very important, something that you alluded to somewhat a little bit earlier in testimony, and I want to thank you for your pioneering and research in the debate in this area of capital gains, has to do with these one-time events which I believe is the vast majority of the capital gains sales that take place within my district; I believe in the districts of all of the Members of Congress. It is certainly within my district, that example of the family who has raised their family, the couple are retiring, are selling that home that is larger than what they need to move into a smaller home, and there is capital gains, a one-time event. Or maybe that middle-class farming family in my district that for whatever reason may be, which is their retirement, to sell this property or maybe it would be a small business, a one-time event, and I would like to have you, if you could, maybe relate a little bit more on this comment on how this bunching up phenomenon might make these statistics that would appear to be that those selling capital gains are the wealthy within our society when in reality we are seeing a lot of bunching up, but if you could comment a bit more on that, I would appreciate it.

Mr. BLOOMFIELD. Thank you, Mr. Herger.

One of the things that I would like to draw your attention to, Chairman Archer indicated that we prepared three special reports for this hearing. They are attached to the back of my testimony.

The reason I mention that, if you look at page 2 of the questions and answers on capital gains, the question is: Isn't it true that most of the direct benefits go to the rich? The source of the data is the IRS. The history of this debate, quite frankly, is that opponents of capital gains tax cuts were saying that most of the benefits of capital gains go to people with incomes of $200,000 and above. Those people included capital gains in income, and, therefore, the data assumed that the same person was doing it all the time.

This was a number that the Congressional Budget Office was using. We looked at the CBO analysis and said it distorts it be-

cause it assumes that it is the same people who have capital gains every year. To engage in the debate, we said let's exclude capital gains from income, and that is why looking at that number, that assumes that they never repeat, they never have capital gains in their income. We therefore used that data and said that half of all capital gains go to people with a wage income of $50,000 or less. Mr. Cohen is correct, that figure is dollars. What about filers? We said three-fourths of the people who filed tax returns with capital gains reported wage income of less than $50,000.

CBO came back, and they said, well, yeah, but we don't know how many people repeat, and at that point, as we say in our Q and As, a panel analysis for the years 1979–93 by the Joint Committee found that 44 percent of taxpayers reporting gains realized a gain in only 1 out of 5 years. Your farmer, of course, probably doesn't buy and sell his farm every 4 years. He probably does it once in a lifetime. So you can see how the numbers are skewed because that person realizes his savings, eats up his savings once in a lifetime, so this is what the debate is about.

I should add, however, that the debate really shouldn't be focused on middle-class Americans because there are some members of this committee, I know, who would suggest that capital gains only be limited to the middle class, and that has all sorts of distortionary effects because what you are concerned about is not the class source of the capital, you want the capital available to all, and therefore what you really ought to focus on is not the distribution but does capital gains create jobs. We believe lower capital gains creates jobs.

Mr. HERGER. Thank you very much, and again I think it makes sense if you have the family that is making $36,000 a year, has this one-time sale, I guess we could ask how many jobs that person who is middle income, middle class, who is just getting by can create. It really takes those who are the entrepreneurs—those who are doing a bit better are the ones who can afford to create the jobs. I think it just makes a lot of sense, and I think what——

Mr. COHEN. Mr. Herger, they don't pay tax now because the one-time sale of a residence you have got a one-time exclusion, so they wouldn't pay any tax today.

Mr. HERGER. Well, I believe there are those who perhaps—again, we are talking about a middle-class individual who perhaps has a small rental that they have that perhaps they are selling or a piece of property that maybe they have had in the family.

Again, these are not wealthy people. This is middle-class America, and people who have saved, who have accumulated a little something. They are the ones where we have historically with our Tax Codes penalized—and I am happy to see you nodding your head, Mr. Cohen in agreement—these are the ones we penalize. These are the ones that I would like to see and certainly in the Contract With America to stop penalizing those who are attempting to produce and begin rewarding those people and try to again create jobs to increase savings.

Thank you very much.

Mr. SHAW [presiding]. The time of the gentleman has expired.

I would like to ask Mr. Cohen a question. I am somewhat intrigued by the way this thing is going, and I think that sometimes

we focus too much on who is getting something rather than trying to focus on what this does for the entire economy.

It takes capital to develop business, create jobs, and all of us will agree that those jobs are better in the private sector; they are more permanent, and that is where we like to see the majority of the jobs in this country. That is what has made this country great.

In following this through, I understood you as saying that you did not believe that capital gains and favorable capital gains treatment would stimulate the economy. Did I misunderstand you?

Mr. COHEN. No, I didn't say that, sir. I just said that the differential in capital gains rate is a religious belief, Mr. Bloomfield and I have discussed this many times, that there will be—if you ask me the question, will there be an unlocking effect if you change the capital gains rate from 28 percent top rate to 20 percent or any other lower rate, yes, there will be more transactions.

I would answer as Mr. Sinai answered a little before this whether that will make sufficient difference to stimulate the economy of the United States, sufficient to pay for the potential costs otherwise, I doubt, but there will be an effect. People will respond to that. People do respond to tax incentives, there is no doubt about that.

Mr. SHAW. Mr. Bloomfield in his testimony said that the income or the revenue received in 1985 from capital gains was more than is being received right now. Is that correct?

Mr. BLOOMFIELD. Yes, Mr. Shaw, the revenue—well, the revenue in 1985 was $26.5 billion. Then it went up in 1986 to $49 billion. In 1987, it was $32.9, $38, $35, $27, $24 billion, and the latest numbers were in 1992, which is $28 billion. That certainly is a drop from what it would have been.

Mr. COHEN. It also had something to do with what the stock market was doing at the time.

Mr. BLOOMFIELD. In that period of time——

Mr. SHAW. I am sure there are other factors, but I think all of the data I have heard would certainly indicate that favorable capital gains treatment is not a revenue loser to the country. I want to explore that further because I think that by the government taking more capital away from the private sector leaves less capital for the private sector to invest.

Mr. COHEN. No, sir, I don't agree with that.

Mr. SHAW. And less money invested in the private sector, means less creation of jobs in the private sector.

Mr. COHEN. I don't necessarily agree with that. The best way that we can increase the stock of capital in the United States is to stop running a deficit. If the United States does not run a deficit, it will not sop up capital and, therefore, there will be more capital left in the economy for the free enterprise system to work on.

Now, that is my belief. Mr. Sinai may have some variance of that, but I think most economists would believe that to the extent that any of this increases the deficit, we are counterproductive.

Mr. BLOOMFIELD. I want to respond to that. Allen, do you want to go first?

Mr. SHAW. Would you two gentlemen respond to that, then I will recognize Mr. Levin.

Mr. SINAI. We are close to full employment now so increasing the deficit significantly would be a mistake. In the early eighties, we were a long way from full employment. Increasing the deficit, if it had only been temporary for 2 or 3 or 4 years, was not a mistake, and so if there is a tax change either because of what it does to the economy or the taxpayer that brings back revenues to the governments, one element in financing it, either that or cutting spending or outlays or the entitlement side on the government side is absolutely essential. I think the budget laws of 1990–93 really make it very difficult not to finance any of the tax cuts you are talking about. I don't detect any mood to overturn that, so it is a choice of which tax cut, can it, does it bring back some revenues, and then how much are the spending cuts or outlay cuts you need to do, to finance that and that is how the overall package looks to me at this time.

I wouldn't be saying the same thing at all times. Deficits are not always bad. If you have a very unemployed economy with a lot of slack, lots of people out of work, you can in that situation by increasing spending, lowering taxes, running bigger deficits, you can actually have a net positive effect.

Mr. BLOOMFIELD. Mr. Shaw, over the long term, though, what we are concerned about is our level of national savings, and obviously after you get through the cyclical aspects of the economy, I agree with Sheldon Cohen that perhaps the biggest thing you could do is reduce the Federal deficit. The difference that Sheldon Cohen and I may have is how you reduce it.

Remember, national saving has three components: Government saving or dissaving; personal saving; and business saving. To the extent to which you reduce the Federal deficit or government dissaving by substantially increasing the tax on personal saving or business saving, you have done the fiscal equivalent of running in place, so I would argue that some of the proposals that people have engaged in the past to reduce the Federal deficit have been counterproductive.

Having said that, that we need to continue to reduce government dissaving in a responsible manner, if you look at the drop in national saving for the last decade or so, we have had a drop in government dissaving because of the deficit. Personal saving has also plummeted, and as Mr. Houghton and I have talked about, business saving has plummeted, so we have got to do things on all three fronts and not just worry about the government deficit.

Mr. SHAW. Thank you, Mr. Bloomfield.

Mr. Levin will inquire.

Mr. LEVIN. Thank you very much.

Dr. Sinai, your estimates for 5 years from the tax provisions are very close to what came from Treasury, as Mr. Stark mentioned, 205 was Treasury and yours are, what, 193? Treasury, when it looks at the period through 2005, comes up with a loss of $725 billion. Do you have any reason to question those estimates?

Mr. SINAI. Yes, but I generally would question any estimates going out that far from anyone, and since we haven't looked at it out to that point, I don't think I could comment one way or the other on the Treasury estimates. Too much happens on budget pol-

icy and in the economy between now and then for that to necessarily be reliable.

Mr. LEVIN. Well, but these are just the tax estimates, for example the $500-per-child credit, the neutral cost recovery.

Mr. SINAI. Oh, is that the total package that you are talking about?

Mr. LEVIN. Yes.

Mr. SINAI. Oh, including the tax credit for the $500 per?

Mr. LEVIN. Right.

Mr. SINAI. Then that number doesn't sound out of line. That particular part of it is very expensive, the $500-per-child tax credit.

Mr. LEVIN. And that the neutral cost recovery shifts from a gain to a loss when you look at 10 years.

Mr. COHEN. Yes, it is back-end weighted, so it recovers money early and loses it late.

Mr. LEVIN. So there is a shift from—you have a $19½ billion 5-year gain, Treasury has $18.4 billion. That shifts to a $120 billion loss over 10 years.

Mr. SINAI. I think the figures I used were 5-year estimates from the House of Representatives.

Mr. LEVIN. So you would question that it is likely that the neutral cost recovery proposal would shift to a gain in 5 to a loss over 10?

Mr. SINAI. Without taking account of what it would do to the economy, I probably wouldn't question that. I think, here again, we have another tax policy which would, that particular one, accelerated depreciation, does have—in my studies in the past I have found that to have significant effects on capital spending, and that would have a significant effect on the economy. So, I think when you take account of what might happen in the economy over that period of time as a result of that tax cut, I would argue that the losses estimated are too high, net, over the whole period of time.

Mr. LEVIN. Have you looked at that specifically?

Mr. SINAI. No, we haven't looked at that yet. I have looked——

Mr. LEVIN. You say it would be less cost effective than reducing capital gains?

Mr. SINAI. Yes, I think that is correct. That is based on some unlocking effect out of capital gains, even if it was a conservative one, because no other tax cut has that particular characteristic. Capital gains is always going to be more effective in the "bang for a buck," depending on the economic side of the impact. On the revenue side, it is always going to be more effective because it is going to generate unlocking. Almost all of the studies show this. The issue is whether you get unlocking over all years going out 10 years or whether you just get it for 2 or 3 or 4 years.

Mr. LEVIN. Let me just mention to you, Mark, the staff calculated the data from 1991 in terms of the dollars that result from a capital gains reduction, and I don't understand your figures because the 1991 figures show that 65 percent of the dollars would go to people with incomes of $100,000 or more, so I would appreciate your supplying this soon for the record. I think we need to take a candid look at all these proposals.

I must say, Dr. Sinai, I read your testimony as the most tepid embrace of the proposals in the Contract. You say the tax reduc-

tions proposed have much to be commended, but then you say the neutral cost recovery would be less cost effective than reducing the capital gains. The IRA provision, the net effect on overall savings is questionable.

On capital gains you suggest over 5 years, this isn't reflective of lock-in, there would be a loss of $62 billion, and acknowledge that there is a problem of equity, the capital gains provision. I think that is an accurate summation of your testimony.

Mr. SINAI. You have picked certain parts of the testimony. Here is the problem, as I see it down here. If you add up the costs of all the cuts, it is fairly expensive. I think the practical problem is are you going to be able to find the spending side reductions to finance that, and so I am saying that you are probably going to have to pick and choose from what is in there. That was the tone of the testimony, in terms of picking and choosing.

Mr. LEVIN. The red light is on. I will finish.

You say that it is especially important to be careful in a time of fuller employment when there could be an even further dangerous crowding out of savings because of the deficit; isn't that accurate? So you say pick and choose, but be especially careful at this point in our economic recovery; isn't that true?

Mr. SINAI. Yes, that is right; that is correct.

Mr. LEVIN. Thank you.

Mr. BLOOMFIELD. Mr. Levin, may I respond to your comments?

Mr. LEVIN. If the Chairman will indulge. I didn't mean to suggest——

Mr. SHAW. Yes, you may continue.

Mr. BLOOMFIELD. The numbers that I referred to earlier were tax returns not including capital gains as part of income, and the reason I refer to that is because these are not the same people realizing capital gains every year.

I think I have got the same chart in my briefing book that you have, and if you look at capital gains, if you include capital gains in income, what is the distribution, and the answer obviously, it is more skewed toward upper income. But if I look at my 1991 numbers and I look at a total of capital gains of 111,443, I look at capital gains in dollar amounts, 22, 23; 778 out of that goes to people $50,000 or less. If you look at filers, the discussion I had with Mr. Cohen, you still have in 1991 about 60 percent.

Mr. LEVIN. I am not talking about filers.

Mr. BLOOMFIELD. You are talking about dollar amounts.

Mr. LEVIN. We are talking about dollar amounts because you can have millions who receive small amounts and thousands who receive large amounts, and there is no use of obscuring this issue, and I think this committee, without a lot of propaganda, needs to look at a number of issues, growth issues, but also distribution issues, so we will continue the dialog as we have in the past.

Thank you, Mr. Chairman.

[The following was subsequently received:]

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Revised
PRELIMINARY
18-Oct-91

DISTRIBUTIONAL EFFECT OF THE ADMINISTRATION'S CAPITAL GAINS PROPOSAL

[1991 Income Levels]

INCOME CATEGORY (1)	Number of Returns With Tax Change (Thousands)	Percent of Total Returns (2) (Percent)	Average Tax Change (3) (Dollars)	Aggregate Tax Change (Millions of Dollars)	Percent Distribution of Aggregate Tax Change (Percent)
Less than $10,000	118	0.5%	$-105	$-12	0.1%
10,000 - 20,000	325	1.4%	-100	-33	0.3%
20,000 - 30,000	738	4.0%	-155	-114	0.9%
30,000 - 40,000	961	7.0%	-208	-200	1.6%
40,000 - 50,000	1,034	10.2%	-256	-265	2.1%
50,000 - 75,000	1,965	14.3%	-385	-756	5.9%
75,000 - 100,000	981	20.9%	-854	-837	6.6%
100,000 - 200,000	1,184	38.0%	-1,670	-1,977	15.5%
200,000 and Over	684	57.5%	-12,526	-8,567	67.1%
TOTALS	7,991	7.1%	$-1,597	$-12,761	100.0%

Joint Committee on Taxation

NOTE: Details may not add to totals due to rounding.

(1) The income concept used to place tax returns into categories is adjusted gross income (AGI) plus: [1] tax-exempt interest; [2] employer contributions for health plans and life insurance; [3] inside buildup on life insurance; [4] workers' compensation; [5] nontaxable social security benefits; [6] deductible contributions to individual retirement arrangements; [7] the minimum tax preferences; and [8] net losses, in excess of minimum tax preferences, from passive business activities.

(2) Total returns include filing and nonfiling units. Filing units include all taxable and nontaxable returns. Nonfiling units include individuals with income that is exempt from Federal income taxation (e.g., transfer payments, interest from tax-exempt bonds, etc.). However, individuals who are dependents of other taxpayers are excluded.

(3) The tax reduction reported here assumes no change in taxpayer behavior. Thus, this measure understates the tax benefit received by certain taxpayers.

End of Text

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Table 1

Distribution of Net Long Term Capital Gains For Returns With Long Term Capital Gains in 1985

(In Percent)

Adjusted Gross Income Class Without Capital Gains	Distribution of Returns With Long Term Gains (1)	Distribution of Long Term Gains (2)	Percentage of Total Returns With Long Term Gains (3)
Less than $10,000	16.9%	19.7%	5.1%
$10,000 to $19,999	16.5	5.9	6.5
$20,000 to $29,999	15.9	6.1	9.8
$30,000 to $49,999	24.7	12.0	13.6
$50,000 to $99,999	19.7	17.5	24.6
$100,000 to $199,999	4.5	12.6	56.2
$200,000 or more	1.8	26.2	76.1
TOTAL	100.0%	100.0%	9.9%

Department of the Treasury
Office of Tax Analysis

March 14, 1989

Source: 1985 IRS Statistics of Income

Columns: (1) = Percent of returns with long term gains by income class (income net of capital gains)
(2) = Share of total dollar volume of gains by income class (income net of capital gains)
(3) = Percent of total number of returns filed in 1985 with long term capital gains

Mr. SHAW. OK. Mr. Hancock will inquire.

Mr. HANCOCK. Thank you very much.

Mr. Cohen, in the second paragraph of your statement you state that it is interesting to note that we have the finest tax system with the lowest cost of collection of any of the developed countries of the world.

I wonder how you arrive at that. For instance, you are a tax attorney. You obviously get paid for working in the tax area. Is your income calculated as part of that compliance cost?

Mr. COHEN. No, sir, I am talking about governmental cost, and I have gotten that from—I do some consulting work for the United Nations and for several international organizations, and I have studied other systems, looked at their cost of operation.

Mr. HANCOCK. But isn't it also true that the cost of operation, it doesn't consider the fact that the small businessman has to collect the money for Internal Revenue rather than Internal Revenue collecting it?

Mr. COHEN. That is true in Britain and France and Germany and Japan also, sir.

Mr. HANCOCK. Well, isn't it also true that Milton Friedman has said that the biggest mistake he ever made was developing the W–4 withholding, that that started concealing from the individual how much income taxes they paid. It was supposed to have been temporary to finance World War II. Boy, once we got it, we kept it, didn't we?

Mr. COHEN. I have read the Beardsley-Rumel report which is in the IRS somewhere. It was invented in 1942.

Mr. HANCOCK. As a small businessman, I can assure you that for several years my cost of complying with the tax law was much more than the amount of the income tax that I paid, and in fact I tried to make a deal with them, to where I will just send you *x* number of dollars if you won't make me do all this paperwork and that we both would come out a lot better, but they didn't think that would be the proper thing to do.

I would like to get back to Mr. Bloomfield and Mr. Sinai on the problem we have with capital gains. I am very much in favor of capital gains; I don't think there is any question. I get too many telephone calls from individuals that say, look, I am ready to retire, I own two or three pieces of property, I would like to sell, do you think we should wait and see if the Congress is going to pass a capital gains tax reduction. In fact, they have been talking about it ever since we got rid of it in 1986.

The Democrat Party has attached a stigma to capital gains, that only the rich benefit from capital gains, I know that is not true. Anybody that is out in the real world knows that is not true. Would it be feasible to come up with some form of a zero capital gains, say, up to the first $1,000 that would apply to everybody across the board, merely to get rid of this asinine statement that capital gains only benefits the rich? The perception I think is what we have got to get rid of if we are going to be able to get the general public to support it, and get the news media off this topic.

Mr. BLOOMFIELD. Well, Mr. Hancock, you could obviously exempt capital gains up to a certain level. You could say that people in the 15 percent bracket, instead of having their tax reduced to 7.5, you

could have an arbitrary number and say zero, so that could be done.

I want to say something about Democrats and capital gains because I think it is very important to recognize that this in the past has not been a partisan issue.

As you may recall, President Kennedy in January 1963 proposed a capital gains tax cut. He talked about it as an engine of economic growth. The history of capital gains tax debates in this Congress—you have people today in the Senate like John Breaux and Joe Lieberman who are for capital gains tax cuts. Tomorrow there will be a breakfast with Democratic Members of Congress who want to reduce capital gains tax cuts. It has not been a partisan issue. It should not be a partisan issue. A capital gains tax cut, as you know, passed a Democratic House of Representatives.

I think, also, if you look at the distribution argument or the fairness argument, the best thing I could bring to bear on this, anecdotally, is a fellow by the name of Joe Dolan, who many of you don't know. Joe Dolan perhaps should be brought to the committee because he could say as much about the fairness of this issue that Mr. Cohen and I talked about.

Who is Joe Dolan? Joe Dolan is a New Jersey painting contractor who was quoted in the Washington Post the day after the election, and he said that "you are looking at a poor man that thinks the capital gains tax cut is the best thing that could happen to this country because that is when the work will come back. People say capital gains is for the rich, but I have never been hired by a poor man."

Mr. SINAI. Congressman Hancock, if I might say, actually Canada has such a system, the first $250,000 is exempt.

The issue of fairness having a—we tax capital too much, as was mentioned by Congressman Crane, too many times as it is, which is part of why savings rates are low and there are enormous distortions in that, so an exemption of zero for lower income families would certainly make sense and could be structured that way. It is a very creative suggestion in terms of dealing with this issue.

To me the criteria are four or five. It is probably a little esoteric and technical, when you use the word "fair" people get very excited about that—I do, too—and the other criteria that I have mentioned have tended to slip by the consciousness of people, and it is just a very emotional rich versus poor issue, that kind of thing.

Mr. HANCOCK. Well in my life prior to the time I came in the U.S. Congress, I was involved in commission selling and getting people started in savings. Anything that we can do to get the young people to start some type of a savings program, it carries on if we get them started early enough. That is what we need to get done. And that is why I would like to consider a zero capital gains rate on the first $1,000 of interest income. I think we ought to look at it real seriously.

Thank you, Mr. Chairman.

Mr. SHAW. The time of the gentleman has expired. Mr. Camp will inquire.

Mr. CAMP. Thank you, Mr. Chairman. I appreciate all the witnesses testifying on our proposals to increase savings and investment.

Mr. Bloomfield, looking through your testimony, it is my understanding that most industrial countries have what we call IRAs or ADS accounts. Is that correct, Canada or Australia?

Mr. BLOOMFIELD. It is correct, yes, sir.

Mr. CAMP. France, United Kingdom. Many of those permit larger contributions than what we have in the United States, is that correct?

Mr. BLOOMFIELD. It is correct. For example, Canada's generous savings plan—in Canada what you can do is you can contribute $3,500 a year to a registered retirement savings plan, and if you do not have an employer pension plan, you can contribute up to $13,500.

Mr. CAMP. So countries, if I understand the tables in the back of your testimony, countries with these IRA-type savings, including Canada's, they have higher savings rates than the United States of America?

Mr. BLOOMFIELD. That is correct.

Mr. CAMP. You note that U.S. personal saving has declined, and you compare the late eighties to the time period between 1960 and 1980, and you also note that net private domestic investment has declined. What do you mean by net private domestic investment?

Mr. BLOOMFIELD. Net private domestic investment is a netting—it refers—for investment you need savings, and investment in the United States can either be financed by our saving or it can also be financed by saving from abroad, and because we did not have sufficient saving in this country we had to rely on savings from abroad in addition to that of the United States, and because there wasn't a total amount of additional savings around, our investment in machinery and equipment, which is what we are particularly concerned about in an economic sense has declined, and as you rightly said, it has declined from 7.4 percent in the sixties and the eighties to less than 3 percent now, and of course the investment level is the key to long-term economic growth.

Mr. CAMP. So savings and investment are directly related?

Mr. BLOOMFIELD. They are related. You cannot have investment unless you have savings, and our savings has been burdened because part of our savings has been used to finance the debt, and that has caused pressure on investment in the United States, and then obviously our ability to continue to bring in savings from abroad is a touchy issue because there is a growing demand for savings in Eastern Europe and around the world.

Mr. CAMP. Is it also fair to say in your testimony that that investment is what is essential to the kind of economic growth to raise real wages for workers across the spectrum, skilled and unskilled?

Mr. BLOOMFIELD. It is critical as Harvard Professor Dale Jorgenson might mention when he appears before the committee on Thursday. The most important determinant of long-term growth is our capital stock, which is a function of the level of investment.

Mr. CAMP. Thank you.

Now, Dr. Sinai, in a table attached to your testimony, you indicate that the IRAs or enhanced IRAs will bring additional revenue to the government in the first 5 years, about $4.7 billion, is that correct?

Mr. SINAI. Yes. Those are estimates done by the House of Representatives, and I have no reason to disagree with them.

Mr. CAMP. All right. But you make the assertion that the IRAs, as outlined in the Contract With America, would not have any net effect on overall saving or that it is a questionable effect on overall saving, yet I don't see any statistics or tables to support that assertion.

Do you have something that you could submit in writing?

Mr. SINAI. We have studied that in the past, and in a study that I did, I did come to the conclusion that there was not a significant effect on the personal savings rate from the IRAs in place at that time. The other research on the subject provides pros and cons.

My opinion is that the research on the subject does not conclusively tell us which way the current proposal would go. I have not done the research on this particular proposal. There are certain incentives to saving having to do with the tax-free drawing for certain kinds of activities, which might make it do better on savings than the past ones. So my answer is I haven't done the research on it to really be able to say.

Mr. CAMP. Would you agree with the tables and the statistics that indicate the countries that have, as I mentioned with Mr. Bloomfield, that have IRA-type accounts have higher savings rates?

Mr. SINAI. You know, they do, but Japan has no IRA or has no provision. They have one of the highest savings rates in the world, so I don't think you can necessarily draw that conclusion based on that two-factor association.

Mr. CAMP. Would you agree, though, that savings and investment are directly related?

Mr. SINAI. Yes, yes. You know, investment decisions can be taken without saving. You then borrow to finance the investment. We borrow internally here in the United States or we borrow externally. Incentives that make businesses invest sometimes are not—they are different than where the saving comes from and you go and you look for the financing. So they are only identical in the definitional sense, not identical all the time in the behavioral sense.

Mr. CAMP. Thank you, Mr. Chairman.

Chairman ARCHER [presiding]. Mr. Cardin.

Mr. CARDIN. Thank you, Mr. Chairman.

Let me thank our witnesses for their testimony today. I think all the members of this committee are concerned about the savings ratios of our country and what role the Tax Code plays in encouraging more savings. We are all looking for ways of modifying our Tax Code to encourage additional savings for this Nation to be more competitive.

In that light, reducing the capital gains rate makes sense and I think would have a very positive impact on additional savings. I also think indexing of capital assets could make some sense if we could figure out how to do it administratively and make it simple and not add additional complexity to the code.

But on the neutral cost recovery, I would like to focus your attention on that specific proposal because that does cause me to wonder whether we are talking about a proposal which appears to look

good from a textbook point of view, but in the real world is not going to accomplish the results that we all desire.

Let me try to explain. What we are asking investors to do is to invest in an asset under neutral cost recovery, to give up more lucrative depreciation schedules, to give up capital gains favorable treatment because we are going to give them a more economically realistic writeoff of their assets.

Now, Treasury indicates that during the second 5 years, from years 6 through 10, that one proposal will cost the U.S. Treasury $139 billion, that one proposal.

Treasury also has indicated that it will cause shelters where economic decisions will be made based upon the tax consequences rather than based upon what is appropriate economic activity as a result of the 3.5 percent assumption on the economic returns.

Now, if Treasury is right, it is likely that Congress won't let that type of schedule continue in years 6 through 10. There are going to be additional modifications to these provisions and I am wondering whether financial advisors are going to tell their clients to trust the Tax Code and use this neutral cost recovery system.

It may well be that the economic consequences that we are trying to achieve won't become reality because of the skepticism about Congress leaving in place a tax law over 10 years or 15 years or 20 years. We would all like to see more certainty in the tax laws, but if we use an academic exercise such as this neutral cost recovery rather than dealing with the problems of the real world, I am not sure we are doing a service to the people we are trying to help.

Many of us would rather we work on the alternative minimum tax problems than working on this neutral cost recovery, and I am curious as to the views of any who care to express a view on this whether we shouldn't be setting priorities. Capital gains I understand, but as for the neutral cost recovery proposal, isn't there a better way?

Mr. COHEN. You will certainly induce in the small business context a lot more expense. As long as the systems are an elective and you can go into the present system or into the new system, that means that the small businessman has to do the analysis many ways, has to engage lawyers or accountants or somebody who can do that for him and try to give him parameters from which he can make the judgment as to whether he wants the benefits short range, long range, however that would work. So that makes it a much more difficult decision.

The government has to gear up and do it both ways, has to train its people to do it both ways. That is a very expensive process.

Mr. BLOOMFIELD. I think that you should try to fix the AMT. Under NCRS, the fancy word for neutral capital cost recovery, AMT taxpayers are better off. In preparation for this hearing, we asked Arthur Andersen to look at NCRS, the theoretical exercise, and see how NCRS affects the tax treatment of investment in seven assets.

In table 4, we look at computer chips, telephone switching equipment, factory robots, continuous steel casting, let's look at your steel production outside of Baltimore. You will find that in a steel company in your district, perhaps, that NCRS substantially increases the present value for investing in continuous steel casting.

Under the 1981 act we had expensing. If you look at the investment in continuous steel casting after the 1986 act, we got to a present value of 81 percent. With the AMT, you only got a present value of 59 percent. Under NCRS, if you are a regular taxpayer, you are at 95 percent and you can see the relief up to 94 percent present value.

So in terms of running it through a computer through the present value analysis, NCRS helps regular taxpayers and AMT taxpayers.

Mr. CARDIN. Which I would suggest to you, if Treasury is right on these estimates, it is unlikely. What advice are you going to give your clients?

Mr. BLOOMFIELD. The question is, what do you do instead. I agree that you ought to use this opportunity to deal with the AMT. And there are various ways to do that. I would also suggest for non-AMT taxpayers that you might consider phasing in expensing. I would like somebody to explain to me Les Samuel's testimony before this committee and I think exactly how you are going to get a lot of tax sheltering. You are not talking about a lawyer or a doctor investing in a building. We do have passive——

Mr. COHEN. It won't be in a passive situation. It will be within a business. You will skew investment within a business or there will be a temptation to skew toward the most beneficial tax situation and it may affect people's judgment on economics. Hopefully it wouldn't, but people are strange, and they take signals. When you signal them that you want them to do something, businessmen seem to get a herd instinct and they all run to it.

Chairman ARCHER. Perhaps some other panel member might like to pursue Mr. Cardin's inquiry, but Mr. Cardin's time has expired.

Mr. Zimmer.

Mr. ZIMMER. Thank you, Mr. Chairman.

Mr. Cohen, you just stated that people take signals and you have been saying throughout your testimony that the Tax Code will have an impact on people's behavior, sometimes making them act in ways that are not economically rational.

Those of us who support cuts in capital gains taxes and IRAs and other elements of the Contract With America believe that the Tax Code properly drafted and properly reformed can influence people's behavior in a way that will substantially increase savings and investment, risk taking and job creation. This is a premise that is disagreed with by some of the people who testified before this committee this month.

I asked Congressman Gephardt whether he believed that the Tax Code could encourage savings and investment and he said he didn't think it could. Mr. Block of H&R Block said essentially the same thing.

Do you share our underlying belief that the Tax Code can in fact increase savings and investment?

Mr. COHEN. I think you can skew investment. You see, you can't get more investment unless there is more savings. That is why I keep emphasizing the deficit because I know that a reduction in the deficit will put more capital into the hands of private industry.

Mr. ZIMMER. I agree. But the other provisions of the Tax Code——

Mr. COHEN. I think you skew it, not create it, that is, you can affect where it goes. You don't create new capital. You have to have pain to have new capital. You have to save it. That is the way you get it.

Mr. ZIMMER. Do you have data to support that. You said it was a religious——

Mr. COHEN. It is part of my religion, yes, sir, and also 44 years of tax practice.

Mr. SINAI. I think you could. What I am about to say I am not going to suggest you necessarily do. But you can use the tax system to reduce consumption. You can use the tax system to increase investment and you can have a permanent change.

Suppose we went to a value-added tax with exemptions at lower income levels as our basic tax system. That would reduce consumption and raise savings. That exists in most countries around the world. Suppose at the same time you reduce capital gains taxes or reduce the corporate income tax. I believe that kind of restructuring would reduce consumption, raise saving and raise investment, and that would happen if the economy were fully employed.

When you are at much less than full employment, you can recover a percentage of it all because you have so much room for growth in the economy which will then generate additional saving and spending at the same time. So I think from the macroeconomic point of view, you absolutely can use the tax and spending ability of the Federal Government, the Congress and the Federal Government to alter macroeconomic behavior in very, very significant ways.

Mr. ZIMMER. Mr. Bloomfield.

Mr. BLOOMFIELD. I concur with the economist on the panel.

Mr. ZIMMER. Mr. Cohen, you have spoken approvingly of the 1986 Tax Act and you have said that our efforts would break the faith that was evidenced in that act in the sense that it would restore deductions that were eliminated in exchange for the reduction of the marginal rates.

Isn't it a fact, though, that the marginal rates have been raised significantly since 1986, roughly a 40-percent increase in the top marginal bracket; so isn't that already the mark of a doublecross, so to speak?

Mr. COHEN. I don't want to condone one ill and, therefore, I induce another one. The difficulty with the Tax Code is that one deduction begets another, one credit begets another, one change begets another and then we are all complaining about the complexity of the Internal Revenue Code.

When I came to this room for the first time in 1952 to draft some legislation, which is when I started drafting legislation for the Treasury, the Internal Revenue Code was not as thick as my thumb. Today it is about 5 inches wide. I don't like that. But I can't stop it. When I came to driving a car, it was a stick shift car without air-conditioning. That has changed. I can't go back.

I am saying that you must be careful, and careful is a relative term. Each of you has to apply it in your own judgment about adding things that add complexity in addition to providing benefits, because one begets another. Each one you add will be the marker for the next person that comes along and says, you can do that or you

can do this and you can but there is a cost attached to it. There is a cost of administration.

The administration of the Internal Revenue Service has fallen off. IRS used to audit 4.5 percent of returns. Today they audit eight-tenths of 1 percent of returns. We used to have 92 or 93 percent compliance. Today we have 82 or 83 percent compliance. Those things go together.

Mr. ZIMMER. Thank you.

Chairman ARCHER. If I may piggyback on that, we eliminated over 6 million people from the tax rolls in 1986. Those were the people that had the easiest compliance of everybody in the tax paying public. So these comparisons must be made in context as to the percentage of compliance.

But it is Mrs. Kennelly's turn.

Mrs. KENNELLY. Thank you, Mr. Chairman.

And having read Mr. Cohen's statements before and having listened to him, I know that he is very firmly a believer that the most important way we encourage savings is to reduce the deficit. I look at someone like Mr. Bloomfield, who has been marvelous in his years of being in business and capital formation and trying to increase savings and I say to you, I read your testimony and you praise the Contract issue after issue and I understand that, and I love them too, but my problem is paying for them.

I wonder, have you thought at all that maybe we can do some but not all of them. Have you looked at the tax of $500 per child for every family and know what a huge figure that is? Is there any way you could guide us to see how we could do some of these things, not all?

Knowing you all these years, I understand this is exactly where you want us to be, except I know you don't want to have the deficit we do. Is there some way we can approach this by not building up the deficit and at the same time the American public gets some good things that they like?

Mr. BLOOMFIELD. Thank you. What I said in the first paragraph, and I want to reiterate it, is that we applaud Chairman Archer and members of the committee for their commitment, which we share, that this Republican contract needs to be revenue neutral in the aggregate. If it is not, that would be very troublesome for the reasons that you have articulated and that Mr. Cohen has articulated.

If you look at where you cut back if you have to cut back, if you look at the 5-year numbers, and this is not a politically attractive response, 60 percent of the 5-year number, understanding that there are budget gains with the other, 60 percent is the $500 tax credit. If you look at polls, Frank Luntz recently did a poll and he said, which one of these proposals is most popular among the American people? The IRA was the one that was most popular.

I juxtapose those because my concern is savings and investment. Here you have a savings and investment proposal which Mr. Neal and Mr. Thomas and others are supporting which makes economic sense. So from an economic point of view, I have some concerns about overall tax cuts, not commenting directly on the fact that Americans do feel that they are overtaxed.

If you go in other areas, and I understand that there is a religious nature to the capital gains debate, but putting that aside, I

think one can make a very strong case that reasonable people can look at that and the revenue cost of capital gains because of unlocking is not that great. Let me just throw that out as a proposition that can be debated.

If you look at other provisions there, I still believe and agree with Larry Summers that IRAs will pay for themselves; in other words, if you look at IRAs, 25 cents of every dollar is what the revenue cost will be. He assumes that if you contribute a dollar, if you get one quarter of new savings coming in, it pays for itself. If you look at NCRS—I have commented on that—I think there are opportunities there to address the AMT.

I would like to go expensing, but you have a revenue problem as you know under 5 years. But my hope is that the committee and the Congress will come up with a revenue neutral aggregate package, which I think is more important than the individual pieces. And if you look at the individual pieces, that is my honest response to how I would cut back.

Mrs. KENNELLY. Am I correct that you probably could not do it in 5 years, but if you do a 10-year figure, you seem to think you could?

Mr. BLOOMFIELD. I don't know what the spending cuts are going to look like.

Mrs. KENNELLY. Good answer, Mark. Nobody does. Thank you very much.

Mr. SINAI. The various tax credits as much as we would like them for American families when you are close to full employment and you may have limited resources to finance tax reductions, tax reductions that stimulate consumption are about the last thing that, from an economic point of view, one would want to do.

Mrs. KENNELLY. Thank you. I think that is the dilemma we are in. We all feel we are paying too much in taxes, we would love to give a tax break, but in the long run, by a tax break, we could end up paying much more than we want to. That is what I am wrestling with.

Out there they think a tax break is a great thing but when you know someone like Mr. Bloomfield who has studied this, you know we can't pay for it at this time under our circumstances with the deficit. We want to give people back more money but, on the other hand, we don't want to increase the deficit. As Mark says, we don't know what the budget cuts are going to be, but we know the money is in Medicare.

You are saying that is a tough one?

Mr. SINAI. I think it is a practical matter to get something done. It is going to be difficult to do all that is in the Contract With America. To try to do it all may lock Washington into a debate about how to finance it that could end up with nothing better done.

In terms of getting something done for some part of the economy and that leads to increased savings and investment, I would encourage you to skinny it down and to make it a more manageable task on the financing side so that Republicans and Democrats and the President can agree rather than ending up having nothing happen from all these very good proposals and the very good debate that has started this year.

Chairman ARCHER. Ms. Dunn.

Ms. DUNN. Thank you, Mr. Chairman.

There is no question that this panel supports the effort to increase America's savings and that is what the GOP contract is all about.

Mr. Bloomfield, I would like to ask you a couple of particular questions. Along that line, one element you have in your testimony but is not yet part of the Contract is the spousal IRA. Would you focus on the spousal IRA and how does it relate to equity and to savings?

Mr. BLOOMFIELD. We are very supportive of the spousal IRA. If I could make reference to our IRA special report that is attached, we have a question on that which is on page 3. The basic problem with existing law, as you know, is there is a bias for two wage earners. They get a $4,000 deduction, whereas a family with one wage earner only gets a $2,250 deduction.

So I think it makes a lot of sense from an equity point of view and reviewing the literature, including the report that just came out yesterday, I think IRAs do work and we definitely shouldn't discriminate against a couple with one wage earner.

Ms. DUNN. Thank you.

Mr. Bloomfield, I would also like you to address an issue important to me considering the district I represent, which has many, many small timber properties. What is your thought on what would happen to these owners if they were not exempt on long rotation crops?

Mr. BLOOMFIELD. You are getting into an area which I am not that familiar with and, therefore, if I could—I rarely like to duck questions, but my understanding is tomorrow there will be some witnesses who are able to respond to that. I am just not that familiar with that issue. I am supportive of a broad-based capital gains tax cut and I don't think that one should discriminate between farmers versus people that own securities.

Mr. COHEN. My son-in-law is an economist and deals in timber. He indicates to me, and this is not my area of expertise, that it does take a lot of incentive to hold that long crop 10, 20, sometimes 30 or 40 years, so that he believes incentives need to be produced for those kinds of products.

Ms. DUNN. I certainly share that belief.

Let me ask a general question to the panel. A lot of what we are doing is going to be helpful in terms of increasing savings, and in other ways across the board, but it occurs to me we are doing a patchwork. What is your view of the long-term Tax Code and tax plan that we ought to be working for? For example, is the Armey flat tax something that we ought to be considering?

Mr. BLOOMFIELD. I, in my testimony, started by saying that I think that the GOP contract is an important beginning. If one talks about a beginning, one wants to know what the end is. With regard to Mr. Cohen's comment about using the Tax Code to skew economic behavior, I would like the ending to be a level playingfield between consumption and investment and saving, and our income tax system is biased against savings and investment.

So what does that mean? That means that I share the Chairman's view that we should take a look at fundamental tax reform. There are a variety of proposals out there, as you know. There is

the Nunn-Domenici consumed income tax, the universal IRA and expensing on the business side, there is European value-added taxes, there is the Boren-Danforth proposal. In many ways, all those proposals, including the Armey flat tax, have more in common than not.

What they basically have in common is the following. Number one, we are going to eliminate the multiple taxation of savings and investment and we are moving, thereby, in a prosavings and investment tax regime. What I ask you to consider when the Chairman holds hearings on this matter is take all the proposals, don't worry about all the specific details, but focus on the most important one, how do they tax saving and how do they tax investment. In my view, I think our long-term economic future depends on a tax system which taxes savings and investment very little if at all.

Mr. SINAI. My guess is a consensus of economists on this issue would be that the tax system should be designed to increase productivity and potential supply of the economy; that is what ultimately determines the real standard of living of the American people, that is their potential rate of growth. That would favor less consumption, more saving, more investment oriented tax systems.

I wouldn't want to say anything more at this time in terms of the particular kinds of taxation algorithms you might go on to do. But I am sure I speak for the profession in terms of designing it to increase the saving, investment, and potential of the economy.

Mr. COHEN. The tax system is kind of interesting—I have been playing with it for 44 years. The question is whether you go to a gross income tax or a net income tax. If you don't get rid of the income tax, the imposition of a VAT is so much more burdensome. It seems to me, if I were to get rid of the income tax and I might consider one of these alternatives, Mr. Armey's alternative is basically a gross income tax. That is going to hit different people in different ways.

A traveling salesman who uses his car, are you going to give him deductions or not? Are you going to give a deduction for charity? That is going to change the way the United States works. We like housing, we give a housing deduction. All those things will have to be evaluated at the same time. It is not a simple process.

A VAT, if you put in a VAT tomorrow, you have an immediate spike in inflation. That doesn't mean the spike is going to stay there forever but you have to remember that many of the European governments, when they put in a VAT the Belgian Government fell because they had an immediate spike of whatever the rate is, that is how much inflation you get the first day.

It takes a long time for that to work its way through the system if you otherwise relieve certain other taxes. So the political heat will have to be taken by whatever does it, so I think I would go slow and think about it a little bit first.

Chairman ARCHER. The gentlelady's time has expired.

Mr. Rangel.

Mr. RANGEL. Thank you, Mr. Chairman. I guess I will address my remarks to Dr. Sinai since he is the first chief global economist I have ever seen.

Mr. SINAI. Titles don't mean anything, Mr. Rangel.

Mr. RANGEL. Listen, when you got it, flaunt it.

Is there—we don't have the luxury on this committee to vote for part of a tax bill, we do in the process. But when it gets to the floor, unless a part of the reforms are that there is an open rule on a tax bill, generally speaking, it is up or down.

If indeed you were in a position to take a look at the Contract With America and you could not pick what you like, what you didn't like, as economists and in your own minds, at least, you know what is best for America, would you vote for this?

Mr. SINAI. Yes. But then you have the spending side and that has to be taken care of. If we put everything in there that is proposed in the Contract With America on the tax side and on the spending side made the Federal Government more efficient, leaner, more effective and financed it that way and then got into the entitlements that need to be reduced, you would, I think, have a marvelous result.

Mr. RANGEL. Let's talk about the spending sides. Do you have any estimate as an economist, after talking with your colleagues, as to what the long-term spending costs would be if any if we adopted all of the Contract tax provisions?

Mr. SINAI. On a static revenue estimate basis, this isn't very precise, there is a lot more work that has to be done on it. Without cutting into the outyear budget deficit, that is a separate issue, just taking care of this, you are talking about $300 billion of spending and transfer payment reductions over 5 years.

Mr. RANGEL. And the language that you are using, static, that is the commonly accepted description of what the people in the financial market will use in order to determine the——

Mr. SINAI. No, I don't think so. I think for people in the financial markets, dynamic scoring is very controversial.

Mr. RANGEL. What you are talking about——

Mr. SINAI. It is presented in the Contract With America in a static way and the cost has been estimated by various people. We have costed out the static nature of the proposals. From an economic point of view, it is a bit more than what is in the document, $300 billion. Other people might say $200 billion over 5 years. Take some number, take $250 billion, and that is the size of what you would have to think about in terms of spending reductions.

Mr. RANGEL. You agree that no matter what professional experts would say for the majority of what it is, that if it is not accepted by economists generally, then it is not accepted by the marketplace, and it could have an adverse effect if we just went on with some numbers; is that right?

Mr. SINAI. Yes. Truth in estimates is very important for financial markets. They will figure out whether it is credible, whether it makes sense and then the verdict will be registered in the marketplace. Remember when you did deficit reduction, which was very hard to do in the early months of the Clinton administration, the financial markets gave resounding applause to that. They knew it was real.

Mr. RANGEL. No matter what economists they get, we still have to deal with the marketplace in terms of judging what was done. Let me ask you another question because I am for savings, and I think we should have incentives, I think America should be more

competitive in how and if we should tax the risks that people make.

You said something which we are saying as Democrats, and I wish more Republicans would say, as exciting as this sounds, we are concerned with how we pay for it no matter what figure we come up with and we think they are taking the right approach. They have to lock in these cuts before we start drafting a bill or something close to that.

Economists never talk about, however, a lack of investment in human skills. They will be the first to agree that if we took a look at our communities with the highest unemployment, the highest number of high school dropouts, the highest level of teenage pregnancy, AIDS, crime, that it costs hundreds of billions of dollars in health and law enforcement, but worse than that, when you put in lost productivity, lost competition and load this into a global economy, if we invested head-on, couldn't we get some dynamic scoring in terms of how much we would save and how much we would gain in the 5- or 10-year period as it relates to the overall economy? Can economists do that?

Mr. SINAI. Yes, they can contribute to that. We are not paying enough, in my view, attention to what you have described as a national problem.

Mr. RANGEL. That is because they want to keep the Federal Government out of local and State government but, my God, when we talk about global competition, we have to talk about the workplace and the labor market and whether or not they, too, can be competitive.

Mr. SINAI. I think the problem which you identify—I am quite sure we all know it is a huge problem and a huge detriment to our family and economic welfare and how our economy performs. Whether you use the Federal Government to do it or some other way through the tax system or through State and local government, that is yet another issue.

Mr. RANGEL. How we do it—it won't be "we" that is doing it. If it is not the Congress, then you have to tell me who.

Mr. SINAI. I am ready to sit on a commission and work with you on the problem.

Mr. RANGEL. I am talking about the national economy, not the local and State, and I am suggesting if I can get your global background to get the interpretation of the cost in dollars and cents of not doing what you think we should be doing, then maybe we can get some static or dynamic scoring for that investment as I am willing to join our chairman and get some dynamic scoring for the reduction in capital gains.

Chairman ARCHER. I thank the gentleman for that comment. With that, his time has expired.

Mr. English.

Mr. ENGLISH. Thank you, Mr. Chairman.

I would like to explore a remark that Mr. Bloomfield made in his testimony. I understand that you have suggested that investment in equipment is the single most important factor relating to economic growth and development. I know in my district there is certainly a very high correlation between creating jobs that are highly skilled and well paying in businesses that are making a constant

effort to invest in new equipment to improve the productivity of their workers and to compete internationally.

Have I accurately portrayed your views Mr. Bloomfield?

Mr. BLOOMFIELD. Yes, you have.

Mr. ENGLISH. Would the other gentlemen care to comment on that viewpoint?

Mr. SINAI. No, I am in agreement.

Mr. COHEN. I don't have disagreement with Mark. We disagree around the edges.

Mr. ENGLISH. Can we explore, then, international comparisons in the cost of capital? I know, Mr. Bloomfield, in your testimony you provided some insights into that. Can you gentlemen generally describe the cost of capital and the treatment of capital in the tax system in our system, in summary, as it compares to our major trade competitors, particularly in manufacturing?

Mr. BLOOMFIELD. Mr. English, what I find most convincing is the table that we had Arthur Andersen prepare for this hearing. There you can look at various pieces of equipment and, if you look at our competitors, whether it be Brazil or Japan or Germany, I think one can make the case from this present value analysis that our capital cost recovery system, including the AMT, is way out of sync.

If you look at OECD countries and you look at where countries get most of their revenue, they rely less on income taxes or they rely more on consumption taxes than we do which, by definition, allow for the immediate expensing of machinery and equipment.

There is a very interesting person you might want to get in touch with, Larry Summers, Under Secretary of the Treasury Department for International Affairs. He and his colleague looked at determinants of economic growth and one of the critical factors was investment in machinery and equipment.

Finally, I would ask that you ask that question of Harvard professor, Dale Jorgenson, who has done that work that I alluded to earlier.

Mr. COHEN. I don't see the cost recovery technique in the United States is that much off from the others. The tax systems vary. For example, the Japanese have a much heavier income tax than we, both on corporations and on individuals. So there is something else going on in the system in terms of the savings rate.

Mr. BLOOMFIELD. I don't think that is true. If you look at corporate tax rates in Japan after the 1986 act——

Mr. COHEN. They are higher. They are not dramatically higher, but they are higher. The individual rates are much higher. Individual rates are around 50 percent.

Mr. BLOOMFIELD. They don't tax capital gains and dividends and all that.

Mr. COHEN. I have not done the study to see how it breaks down for different kinds of income.

Mr. ENGLISH. Would any of you care to comment on whether our tax structure at this time puts us at a competitive disadvantage? Particularly, I would like to gear this to manufacturing, because I have always understood that manufacturing is more sensitive than other areas of the economy to tax changes and level of taxation just because of its nature.

Would you agree with that?

Mr. BLOOMFIELD. I would agree. The big issue is capital costs and that is more than tax policy. If you look at work that Professor John Shoven at Stanford has done, you will find that he attributes our high capital cost, one-third to our tax system, and our tax system does so by heavily taxing investment.

Mr. SINAI. I think once you take out interest rates, that is the major determination of cost of capital. Once you extract from that, I believe we are internationally at a competitive disadvantage. The more incentives which exist, and the more complete a tax system which would help savings and help investment, and any country that employs a VAT, and I am not necessarily for a VAT, but any country that employs a VAT automatically is cutting back the share of consumption in their economy just by that tax method alone, and we are maybe one of two countries that don't use that. We do tax capital many times and have for many years in this country, and that you will not find in many of the countries with whom we compete.

Mr. ENGLISH. I have a few more questions, but we are running late so I want to thank the three of you. I appreciate your coming out and providing your massive expertise.

Mr. SINAI. If I might ask permission to excuse myself. I do have to get a plane.

Chairman ARCHER. We understand, and we are very appreciative of your coming and being with us today. You made a great input to the panel.

Mr. Ensign will inquire.

Mr. ENSIGN. Thank you, Mr. Chairman.

I have a couple of issues to address. First, we have been talking about welfare reform in this committee as well, and one of the comments that Mr. Rangel has made and I share his concern, is where are these jobs in the inner cities going to come from if we are talking about workfare-type programs.

Since we are talking about capital gains taxes, could you address how to encourage jobs in the inner cities, about having a zero capital gains tax in so-called enterprise zones in the United States, to encourage capital investment in those enterprise zones and, therefore, create jobs in the inner cities?

Mr. BLOOMFIELD. First, I think the correct approach to capital gains is a zero capital gains tax rate and some of the enterprise zone proposals do that.

Two, capital gains has a macroeconomic impact in terms of capital costs and it applies to big businesses and small businesses as well.

Third, capital gains taxes are particularly important for startups. The fellow who wants to start a small business, he can't go to a bank or the New York Stock Exchange; he has to go to his friends and his relatives. Obviously, his relative could put money into a bank and get a reasonable rate of return or he can take a risk and invest in a new startup. He will take that risk because his aftertax rate of return is low and, therefore, capital gains has an important microimpact on startups which, hopefully, is where some of these initial jobs will come from.

Mr. COHEN. I suspect that more important than anything the Federal Government does is what is the State and local tax situa-

tion, that is real estate taxes and taxes on the property, that is put in there, cost of land, transportation system, police protection, a whole variety of things that need to go into that inner city to make me put a small plant there.

Mr. ENSIGN. I agree, but we don't have control over that so that is why we are addressing the capital gains issue from this level.

Mr. COHEN. That is a marginal effect. He won't go in even if he gets a capital gains break unless he gets these other things.

Mr. ENSIGN. Another issue that you addressed, Mr. Bloomfield, that I agree with, to deal with entrepreneurship and the capital gains and world competitiveness from the United States. You mentioned that lowering the capital gains tax encourages small startups and much of technology breakthrough has come from small companies.

To make the United States more competitive on a world stage, it would seem to me that we want to encourage small startups, from where these technology innovations are going to come from.

Mr. BLOOMFIELD. Congressman, I think what one needs to focus on, in terms of these new technological breakups and job creation, is the whole entrepreneurial process. As you know, the process of starting new businesses involves the entrepreneur. He will be sensitive to capital gains. He will leave the Fortune 500 company and go to a startup because he has the prospect of having a capital gain through stock options. The more formal investors are a second part of the process.

They, of course, are very sensitive to capital gains tax rates. They are going to make a decision whether to put the money in a bank and get a safe rate of return or take a risk on a new business. Venture capital pools, and of course a healthy public market, are important because if you start a technologically sound company, sooner or later they will want to go public.

My point is that all of those are extremely sensitive to capital gains tax cuts. But I know that you are going to have a wonderful panel of entrepreneurs and you should and will address the question to them.

Mr. ENSIGN. My last quick point, Mr. Cohen, and that is we have heard a lot about the economy being at virtually full employment. We are talking about work programs, once again getting back to welfare, and they are saying where are these jobs going to come from, full employment seems like a dichotomy. But we hear capital gains and tax cuts will overstimulate the economy but yet we are concerned that there are not enough jobs for people coming into the work programs from welfare.

Mr. COHEN. The problem is, we are in a technological society and the jobs are for the best trained people, people who are computer literate trained in skills. The folks without the skills are basically locked out. Full employment or not, you can't hire as a computer operator a person who is not literate and can't operate a computer. It is a sociological problem. We do have a class of people who have not received sufficient education to be employed in this kind of an economy.

Mr. ENSIGN. Thank you, Mr. Chairman.

Chairman ARCHER. Dr. McDermott.

Mr. MCDERMOTT. Thank you, Mr. Chairman.

Unfortunately—well, first of all, welcome. Our economist slipped away. Senator Henry Jackson used to say he was always looking for a one-armed economist because he couldn't say on the one hand this and on the other hand that.

I think some of us on this committee, in looking at this tax break question, are searching for some way to think about it conceptually that makes some sense. Most of us on this end of the dais voted last year to raise taxes and to cut programs because we were led to believe that deficit reduction was the main thrust of what we ought to do for the economy. So we went through that exercise, painful as it was. Some say we are in the minority in part because of that.

So now we are in a position where I guess the deficit is all taken care of and we should now begin reducing taxes, because I don't know how I am going to go back to my aerospace mechanics and explain to them why we raised taxes last year to deal with the deficit and this year we are now reducing taxes when the deficit is still there, when the national debt is still rising.

How would you explain to the ordinary citizen, because that is our problem—we vote for these tax cuts—what do we say to people to make sense in that kind of tacking back and forth in the ocean of economics?

Mr. COHEN. It is easy to vote for a tax cut. That is the most popular thing in the world. One of the problems that—I was testifying before the committee when the committees back in the seventies started indexing things and I said tax committees would live to regret indexing, although you can't argue with it theoretically. Once you index, the people on this committee only get to vote for tax increases, it is hard to vote for tax decreases. They happen automatically.

I am a deficit hawk. I think that the best thing we could do for the United States is to work at reducing the deficit, certainly in the full employment situation we find ourselves in. If we don't reduce the deficit now, when will we, next time there is a slight dip in production or employment statistics? Of course we won't. We have to do it now and that is why I have been leaning on that element of it.

Mr. MCDERMOTT. Could you, in any way, justify any of these tax reductions on the basis that it is going to be put into savings, in other words, we ought to vote for the ones that can be forced into the savings pool? Would that make sense in terms of economics in the long run?

Mr. BLOOMFIELD. I think the answer to the aerospace worker in your district is I think he would be for proposals that provide for more modern machines and equipment, for better tools. I think also, the fact that Luntz' polls and others indicate the most popular proposal in this Contract is not the $500 credit but it is the IRA proposal. I think he would understand that to the extent to which these things affect savings and investment, and we could have reasonable arguments about whether they do or not, I think that he would be supportive.

Mr. MCDERMOTT. Do you then think that the IRA proposal here is sort of kind of a tax shelter savings account that you can jerk it out at any time, you are going to take off the penalties. The IRAs

I have now, I could get the money, but it is going to cost me a chunk. These ones are kind of loose and they have a certain instability in terms of real savings to them, don't they?

Mr. BLOOMFIELD. Well, there is a question about whether you can withdraw them too quickly. I might have constructed a different IRA proposal. There is a question about whether they shift savings or not, but I still think this IRA proposal will, on balance, create new savings. The fact that your constituent would favor that over a $500 tax credit indicates that he wants to do things that make economic sense.

Mr. COHEN. But it is basically a self-certification and if it is self-certification, that means there is no governor, they can take it out any time they want to.

Mr. BLOOMFIELD. One of the arguments about shifting concerns the fact that the average net assets of an American family is $1,000. So obviously there is not going to be that much shifting. That statistic alone indicates that, sooner or later, people are going to save more through IRAs. It makes economic sense, and your average constituent also doesn't think his savings ought to be taxed. That is a savings proposal.

We can have a debate about your aerospace worker in terms of what proposal would give him more modern machinery and equipment, and that is what I think the committee is about, NCRS or some version of NCRS.

Mr. MCDERMOTT. So on your list, the earlier question you were asked about ranking pieces of this Contract, you would say that the IRA is the number one item that you would go for on the list?

Mr. BLOOMFIELD. No, I don't. I would prioritize them. I think capital gains is in a category by itself because I think the unlocking pays for a lot of it. I don't want this thing passed unless, in the aggregate, it is revenue neutral. There are various IRA proposals. Mr. Neal has his proposal, the President does and others.

As far as NCRS is concerned, I know members of this committee have expressed some concerns and, therefore, there are alternatives there—I wouldn't prioritize one over another.

Chairman ARCHER. The gentleman's time has expired.

Mr. Christensen.

Mr. CHRISTENSEN. I wanted to touch briefly on a couple of points. Early last week, the administration briefed Members of my class on the Mexican bailout or the loan guarantee and during that briefing they handed out materials that talked about some things on the Mexican situation. In there they had one sentence that I liked. This was from the administration. It said "Who benefits?" Well, millions of American middle-class families invest their money in mutual funds.

I tell you, Mr. Bloomfield, for so long I have been hearing this class warfare argument about how a capital gains reduction isn't going to help the middle class, and I am just glad to hear a lot of my colleagues on both sides of the aisle, and this is truly a bipartisan measure, are not taking part in this class warfare bit.

And there have been those that are still out there hollering about it, mainly Les Samuels. We heard him here talking about that. Mr. Samuels stated that there is going to be a sheltering effect. Where in the world is this tax shelter that we are creating? Please explain

it to me because I sure don't see it. I have heard it this morning by Mr. Cohen.

Mr. COHEN. It depends on how you define capital gains. As I indicated in my testimony, I don't want to have to brush up on my collapsible corporations again. There are a variety of techniques by which investors can convert what would otherwise be ordinary income into capital gains. If that is allowed, then you will have a great deal of economic activity from lawyers and accountants.

Whether it will be productive economic activity is another question. That goes to how you make the change and how you define it. I don't oppose the true capital gain, but one has to be very careful that you don't allow a variety of activities that don't produce anything and don't do anything for the economy to yield a benefit nevertheless.

Mr. BLOOMFIELD. There is another answer to it. Mr. Cohen pointed out at the beginning of the hearing that our income tax system has a very low cost of administration. I would suggest that it has a very high cost of administration, Mr. Christensen.

If you look at the corporate side, Joel Slemrod at the University of Michigan pointed out for large corporations that it is the most inefficient tax because it costs more to collect and administer it than it does in terms of revenue. If you do what I think you want to do, and that is to have a zero tax on capital gains, if you had a consumption tax, not an income tax—the problem with an income tax is they spend a lot of time trying to figure out what income is versus what capital gains is. They spend a lot of time trying to come up with the ideal depreciation system.

A lot of these technical issues are implicit in an income tax. If you go to a flat tax, you will get rid of a lot of the complexity.

Mr. CHRISTENSEN. Mr. Bloomfield, I want to add to that. I don't want to pick on Mr. Cohen, but you did say you have been involved since around 1952?

Mr. COHEN. I first started drafting legislation for this committee in 1952.

Mr. CHRISTENSEN. You said, I don't like it, but I can't stop it. I guess I would challenge you on that, because I believe you can stop it. You were the Commissioner of the IRS for a long time and that code grew larger and larger.

Mr. COHEN. I administered laws that you folks passed.

Mr. CHRISTENSEN. I think we are heading in the right direction for the first time in a long time. Thank you.

Chairman ARCHER. Mr. Ramstad.

Mr. RAMSTAD. Thank you, Mr. Chairman.

I just have a brief question. I know your bladders are being severely tested with the longevity of your being here. My question is this: Is there a better holding period than 1 year? Would, for example, a 2-year period be preferable perhaps or some other holding period?

Mr. COHEN. Back in the twenties when capital gains first came in, they had a graduated holding period. That is—you can get a different result from people by imposing a different standard. That test went, the longer you held it, the lower the rate. I don't necessarily approve of that. I merely recount that as a historian.

Mr. BLOOMFIELD. I can submit, if you would like, a history of the capital gains tax treatment and, as Mr. Cohen did point out, you had a sliding scale in the thirties. Part of the problem with a sliding scale is, how fast do you slide and, as you get close to the new rate, are you locked in? This is implicit in any discussion of capital gains if you don't have a zero capital gains tax rate.

So the answer is, is a sliding scale better than a rate reduction or indexing. It depends how that sliding scale is crafted, how long the slide is and what the rates are. You will also have a debate among different people who are involved in capital gains. Venture capitalists would like a very long holding period to encourage long-term investment, but then you have the mobility argument that we alluded to earlier.

Mr. RAMSTAD. The bottom line for me is, is output growing this economy? I look at the various econometric studies, for example, the one referred to by Dr. Sinai. His bottom line is that if we could create 1.4 million new jobs over a 5-year period, output would stand to increase by $4.4 billion a year. Now, obviously this assumes the rate reduction and indexing and the 1-year holding period.

Would you care to comment how those numbers might change, if at all, given a 2-year holding period?

Mr. BLOOMFIELD. The only thing I would say in response to that is a longer holding period—and you can check with Dr. Sinai on it—a longer holding period would not be good for capital costs in general. That is the fundamental point there.

The other thing I would like to say is that Mr. Archer's capital gains proposal, as a package, it has three parts—it includes corporations, there is no minimum tax—is probably as good a capital gains package as has appeared before this committee and that is no aspersion upon your predecessor, Mr. Frenzel, who played a key role in 1978.

Mr. RAMSTAD. If he were here today, I am sure he would corroborate your testimony. I appreciate eliciting that statement from you. Thank you, gentlemen.

Chairman ARCHER. Mr. Neal.

Mr. NEAL. Thank you, Mr. Chairman.

Mr. Bloomfield, thank you for reinforcing support for the IRA proposal which has been offered by Mr. Thomas and myself. I have offered two versions of the IRA. I offered a more narrow version which would indeed be more difficult for the consumer to get at until retirement. I think in the end that is where some of this debate is going to go.

The expansive IRA that we have offered I think has merit considering some of the issues which confront the American family at this time. But how would you respond to waiving the penalty for withdrawing, that if the vehicle that you are creating is for savings, why would you let people after a prescribed period of time get at it? That is——

Mr. BLOOMFIELD. I think you answered the question. You provided the answer the way you phrased the question. I am troubled with the ease of getting it out. I prefer that it be in there for a while.

Mr. NEAL. Mr. Cohen.

Mr. COHEN. I am worried about the auditability of getting it out. If you have to certify the reason you get it out and that it is on your own self-certification, the government has no way of knowing, except in a very limited audit circumstance whether you really had the education expense, the medical expense or whatever it was. Therefore, you create a problem both ways, that is, the money can evaporate quickly and there is no way of testing whether it ought to be taxed or not.

Mr. NEAL. At the risk of sounding superficial, Mr. Greenspan some years ago in front of the Banking Committee I thought summed it up very nicely when he said that the number one economic problem that America has today is our low national savings rate. Long before this Contract With America was outlined I have been pushing for restoring the traditional advantages of the IRA, and would you comment on that simple assertion that Mr. Greenspan made?

Mr. BLOOMFIELD. Well, I agree, I think he was talking about national savings and obviously there are three components to national savings.

Mr. Cohen and I agree that one of the biggest things is eliminating government dissaving, which is the deficit. I am very concerned that if you eliminate government dissaving by higher taxes on personal saving or business saving you haven't made any progress, so if you eliminate the government deficit by not increasing the burden on other saving, you have made progress, but having said this, if you look at the decline in national saving over the last decade, you have had an increase in government dissaving, you have had a decrease in personal saving, and you have also had a decrease in business saving, so where I might differ with some of my colleagues is that I am worried how you reduce the deficit, and I also think that you can do a lot about personal savings, and, as you know, some witnesses may not agree that IRAs work.

Mr. COHEN. I don't happen to believe IRAs work. My own experience is most of it is transferred, the bulk of it. That isn't to say it doesn't work a tiny bit.

The question is, then, whether the price is worth it. Why savings have fallen so dramatically, I mean, since the time I was in office until now, I don't know. And I don't think anybody else knows, unfortunately. Whether economics has anything to do with it or there are other societal pressures, I think would be an interesting sociological study as well as economic study.

I have seen some of the economic studies. I have not seen any of the sociological studies. It is not fashionable for young people to say I have savings. When I first went to work my brother and I organized an investment club, which still has its money in the account and has been discussed in an economics text of the way it ought to be done. I started when my children first got their first jobs, and we have an investment club, and it invests each month. I did this because I thought that encouraged them as a group, it was a group pressure, if one saves, they all have to save. It has provided a good discipline, but that is not a societal way to do it. I think somebody has to think about that in the broad context of why we changed our behavior in the last 25 years or so.

Mr. BLOOMFIELD. I would suggest that if you compare a country like Singapore with the United States, let's use Singapore many years ago, why were their personal savings rates higher than ours, and I would suggest three factors.

Number one, they made people save. I mean, the government made you as a taxpayer put a certain amount in a postal account. Number two, they had incentives that make our IRA proposals look like pipers, and, number three, they had a big cultural thing. I mean, those people are scared. Having said that, though, you can affect personal saving to a very large extent, it seems to me, through something like the Tax Code and you are not going to make people save in this country, but incentives can work.

Mr. NEAL. Thank you for that timely information.

Chairman ARCHER. Mr. Collins.

Mr. COLLINS. Thank you, Mr. Chairman.

Mr. Cohen, when were you with the Treasury Department or the IRS?

Mr. COHEN. Two different times, from 1952 to 1956 and from 1963 to 1969.

Mr. COLLINS. OK. I think some of the reasons for lack of savings now is because we baby boomers have just gone through about 10 to 15 years of raising dependents, affected by the higher cost of living, college tuition, and so forth.

Mr. COHEN. I had four children in college at one time, sir.

Mr. COLLINS. We didn't have room or the money left in our budget for savings, but that is not part of my question.

A lot has been said about the deficit, but I believe the parameters for the tax reform that we will eventually consider on the floor of the House will actually be determined by the preceding budget reconciliation bill that we will take up first. I think that is going to drive the actual end results of what we do in this committee.

A lot has been said about capital gains and it being used as a tax shelter, but the gain comes only after a person or a business divests itself of a capital investment; is that not true?

Mr. COHEN. Well, sir, that is true, but there are various techniques that lawyers and accountants engage in that have the possibility of converting ordinary income to capital gains. We have those techniques in our arsenal, and unless you stop us, we will have to do it. I mean, that is my job.

Mr. COLLINS. There is really no gain until such time as a person actually divests themselves of the cash—but my point is that once that is done, it enhances the cash flow of the private sector, which leads to taxation.

Mr. COHEN. Well, we are going to differ there, sir. I mean, that is—what you are saying is a truism, but whether it can be abused is what I am saying, and, yes, it can be abused. There are other techniques for abusing it to create what is an artificial capital gain.

Mr. COLLINS. OK. I want to get on to my last question, though.

A lot has been said about how tax policy can actually influence capital investment, and it was mentioned, too, about the aerospace industry. During meetings with General Electric and Boeing, I heard both of them make the same statement about a provision in the Tax Code that had really affected their sales because the air-

line industry had been experiencing huge deficits, but was still subject to tax liability, because of their capital investments in aircraft. And the reason they had a tax liability is the alternative minimum tax.

What should we do or should we be looking at the alternative minimum tax? Should we repeal it or should we lower the rate? Or what should we do and why or why not? I would like to hear from both of you.

Mr. BLOOMFIELD. Well, Mr. Collins, as you rightly observed, you get into an alternative minimum tax situation for three reasons: One, you invest and you get more deductions and you don't pay enough taxes. It is crazy, you get an alternative minimum tax because you invest, which is how you get long-term economic growth. You get an alternative minimum tax if your business is in a down cycle and there is a third reason you get into it, so it is a very bad tax in terms of economic policy.

What are the options on the alternative minimum tax?

Well, obviously you can eliminate it, you can speed up the depreciation lives, you can do away with some of the limitations on AMT credits. I mean, there are a variety of specific things you can do.

There will be a panel on NCRS, and I have seen some of the testimony that they will submit, and I would just look at all those. You have got some good witnesses and look at the pros and cons. But I would try to use this opportunity to do something about it, and NCRS, per se, does improve the situation for NCRS AMT taxpayers, as my chart suggests in the testimony.

Mr. COHEN. AMT came into the law in 1969, as I recall it. It came in because there were a variety of large taxpayers, both individuals and corporations, who paid little or no tax while they had allegedly large economic gains. It is a substitute, it is a crude substitute for looking at how deductions and credits, et cetera, ought to apply.

I would prefer if you ask me what is the best way to deal with this. The best way to deal with this is to look at each of the deductions and credits and so forth critically and say do we want to limit them in some way so that they can't apply in an excessive manner rather than coming at this crude measure of this rough and ready AMT. But it came about because the committee at that time couldn't decide on the direct technique and came at it indirectly, so nobody is going to bless it as being a perfect instrument. It is not, it is a very crude instrument.

Mr. COLLINS. I think GE and Boeing both are good examples, though, how this type of taxation has led to fewer jobs on the assembly line.

Thank you, Mr. Chairman. Thank each of you.

Chairman ARCHER. Gentlemen, thank you for I think outstanding input to the committee today, and particularly for your patience in staying here with us for slightly over 3 hours. We appreciate your input.

The committee will recess for about 2 minutes while the next panel takes seats at the witness table.

[Brief Recess.]

Chairman ARCHER. Gentlemen, welcome to the committee. Joseph Lane, who is scheduled to be on the third panel has an imper-

ative need to get away earlier so we have moved him up to this panel, and we are pleased to do that to accommodate you.

At this point inasmuch as you may have to leave before this panel completes its testimony, I would like to recognize you first for your testimony, and you may proceed.

STATEMENT OF JOSEPH F. LANE, MEMBER, GOVERNMENT RELATIONS COMMITTEE, NATIONAL ASSOCIATION OF ENROLLED AGENTS

Mr. LANE. Thank you, Mr. Chairman. Thank you to the members of the committee for providing this opportunity to testify before you today.

My name is Joseph Lane. I am an enrolled agent in private practice in Menlo Park, Calif., and I am appearing here today on behalf of the National Association of Enrolled Agents.

Our 8,900 members are primarily small businesspersons themselves, and they also represent over 4 million individual and small business taxpayers each year in the process of preparing tax returns for them and also representing them before the Internal Revenue Service.

We are happy to be able to comment on some of the specific proposals outlined in H.R. 9, particularly with respect to the capital gains reduction.

We agree and endorse the committee's proposition to reduce that by 50 percent. One area of concern to us is that in the event that this does go through, we would like to see the prior exemption—we are assuming if you have that 50-percent exclusion that it will become a preference item for AMT purposes, and if that is the case, we would like to see the exemption provided for the gain on the sale of the personal residence that was in the prior law also reestablished to exclude that gain from AMT calculation purposes. So if the committee could note that, we would appreciate it.

We agree with the proposal to provide capital loss treatment for the sale on a personal residence. We would like also to see the indexing, we would like to see indexing extended to shareholders of sub-S corporations to the extent that they have basis available.

With respect to the exclusion on the foreign stock corporations, we would like to see the provision that exists in the proposal already to provide an exemption for foreign corporate stock, or ADRs, that are traded on the American exchanges extended to also cover foreign stock mutual funds, which are available to American citizens for investment. As our world economy increasingly diversifies, more and more Americans are allocating a small portion of their investment portfolio to foreign stock mutual funds, and we would like to see that exemption extended to provide for them as well so they can get indexing on those funds that they invest in. For example, T. Rowe Price and Fidelity are the type of firms that offer foreign market funds and we don't see any reason why they should be excluded from the indexing.

With respect to neutral cost recovery, we agree that a major revision to current rules governing depreciation methods ought to be employed, but we think that the driving force ought to be simplification of the tax laws. Mr. Hancock commented before about the difficulty of small businessmen keeping track of this and com-

plying with these regulations. We think this neutral cost recovery proposal could create a situation where the average small businessperson couldn't conceive of how to compute his own depreciation, and we think what you really need to do is lock in on a few simple asset lives and agree not to change the law for a while, and I think you will get a much higher level of compliance and understanding by the taxpayers and the practitioners to boot.

We also have a concern about the way the proposed calculation would work. You actually could be increasing the depreciation basis on an asset that is actually dropping in value. For example, some rental property in California of late would prove that.

On the small business initiatives, we endorse the 179 proposal to increase the annual limitation from $17,500 to $25,000. We think that is clearly in favor of helping businesses become more competitive and aids the small businessperson.

On the home office deductions, we completely support the new definition of a principal place of business that is outlined in your proposal. We think the *Soliman* ruling was a disaster for small business, and we hope that this would overturn that in effect by eliminating the constant interruption by the Internal Revenue Service of the small businesses that operate out of their homes.

The estate tax changes. We also note the proposal to increase it to $750,000. It does benefit owners of small business, farmers, and since that limit has not been changed for almost 15 years, there is probably an inflation increase warranted alone, and the future indexing should allow the estates to be taxed on the true economic value of the estate assets.

So we stand in favor of most of these proposals that you put forth today. We think in terms of small business, the taxpayers that we represent, it clearly would aid them and reduce the burden and simplify some of the rules they have to follow.

[The prepared statement follows:]

TESTIMONY OF JOSEPH F. LANE
NATIONAL ASSOCIATION OF ENROLLED AGENTS

Chairman Bill Archer, Ranking Member Sam Gibbons and Ways and Means Committee members, thank you for the privilege of testifying today. My name is Joseph F. Lane and I am an Enrolled Agent in private practice in Menlo Park, California. I am here to testify on behalf of the National Association of Enrolled Agents (NAEA).

The National Association of Enrolled Agents appreciates the opportunity to comment on this very timely issue which is of great significance to our members, who are themselves primarily small businesses, and their small business clients. Our organization represents more than 8900 Enrolled Agents, specialists in representation of individual and small business taxpayers. Enrolled Agents work with more than four million (4,000,000) individual taxpayers annually.

It is in our role as the voice for our members and for the general taxpaying public that NAEA presents this testimony on the "Contract With America" proposals contained in the Job Creation and Wage Enhancement Act of 1995 (H.R.9).

Our comments on the specific sections of the proposed legislation are presented in an effort to suggest the best means for the Congress and the Administration to administratively implement whatever terms of the bill finally win passage. As we have not received any cost estimates for H.R. 9 as of yet, we are not able to comment on the fiscal impacts which would result from the bill's implementation.

Capital Gains Changes

NAEA supports the initiative that provides for amending Section 1201 to allow for a Capital Gains deduction of 50% We believe passage of this section will aid small businesses in capital formation, encourage investment in our economy and create new jobs for America's citizens. One area of concern to us in evaluating this change is the treatment of this new exclusion when computing the alternative minimum tax. Under prior law, the capital gains exclusion was a preference item for purposes of computing alternative minimum taxable income. If Congress intends to provide for a similar interpretation for this exclusion, we would like to see reestablishment as well of the prior exemption for the gain on sale of the taxpayer's principle residence as an alternative minimum tax preference item.

We also endorse the proposal to permit the capital loss on the sale of the taxpayer's personal residence. This is a change that is long overdue! For many of America's citizens, the home is the one major investment they enjoy. It is only fair that they be afforded the benefit of a capital loss should they suffer such financial reversal. In all, it results in a fairer tax system and this perception of fairness is critical to increasing taxpayer compliance with the tax laws.

We also conceptually support the proposal to index certain assets for purposes of determining gain or loss (Section 1022). We suggest that Congress reconsider the exclusion of Stock in Sub-Chapter S corporations from indexing. A great many small business entities, which provide the vast majority of newly created jobs in our economy, begin their existence as sub-chapter S corporations. While many of these entities elect to convert to regular corporate status once they reach profitability, we do not believe that owners who took the risk to strike out on their own and invest in America by building a business and creating new jobs should be denied the benefit of indexing their original investment in their businesses. This is especially significant if the Congress desires to send the message that entrepreneurship is going to be supported and not discouraged. If a taxpayer can index his investments in existing companies but not his own start-up, it appears to us that the message being communicated is the exact opposite of what we believe is the intent of "Contract with America" initiatives.

A final suggestion for change in this proposed legislation is the exclusion from indexing of stock in foreign corporations. While the bill does provide an exception to foreign corporation stock or ADRs traded on American exchanges, we believe this exception should also be extended to the many foreign stock mutual funds, which are available to American

citizens for investment. Many of these foreign funds are offered by U.S. investment management firms such as Fidelity and T. Rowe Price and reflect diversification in their family of funds. As our world economy increasingly diversifies, more and more Americans are allocating a small portion of their investment portfolios to foreign sector mutual funds. We do not believe there should be a "penalty" for making this investment decision.

Neutral Cost Recovery

We agree with Congress that a major revision of current rules governing depreciation methods for business is needed. But, we think the primary factor driving the revision ought to be simplification of the tax laws. Unfortunately, the proposal contained in the Bill (Section 2001) does not meet this critical criterion.

While we do not disagree with the basic premise, that a business ought to be permitted full "economic" expensing of assets employed for productive use, the proposed formula is too cumbersome for business owners to deal with, too complicated for tax preparers to calculate, and too administratively convoluted for the Internal Revenue Service to uniformly enforce. The annual adjustment needed to determine the 3.5% per annum rate of return and the general inflation in the economy since the asset's acquisition date places an unreasonable burden on small business owners to track these assets and the return preparers to properly report them on the tax returns.

In addition, there is potential for significant distortion to reality in the proposed equation. For example, it is possible to have an increase in the general inflation in the economy and an adjustment for the 3.5% rate of return and, at the same time, have the asset drop in market value. California real estate prices in the last few years provide an example. If we applied this proposed formula to a rental home in California we would have increased the depreciable basis of an asset as it drops in value!

A far preferable, and fairer, system for depreciation would be to standardize a few simple asset life rules and agree not to change them for the foreseeable future. This would permit business to plan more cogently, permit tax preparers to accurately calculate depreciation and simplify the verification process for Internal Revenue Service examiners.

Small Business Initiatives

NAEA believes that the proposal to amend Section 179(b) and increase the annual dollar limitation from $17,500 to $25,000 will benefit small business. We believe for most small businesses it will substantially alleviate the cumbersome cost recovery calculations, since it provides an immediate write-off for cash investments made during the year. Businesses which reinvest in their productive capabilities increase their competitiveness. We suggest that the effective date be upon enactment rather than for taxable years beginning after December 31, 1995 as many business owners may defer purchasing needed equipment until 1996 to qualify for the new limit and our small business manufacturing and sales clients would prefer to have their sales increase as soon as possible. Increased sales directly benefit our national economy.

Home Office Deductions

From its inception, the home office deduction has been a contentious issue. Over the years, the Internal Revenue Service has expended a considerable amount of time and resources defining and defending its position in this area at great taxpayer expense. The current law regarding this deduction, resulting from the Supreme Court's *Soliman* decision, has further clouded this issue.

NAEA views the *Soliman* decision's definition of a taxpayer's "principal place of business" as too restrictive and predicts its impact will be devastating on small businesses. This decision has resulted in a definition of "principal place of business" which is extremely

difficult to determine and which according to IRS guidance qualifies very few taxpayers for the deduction. "Relative importance" is a very nebulous concept which is very arduous for taxpayers to comprehend. Consequently, the home office deduction remains a contentious issue over which the IRS, taxpayers and their representatives will continue to expend much time and monetary resources.

From a social and economic standpoint the *Soliman* decision is a disaster. More and more businesses are encouraging their workers to work from home and for many fledgling entrepreneurs it's a necessity. Home based workers don't have to commute to work thereby reducing air pollution and conserving our energy resources.

H.R. 9 contains a proposal that would effectively repeal the *Soliman* decision. The home office deduction would be allowed if essential administrative or management functions regularly are carried on in the home office and the taxpayer has no other location for performing such functions. We support this definition of "principal place of business". It better reflects the reality of many legitimate home office situations than the current definition under *Soliman*. In addition, it would be much easier to ascertain compliance than the "relative importance" test. Consequently, fewer conflicts between the IRS and the taxpaying public would arise regarding this issue thereby substantially reducing the time and resources expended resolving differences.

Clearly, the current law regarding the home office deduction leaves much to be desired from the standpoints of fairness, economic policy, social policy and administerability. It is our opinion that legislation along the lines of that contained in H.R. 9 would address the current deficiencies in the law and create a vastly improved home office deduction.

Estate Tax Changes

NAEA notes the proposed changes to Sections 2010 and 2001(c) and agrees that increasing the decedent's exclusion amount to the $750,000 limit does provide additional benefit to the families of small business owners and farmers and other taxpayers. Since this limit has not been changed in almost fifteen years it would appear that an adjustment for inflation alone is warranted. Future indexing of these exclusion amounts should permit annual adjustments to more fairly reflect the true economic value of the estate's assets.

Summary

NAEA appreciates the opportunity to present its views to the Committee on these issues impacting small business taxpayers. We stand committed to further assist the Committee in future deliberations on these issues, and will be happy to provide more specific testimony on key points on the "Contract with America" at future hearings.

Chairman ARCHER. Thank you, Mr. Lane.

Our next witness is William Sinclaire, senior tax counsel for the Chamber of Commerce.

Mr. Sinclaire.

STATEMENT OF WILLIAM T. SINCLAIRE, SENIOR TAX COUNSEL AND DIRECTOR OF TAX POLICY, U.S. CHAMBER OF COMMERCE

Mr. SINCLAIRE. Thank you. Mr. Chairman and members of the committee, good afternoon. I am Bill Sinclaire, senior tax counsel and director of tax policy for the U.S. Chamber of Commerce. The Chamber is the world's largest business federation, representing 215,000 businesses, 3,000 State and local chambers of commerce, 1,200 trade and professional associations, and 72 American chambers of commerce abroad.

The Chamber appreciates this opportunity to testify again before the House Ways and Means Committee. I am here today to focus on some of the tax-related aspects of the Contract.

The Chamber has long advocated the need to reduce the tax on capital gains and fully supports the reform proposal. The current maximum tax rate on long-term capital gains of individuals is near its historic high, and the rate for corporations is the highest ever. The proposal would permit a 50-percent deduction for net long-term capital gains, thereby reducing the effective rate for all taxpayers.

Perhaps the most unfair aspect of the current method of taxing capital gains is that much of the gain is often attributable to inflation. The proposal would eliminate this unfairness by indexing the cost of capital assets for inflation.

Unlike a normal investment, if a taxpayer sells his principal residence at a loss, that loss can never be deducted from income, even if there is a gain from the sale of a subsequent principal residence. The proposal also corrects this anomaly.

A neutral cost recovery system is supported by the Chamber. Businesses are not currently permitted to recover the full economic equivalent of their investments in depreciable business property. Businesses are only allowed to recover the historical costs of their capital expenditures. The proposal would allow depreciation deductions to be increased to approach the economic equivalent of expensing by accounting for inflation and the time value of money.

The Chamber supports the unified estate and gift tax credit increase proposal, and strongly favors reform, simplification, and an overall reduction in the estate and gift tax burden on individuals and the owners of family businesses.

The current unified credit has not been indexed for inflation since it was fully phased in in 1987. Increasing the estate and gift tax exemption to $750,000, with indexing, would be a move in the right direction for the preservation of savings and family businesses. However, the value of a small family business or a family farm can exceed the $750,000 limit, and while the proposal would improve the situation, consideration should be given to having an even higher limit.

The original House version of OBRA 1993 proposed increasing the small business expensing allowance from $10,000 to $25,000.

Nonetheless, the final version only provided for an increase to $17,500. The Chamber supported the original House OBRA version and now supports the proposal to increase the allowance to $25,000. In addition, the Chamber encourages consideration of raising the proposed $25,000 limit to an even higher level.

The Chamber supports the proposal that would allow a home office deduction to an individual if the office is the location where essential administrative or management activities are conducted on a regular basis, and the office is necessary when there is no other place to perform such activities.

The Chamber opposed the OBRA 1993 provision which increased from 50 to 85 percent the portion of Social Security benefits subject to income tax. The Chamber supports the provisions that would repeal that increase.

In conclusion, the Chamber is anxious to work with this committee and the 104th Congress to develop a further agenda to help American businesses grow, create jobs and opportunities, and expand our economy while keeping America strong and competitive in the global marketplace.

To open this dialog, let me just name a few other tax areas that concern the Chamber community—the alternative minimum tax, environmental remediation expenditures, subchapter S reform, and the research and experimentation credit.

The Chamber looks forward to continuing to work with this committee and the entire Congress to achieve this goal.

Mr. Chairman, thank you for the opportunity to share with the Ways and Means Committee the views of the U.S. Chamber of Commerce.

This concludes my oral statement. I would be pleased to address any questions you might have.

[The prepared statement follows:]

STATEMENT
on the
CONTRACT WITH AMERICA
before the
HOUSE COMMITTEE ON WAYS AND MEANS
for the
U.S. Chamber of Commerce

by
William T. Sinclaire
January 24, 1995

Mr. Chairman and members of the Committee, good morning. I am William T. Sinclaire, Senior Tax Counsel and Director of Tax Policy for the U.S. Chamber of Commerce. The Chamber is the world's largest business federation, representing 215,000 businesses, 3,000 state and local chambers of commerce, 1,200 trade and professional associations, and 72 American Chambers of Commerce abroad.

The Chamber appreciates this opportunity to testify again before the House Ways and Means Committee. Twelve days ago, Carol L. Ball, Publisher and Chief Executive Officer of Ball Publishing Company, and a member of our Board, testified generally on the *Contract with America*; I am here today to focus on some of the tax-related aspects of the *Contract* -- capital gains, neutral cost recovery, the estate tax credit, small business expensing, the home office deduction, and the taxation of Social Security. I will also address a few other tax concerns of our members that relate to the overall intent of the *Contract* -- the alternative minimum tax, environmental remediation expenditures, Subchapter S reform, and the research and experimentation credit.

CAPITAL GAINS REFORM

The Chamber has long advocated the critical need to reduce the tax on capital gains and fully supports the proposed capital gains provisions included in the *Job Creation and Wage Enhancement Act of 1995* (the "Job Creation Act").

The current maximum tax rate on the net long-term capital gains of individuals is 28 percent and it is 35 percent for corporations. The rate for individuals is near its historic high, and the rate for corporations is the highest ever. This level of capital gains taxation discriminates against capital gains income, discourages venture capital formation, impedes job creation, and hinders America's international competitiveness.

The capital gains reform proposals would permit a 50 percent deduction for net long-term capital gains for all taxpayers. Lower capital gains tax rates would stimulate economic growth, promote technological innovation, and create employment opportunities.

Opponents of a capital gains rate reduction continually renew the myth that a capital gains tax rate reduction would only benefit the wealthy. This is untrue, and the myth must be nullified for it not only harms middle- and lower-income Americans, it also imperils our position in the world economy.

According to Treasury Department estimates, over 55 percent of the individual taxpayers reporting capital gains income in 1993 had adjusted gross incomes of $50,000 or less, and nearly 74 percent had adjusted gross incomes of $75,000 or less. In addition, it must be remembered that these income figures include the capital gains.

Perhaps the most unfair aspect of the current method of taxing capital gains is that much of the gain from the sale of a capital asset is often attributable to inflation. When capital gains are due entirely or in part to inflation, taxing the entire gain serves only to confiscate capital generated from past income -- income that has already been taxed at least once. However, the proposals would eliminate this unfairness by indexing the cost of capital assets for inflation.

Unlike a normal investment, if a taxpayer sells his principal residence at a loss, that loss can never be deducted from income -- even if there is a gain from the sale of a subsequent principal residence. The proposals would correct this anomaly by allowing the loss from a sale of a taxpayer's home to be deductible as any other capital loss.

NEUTRAL COST RECOVERY

A neutral cost recovery system is supported by the Chamber. The Internal Revenue Code (the "Code") currently does not permit businesses to recover the full economic equivalent of an investment in depreciable business property. The Code only allows businesses to recover the historical cost of their capital expenditures for business property and does not take into account inflation and the time value of money.

Inflation and time erode the full recovery of capital expenditures when historical costs are used without future adjustments for inflation and the true cost of money. The Chamber believes capital investments made by a business should be recovered using a depreciation system that provides for the use of the full present value of investments, thereby achieving the economic equivalent of expensing.

The proposal for neutral cost recovery in the Job Creation Act would allow depreciation deductions to be increased to approach the economic equivalent of expensing by accounting for inflation and the time value of money. The Chamber embraces this proposal.

SMALL BUSINESS INCENTIVES

Increase in Unified Estate and Gift Tax Credits

The Chamber supports estate and gift tax reform and strongly favors simplification and an overall reduction in the estate and gift tax burden on individuals and the owners of family businesses. The Chamber supports the unified estate and gift tax credit increase proposal in the Job Creation Act.

The current estate and gift tax system is punitive. It depletes savings and family businesses and effectively punishes capital accumulation and the hard work of a lifetime. Today's estate and gift tax structure can force a successful family business to liquidate or be over-burdened by debt incurred to pay estate taxes.

When a small business owner achieves a moderate level of success, attention must be diverted from the business to the development of an estate plan to help preserve what has been accomplished. With the estate and gift tax laws being very complicated, estate planning and administration can be very expensive. This diverts time, money, and energy that could be devoted to business expansion, economic growth, and job creation.

The current unified credit, which exempts from estate and gift taxes estates under $600,000, has not been indexed for inflation since it was fully phased-in in 1987. Increasing

the estate and gift tax exemption from $600,000 to $750,000, with indexing, would be a move in the right direction for the preservation of savings and family businesses. However, even the value of a small family business can exceed the $750,000 limit and, while the proposals would improve the situation, consideration should be given to having an even higher limit.

Increase in Expense Treatment for Small Businesses

Increasing the small-business expensing allowance would give businesses a greater incentive to purchase equipment and other tangible property. Assets which are purchased and not immediately expensed must be capitalized and depreciated over a number of years. Not only does this depreciation requirement extend the time period in which a small business can recover the cost of the original investment, it takes into account only an asset's historical cost, and forgets inflation and the time value of the money invested.

Currently, businesses can immediately expense up to $17,500 annually for equipment and certain other capital asset purchases. To the extent a taxpayer's total capital expenditures exceed $200,000 in a particular year, the amount of the deduction is reduced on a dollar-for-dollar basis.

The original House version of the Omnibus Budget Reconciliation Act of 1993 ("OBRA") proposed increasing the expensing allowance from $10,000 to $25,000. Nonetheless, the final version of OBRA provided for an annual limit of $17,500.

The Chamber supported the original House OBRA version, and now supports the proposal in the Job Creation Act to increase the small-business expensing allowance to $25,000. The Chamber believes that increasing the small-business expensing level to at least $25,000 would encourage small- and medium-sized firms to invest more of their resources in productivity-enhancing equipment.

However, in today's marketplace, $25,000 will not purchase very much equipment, even for a small business. Accordingly, the Chamber encourages consideration of raising the proposed $25,000 limit to an even higher level. Increasing the annual amount would spur economic growth and job creation even faster.

Clarification of Definition of Principal Place of Business

Until recently, to deduct home office expenses, a taxpayer had to establish that (a) the space in his home used for business purposes was devoted to the "sole and exclusive use" of the office, (b) he had no other office for his business, and (c) his business generated enough income to cover the deductions. Now, a taxpayer must additionally establish that (a) the customers of a home-based business physically visit the home office, and (b) the business revenue must be produced within the home office itself.

The proposal in the Job Creation Act would allow a home office deduction to an individual if his office is the location where essential administrative or management activities are conducted on a regular basis and the office is necessary because he has no other place to perform such activities. In addition, expenses allocable to the storage of product samples would also qualify as home office expenses.

Home offices are becoming more popular because they make sense for businesses, families, and individuals. The narrowing of the home office deduction ignored or tried to roll back fundamental changes taking place in the economy -- more telecommuting, more two-income families with one parent working out of the family home, more elderly and

disabled people working at home, more entrepreneurial people who start businesses operating from their homes to minimize costs, and the easing of traditional business hierarchies as more functions are contracted out.

The Chamber supports the proposal in the Job Creation Act that clarifies and expands the availability of the home office deduction.

REPEAL OF INCREASE IN TAX ON SOCIAL SECURITY BENEFITS

The Chamber opposed the OBRA provision which increased from 50 to 85 percent the portion of Social Security benefits subject to income tax. The Chamber believes that reducing the taxes of middle-income retirees is beneficial not only from a social standpoint, but an economic one as well for it would make available additional funds for injection into the economy. Additional spending would help with job creation and the expansion of American businesses.

The Chamber supports the *Senior Citizens' Equity Act* provision that repeals the increase in the portion of Social Security benefits subject to taxation.

BEYOND THE *CONTRACT WITH AMERICA*

Moving from the specific business provisions of the *Contract*, the Chamber is anxious to work with this Committee and the 104th Congress to develop a further agenda to help American businesses grow, create jobs and opportunities, and expand our economy, while keeping America strong and competitive in the global marketplace. This would include the alternative minimum tax, environmental remediation expenditures, Subchapter S reform, and the research and experimentation credit, among others.

THE ALTERNATIVE MINIMUM TAX

The Alternative Minimum Tax (AMT) was enacted in response to well-publicized cases of corporations with substantial income paying no income taxes. Since its enactment, the AMT has become the primary tax system for some of America's basic industries, including the steel, energy, paper, chemicals, mining, transportation, and building sectors.

AMT taxpayers are not allowed many of the investment incentives available to regular taxpayers, including the research and experimentation credit, targeted jobs credits, and other general business credits. Likewise, AMT companies are relegated to one of the worst cost recovery systems for depreciable assets in the industrialized world. The net effect is to discourage participation in some of the most capital-intensive industries and limiting the means for obtaining capital for needed investment in plants and equipment.

Fundamental AMT depreciation reform is critical to any tax policy initiative designed to increase investment since the AMT currently operates to recapture the investment incentive provided by the regular tax. The Chamber believes that there should be no difference between AMT and regular tax depreciation.

The Chamber advocates AMT reform because the incentives to invest in plant and equipment, which create jobs and improve productivity, should be equally available for all assets regardless of the current profitability of a particular company.

ENVIRONMENTAL REMEDIATION EXPENDITURES

The question of how to treat environmental remediation expenditures -- ordinary and necessary business expenses or capital expenditures -- is significant as American businesses are spending billions of dollars in site cleanup, complying with federal mandates, and making energy efficiency improvements.

Last June, the Internal Revenue Service (IRS) issued a revenue ruling recognizing that the costs incurred to clean up land and to treat groundwater contaminated with polychlorinated biphenyls (PCBs)are properly deductible as ordinary and necessary business expenses and do not have to be capitalized. While this ruling is commendable, and it adopted the premise advanced by the Chamber -- environmental cleanup costs are ordinary and necessary business expenses and not capital expenditures -- it is being narrowly construed by the IRS. The issue of whether cleanup costs are current expenses or capital expenditures is not limited to PCB-contaminated soil and groundwater -- it also arises in connection with asbestos, CFCs, lead, leaking storage tanks, and other carcinogens and hazardous materials.

With businesses showing a willingness to spend billions of dollars, the correct tax treatment established by the IRS ruling for PCBs must be extended to its logical conclusion for all contaminants. The Chamber urges finality of the issue with an extension of the IRS ruling that environmental cleanup costs, no matter what the contaminant is, are ordinary and necessary business expenses and not capital expenditures. A resolution of the issue will permit businesses to make an informed decision before committing substantial financial resources.

SUBCHAPTER S REFORM

Subchapter S was first enacted in 1958 to help remove tax considerations from the decisional process of a small businesses owner contemplating incorporation. This has proved quite helpful to small businesses over the years, especially to start-up businesses. Today, over 1.6 million American businesses are S Corporations; however, these businesses are still subject to provisions dating back to the Subchapter S enactment in 1958.

It goes without saying that times have change since 1958. Unfortunately, Subchapter S has not kept pace with the realities of modern business. Business and financial environments are far more complex and the 1950's Subchapter S rules have been outgrown. The Chamber believes Subchapter S needs an overhaul and one should be undertaken.

THE RESEARCH AND EXPERIMENTATION TAX CREDIT

The Research and Experimentation Tax Credit (R&E credit) is due to expire shortly. The Chamber believes it should be made permanent because it will benefit the economy in both the long and short term.

Permanency of the R&E credit is an issue that affects the entire business spectrum. Of all the companies that claimed an R&E credit in 1991, 36 percent had total assets under $1 million. However, the major amount of research and experimentation dollars is spent by large corporations.

The greatest opportunity America has to retain its edge in the world economy is through innovation and technological development and advancement. America must keep pace with its major trading partners and competitors -- Japan and Germany -- by encouraging research and development activities. The growth in research and development

spending in Japan is twice that of America, and in Germany, it is half again greater than ours. Both of these countries emphasize research and development through tax incentives.

Research and development cycles can last years, and high levels of research and experimentation must be performed continuously. The R&E credit must be permanent for there to be firm commitments for long-term projects. This, in turn, would benefit all Americans through the creation of jobs, an expansion of the economy, remaining internationally competitive, and raising the quality of life.

The R&E credit is a jobs-creation incentive, and the Chamber believes America needs a permanent R&E credit.

CONCLUSION

Tax policy plays a pivotal role in our economic environment. Sound tax policy can stimulate investment, foster new businesses, spur job growth, and encourage individuals to work harder and save more. However, bad tax policy can retard capital formation, hinder entrepreneurship, reduce job growth, and adversely impact the economy.

The *Contract* will play a key role in reducing the tax burden on Americans, however, sight should not be lost of the steps that need to follow for a comprehensive review of the federal tax laws. Members of this Committee, together with the other members of the 104th Congress, have the opportunity to reduce the tax burden on Americans, create jobs, and a build a vibrant economy. The Chamber looks forward to continuing to work with this Committee and the entire 104th Congress to achieve this goal.

Mr. Chairman, thank you for the opportuinty to share with the Ways and Means Committee the views of the U.S. Chamber of Commerce.. This concludes my statement. I would be pleased to address any questions you might have.

Chairman ARCHER. Thank you, Mr. Sinclaire.

Our next witness, Paul Huard with NAM. Mr. Huard.

STATEMENT OF PAUL R. HUARD, SENIOR VICE PRESIDENT, POLICY AND COMMUNICATIONS, NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. HUARD. Thank you, Mr. Chairman.

Chairman ARCHER. Let me say also at this time that at the conclusion of your testimony we are going to have to run over and answer this quorum call and subsequently vote, so the committee at the conclusion of your testimony will be in recess until we can get back.

Mr. HUARD. Thank you, Mr. Chairman.

It is a pleasure to be here on behalf of our more than 13,000 manufacturing members, 8,000 of whom are smaller firms with fewer than 500 employees. The panel is large and the hour is late so I will submit my full statement for the record and abbreviate my remarks.

I would like to address three areas.

Chairman ARCHER. Without objection, all of your statements will be inserted in full in the record.

Mr. HUARD. Thank you. I would like to limit my comments to the three areas we feel are most critical for the issue of savings and investment, and that is capital gains, individual retirement accounts, and capital cost recovery.

On capital gains, I will say only that we support both the reduction in the capital gains tax rate through the 50-percent exclusion as well as the inflation indexing for cost basis. We strongly urge you to go ahead and do it because it is good for the country, it is going to be good for the economy, and you ought to forget about class warfare and tax policy by distributional tables.

On IRAs, similarly, we support the Contract's provision to improve incentives for IRAs. We basically are supportive of any incentive which will do something to increase our scandalously low personal savings rate. In this particular case, it is also something we think is essential to take pressure off the Social Security system, which, frankly, has questionable long-term viability once the baby boomers start to retire.

Finally, on the issue of capital cost recovery, I think the neutral cost recovery system is a problematical issue. The back-end loading is troublesome, you know. There are a lot of businesses who can't spend present value, they have to rely on cash flow, and also you get the outyear revenue effects.

Those of us that were around when NCRS was put in in 1981 and promptly chiseled away at for the next 7 years have some doubts about the value of putting in something with large outyear revenue losses.

There is also the complexity issue. It might well be better in terms of improving the short-term picture for capital cost recovery to focus on either repealing or substantially curtailing the effect of the AMT and also dealing with the subchapter S issue. As you know, the subchapter S corporation that retains its earnings and reinvests them in capital equipment still has to pay an outrageous rate because you are taxed at the personal rate of the shareholders.

Finally, I would urge you once you complete your work on the Contract to treat it as a beginning and not think that the job is done and to look at the real need for comprehensive overhaul of the tax system that will truly make the system better and more friendly to savings and investment by eliminating all these levels of multiple taxation we have on savings and investment.

In that respect, I think any of the plans that are out there, whether it is Mr. Armey's plan, Senators Nunn and Domenici's plan, the Danforth-Boren plan are well worth looking at. As Mr. Bloomfield on the prior panel pointed out, they have many features in common and one of the most attractive ones is the expensing of capital equipment.

I yield back the balance of my time.

[The prepared statement follows:]

TESTIMONY ON SELECTED PROVISIONS OF THE "CONTRACT WITH AMERICA" DEALING WITH SAVINGS AND INVESTMENT

BY PAUL R. HUARD
SENIOR VICE PRESIDENT, POLICY AND COMMUNICATIONS
NATIONAL ASSOCIATION OF MANUFACTURERS

BEFORE THE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

JANUARY 24, 1995

The National Association of Manufacturers (NAM) is a voluntary business association of more than 13,000 firms, large and small, located in every state. Our members range in size from the very large to the more than 8,000 smaller members that have fewer than 500 employees. The NAM's member companies produce more than 80 percent of the nation's manufactured goods.

We appreciate this opportunity to testify on certain tax provisions included in the "Contract With America" intended to encourage greater savings and investment. We remind Committee members that most of our comments are directed to the provisions under Title II of the Contract titled "Job Creation and Wage Enhancement Act" because manufacturing jobs in general provide high wages along with good employee benefits, including health care coverage. We, too, are interested in tax laws that will effectively encourage greater savings and investment which in turn results in the creation of more high wage jobs.

Capital Gains Reform

The NAM supports the two-pronged reform of the tax treatment of capital gains by 1) excluding 50 percent of capital gains from taxable income and 2) indexing for inflation the cost basis of capital assets. This reform, which is applicable to both corporate and individual taxpayers, is long overdue and recognizes that tax proposals which will effectively stimulate economic growth, investment and job creation must be directed to all taxpayers regardless of income and economic status. In the case of indexing, this reform is essential to end the confiscatory taxation of illusory "gains" on long-held assets.

Neutral Cost Recovery System

The legislative goal of the Neutral Cost Recovery System (NCRS) proposal -- to improve the capital cost recovery for productivity-improving assets by providing deductions that are the "economic equivalent" of expensing -- is commendable, as is the congressional recognition that such change is needed. The NAM has long advocated immediate deductibility of capital expenditures; however, the goal of expensing should not be limited only to regular taxpayers. Firms subject to the corporate alternative minimum tax (AMT) will still incur a significant tax penalty on investment under the NCRS because the current law AMT recovery period is, in most cases, about twice as long as the regular tax recovery period. Thus, the economic equivalent of expensing will never be achieved under the NCRS by AMT payers and the current negative effects of the AMT, i.e., disincentives for job creation and investment, will continue.

AMT payers currently rank as having one of the worst capital cost recovery systems among industrialized nations despite repeal of the adjusted current earnings (ACE) depreciation adjustment in 1993. The depth of the AMT problem is widespread and affects

many industries, including the manufacturers of chemicals, electronic equipment, energy, metal, paper and steel, as well as transportation-related businesses. In fact, many firms are still paying the AMT today despite an improved economy because of investments they made during the last recession.

Thus, the NAM urges this Committee to consider rectifying current tax code impediments for investment by reforming the corporate alternative minimum tax (AMT). One specific recommendation advanced by President Clinton in February 1993 and advocated by the NAM would be to conform AMT recovery periods with regular tax recovery periods. This recommendation would substantially reduce the cost of capital for AMT payers with basic manufacturing assets and negate the current tax code inequity between companies in the same industry which make the same investments yet have considerably different recovery costs for those similar investments based on the profitability of the companies. Due to the perverse effects of the AMT, the less profitable company often has the higher tax liability.

The NAM would be pleased to work with this Committee in drafting changes to mitigate current tax code penalties on capital investment so as to encourage investment and job creation for both AMT and regular taxpayers. In the long run, of course, the best solution has always been and will continue to be outright repeal of the AMT.

One additional concern about the NCRS worth mentioning is whether the goal of the "economic equivalent of expensing" will actually be achieved given the relative instability of the tax law. If history is any indication, the probabilities for future repeal or limitation of this proposal are high.

I might also note that adding yet another depreciation system will do nothing to alleviate the already byzantine level of complexity faced by business taxpayers making capital investments. Because of this -- and because many businesses survive on their cash flow and would be unable to "spend" the present value of a stream of future NCRS deductions -- an attractive alternative might be a substantial increase in the expensing limit that would be available to businesses of all sizes.

Small Business Provisions

Small businesses have always been an engine of job growth. Two provisions in the "Contract" that would stimulate increased job growth among small businesses are the

1) proposal to increase the amount of capital investment that may be expensed from the current level of $17,500 to $25,000, and 2) the proposal to phase in an increase of the estate and gift tax exemption from the current level of $600,000 to $750,000 with indexation thereafter of the exemption limit. While supporting these proposals, the NAM urges you to address the following problems as part of your approach to dealing with small businesses:

First, no relief is provided from the excessively high rates of tax paid by shareholders of an S-Corporation on income that is retained and reinvested in the business.

Secondly, the relatively low gift tax exemption still leaves the heirs of family businesses with estate tax bills that could force the sale of these family firms. This is one of the primary reasons why it is so difficult and so unusual for family businesses to survive into the second and third generations.

Lastly, the expensing provision is structured in such a way that the increased amount is irrelevant for a small to medium-sized, capital-intensive manufacturer. The expensing provision is reduced dollar-for-dollar when capital expenditures exceed $200,000 -- an absurdly low amount when the cost of even the smallest machine in many industries starts at that level. At many small to medium-sized companies, capital expenditures -- even in a low year -- exceed this $200,000 threshold, so they are never able to take advantage of the

expensing provision and it provides no incentive for additional investment. Furthermore, automobiles and trucks may not be expensed under current law. For small businesses of all types, vehicles are critically important and we believe they should fall under the expensing provision.

Expanded IRA Incentives

The NAM has consistently supported changes that would encourage individuals to put more money in individual retirement accounts (IRAs). Additional IRA savings expand the pool of job-creating investment capital and help relieve pressures on the Social Security system, whose long-term viability is extremely questionable.

Tax Reform

The "Contract With America" does not address the issue of overhauling the entire U.S. tax code. Yet compliance and administrative costs associated with our ridiculously complex tax laws exceed tens of billions of dollars annually. And the anti-growth, anti-savings, anti-competitive bias of the present system hurts both domestic and multinational companies in the U.S. The NAM urges that this Committee -- as soon as it completes its work on the Contract -- begin the debate on the long-term goal of tax system overhaul. Major goals of reform of the current tax system should include moderate tax rates at all points in the system; simplicity; stability; elimination of anti-savings biases; proper integration of the corporate and individual tax systems; and greater compatibility with other countries' tax systems so as to improve international competitiveness of U.S.-based taxpayers.

This concludes my prepared testimony, Mr. Chairman. We would be pleased at this time to address any questions you or other members of the Committee might have.

Chairman ARCHER. Thank you, Mr. Huard.

The committee will recess for this vote. We will be back. Thank you for your patience.

[Brief Recess.]

Mr. HERGER [presiding]. The committee will resume, and our speakers will take their seats, please.

Mr. Kleckner.

STATEMENT OF DEAN R. KLECKNER, PRESIDENT, AMERICAN FARM BUREAU FEDERATION

Mr. KLECKNER. Thank you, Mr. Chairman.

I am Dean Kleckner. I am president of the American Farm Bureau Federation. I am a hog, corn, soybean farmer from Rudd, north central Iowa.

I appreciate the opportunity to comment on tax issues important to our 4.4 million member families in the Farm Bureau. The Contract With America contains many good tax reform proposals supported by the Farm Bureau. We urge the committee to view these proposals as a start of a series of tax changes that will improve the economic well-being of our Nation's farmers and ranchers.

In the area of capital gains, the maximum tax rate for real capital gains should be 15 percent, and capital gains should be indexed for inflation. The proposals to provide a 50-percent exclusion and indexing for future price level changes are a substantial improvement over current law.

The capital gains tax creates a disincentive for farmers to upgrade their farming operations because taxes must be paid on assets that are sold to finance improvements. The unimproved farm businesses are less profitable and are uninviting to young farmers contemplating a career in agriculture. Many older farmers and ranchers who would like to transfer assets for retirement income are discouraged by the high taxes on inflationary gains and asset values. This delay in sale of farm assets is a hindrance to young farmers trying to obtain land and equipment necessary to begin a farming operation.

Mr. Chairman, I have had a number of farmers in many States tell me they are just waiting, hopefully for the rate to drop, so they can transfer or sell. They want to do that but they can't afford the current rate.

Many farm commodities like timber, Christmas trees, breeding livestock, dairy cows and equine have extended production cycles and therefore qualify for capital gains tax treatment.

Taxing capital gains on slow maturing commodities, like I mentioned, at ordinary rates reduces the profitability of these operations and fails to compensate producers for risk.

In the estate tax area, that exemption should be increased to $2 million, and indexed for inflation. The $750,000 limit to the adjustment in value that can be made when farmland is valued at its actual use rather than its highest and best use should be eliminated.

The unified tax credit and use value allowance no longer allow many family farm businesses to pass from one generation to the next. When farm business assets must be sold to pay estate taxes, the economic viability of an operation can be destroyed and family members forced to abandon the farm.

Removing the $750,000 limit on the allowable adjustment for use valuation is especially important in areas of the country that are becoming increasingly urban. If this cap cannot be eliminated, it should, at the very least, be increased and indexed for inflation.

Health insurance is an issue that is not addressed in the Contract With America, but it is of extreme importance to farmers, and that is the deductibility of health insurance premiums. A tax deduction for the cost of insurance premiums will go a long way to help farmers and ranchers provide for their own health insurance needs.

There is urgency in reinstating the 25-percent deduction for health insurance premiums paid by the self-employed before farmers file their 1994 tax returns. I might point out, Mr. Chairman, that for a great many farmers that file, that date is March 1, not April 15, so there is even more urgency than you might have thought.

In addition, we think there should be a permanent 100-percent deduction for health insurance premiums paid by the self-employed individuals.

On related farm business tax issues, we support accelerated depreciation; investment depreciation should equal the full value of original investments; and the amount of investment in equipment inventory that can be expensed each year should be increased.

One key item not currently under consideration is the tax treatment of disaster payments. Farmers and ranchers should be able to count income from forced livestock sales and disaster payments in the year that they would normally have occurred so that taxes paid are a fair and true reflection of normal farm income.

In conclusion, but before closing I would like to just mention a tax issue that is threatening the future of agricultural organizations, including the Farm Bureau. The IRS is attempting to tax the dues of Farm Bureau's associate members as unrelated business income. This is misguided, unprecedented, and a reversal of longstanding policy. We urge you to examine the issue and pass correcting legislation.

Mr. Chairman and the committee, thank you for the opportunity to present these ideas.

[The prepared statement follows:]

STATEMENT OF THE AMERICAN FARM BUREAU FEDERATION
TO THE HOUSE WAYS AND MEANS COMMITTEE
ON TAX PROVISIONS OF THE "CONTRACT WITH AMERICA"

PRESENTED BY DEAN R. KLECKNER
PRESIDENT OF THE AMERICAN FARM BUREAU FEDERATION
JANUARY 24, 1995

Good day. I am Dean Kleckner, President of the American Farm Bureau Federation and a hog, corn, and soybean farmer from Rudd, Iowa. Farm Bureau is the nation's largest general farm organization with a membership of 4.4 million member families in 50 states and Puerto Rico. Farm Bureau members produce virtually every commodity grown commercially in this country. Our policy is developed by producer members at the county, state and national levels of our organization. I appreciate the opportunity to comment on tax issues important to our member families.

Farm Bureau applauds the efforts of this committee to hold hearings and move forward with tax legislation early in the 104th Congress. Making tax policy more farmer-friendly has been on the top of Farm Bureau's agenda for many years. The "Contract with America" contains many good tax reform proposals which are important to farmers and supported by Farm Bureau. We urge the committee to view these proposals as the start of a series of tax changes that will improve the economic well-being of our nation's farmers and ranchers.

Federal tax policy must give all citizens, including farm and ranch families, more opportunity to keep their own money and create their own personal financial safety net rather than rely on government programs. For farm families to be financially secure, tax policy must create a business climate where well managed farms can produce profits. Then, tax policy must allow farmers to keep more of their income so they can save for future financial security.

Capital Gains

Farm Bureau supports setting the maximum tax rate for real capital gains at 15 percent and indexing capital gains for inflation. Proposals to provide a 50 percent exclusion and indexing for future price level changes are a substantial improvement over current law.

Farming and ranching are extremely capital intensive businesses. Farmers hold land an average of 28.6 years; over this period, the value of total farm real estate in the United States has increased 4.27 times. Much of this increase in value has been due to nothing more than inflation. Farm Bureau believes that taxes on capital gains should be assessed only on the real increases in the value of property and not on nominal gains caused by inflation.

In most instances, the capital gains tax is not a tax on income, but rather a tax on transferring capital from one asset to another. The tax creates a disincentive for farmers to upgrade farm operations because capital gains tax must be paid on land and other farm assets sold to finance improvements. Unimproved farm businesses are less profitable and are uninviting to young farmers contemplating a career in agriculture.

Many older farmers and ranchers who would like to transfer land and other capital property to some other assets for retirement income are prevented by the high taxes on inflationary gains in asset values. This delay in the sale of farm assets is a hindrance to young farmers trying to obtain land and equipment necessary to begin a farming operation.

Many farm commodities, such as timber, Christmas trees, breeding livestock, dairy cows and equine, have extended production cycles. These extended production cycles merit capital gains tax treatment of income when the commodities are marketed. Taxing capital

gains on slow-maturing commodities at ordinary rates reduces the profitability of these operations.

Estate Taxes

Farm Bureau supports increasing the estate tax exemption from $600,000 to $2 million and indexing the exemption for inflation. We also support elimination of the $750,000 limit to the adjustment in value that can by made when farmland is valued at its actual use rather than its highest and best use under Section 2032A.

Farming in this country is both a way of life and a business. Perhaps like no other family business, today's farmers and ranchers owe a great deal to the generations who farmed before them. Most learned how to farm from their parents and most started their careers in production agriculture using assets provided by the previous generation.

Estate tax laws that govern the transfer of farm family business assets from one generation to the next were last updated in 1981. Due to gradual inflation and pressure from land development, the current $192,800 unified tax credit and allowance for farm use valuation are no longer sufficient to allow many family farm businesses to pass from one generation to the next. Because more and more farms have assets exceeding the $600,000 exemption, heirs are forced to sell land, equipment and/or buildings to pay estate taxes. When the portion of farm business assets that must be sold is too great, the economic viability of the operation is destroyed and family members are forced to abandon the farm.

Removing the limit on the allowable adjustment for use valuation is especially important in areas of the country that are becoming increasingly urban. Land values for development in these areas are much higher than for agricultural use rendering the $750,000 cap ineffective in preserving farmland. If this cap cannot be eliminated it should, at the very least, be increased and indexed for inflation.

Health Insurance Deduction

An item not addressed in the "Contract with America" but of extreme importance to farmers is the deductibility of health insurance premiums. Farm Bureau must stress the urgency of reinstating the 25 percent deduction for health insurance premiums paid by the self-employed before farmers file their 1994 tax returns. In addition, Farm Bureau supports a permanent 100 percent deduction for health insurance premiums paid by self-employed individuals.

It is difficult to understand why, during the recent debate about health care, this provision to make health insurance more affordable has not been expanded to 100 percent and made permanent. High health insurance costs are particularly troublesome in farming and ranching because it is a hazardous occupation. High risk translates into high insurance premiums, and many farmers are reducing their coverage or dropping it entirely because they cannot afford it. A tax deduction for the cost of insurance premiums will go a long way to help farmers and ranchers provide for their own insurance needs.

Individual Retirement Accounts

Farm Bureau supports changes in individual retirement accounts (IRAs) to expand their use for saving for education, for the purchase and upgrade of primary residences, and for medical illness. Tax changes to reinstate IRAs, to allow non-employed spouses to participate, and to expand the uses for saved funds will be good for farm and ranch families of all ages and are supported by Farm Bureau.

Farm and ranch income can vary greatly from year to year. When farmers and ranchers have good income years, their incomes are heavily taxed as well as their earnings on

savings. Proposed changes in IRA rules will allow them to save more money and allow them to retain more of the income from savings. In addition, increasing the variety of uses for savings will give farmers more control of their financial future.

While farmers and ranchers understand the importance of saving for retirement, business capital needs frequently supersede retirement savings. To many farmers, investing in farm assets that can be productive now and sold in the future to finance retirement makes sound business and personal sense.

As mentioned before, farm income can vary greatly from year to year. IRA rules place limits on the amount of funds that can be invested each year. During tough financial years, farmers and ranchers may not have money to invest. Yet in years when they show a profit and could invest, the amount of retirement savings they can shelter from taxes is limited.

Farm Bureau supports allowing farmers and ranchers, in preparation for retirement, to invest proceeds from the sale of property and machinery into a special retirement account on which taxes would be due at the time of withdrawal. Using an IRA, farmers and ranchers could defer capital gains on the sale of qualified farm assets until the money was withdrawn from the special account.

Farm Business Tax Issues

Farm Bureau supports accelerated depreciation. Proposals to increase the value of investment depreciation to equal the full value of original investments and to increase the amount of investment in equipment and inventory that can be expensed each year would help farmers and ranchers and is supported by Farm Bureau. Depreciation rules keep becoming more complex and have less and less relationship to actual investment decisions on farms and ranches. Simplification is long overdue.

One key item not currently under consideration that is very important to farmers is the tax treatment of disaster payments. Farm Bureau supports allowing farmers and ranchers to count income from livestock sales and disaster payments in the year that they would normally have occurred so that taxes paid are fair and a true reflection of normal farm income.

Weather is a factor that can't be controlled or even accurately predicted. In years of natural disasters, farm income from the sale of crops may be severely reduced or even eliminated. Livestock producers who face multiplied feed costs may be forced to sell animals prematurely. In addition to problems caused by reduced income, irregular and unexpected cash flows make farm financial planning very difficult.

Fortunately, the federal government provides disaster assistance to farmers and ranchers in these times of need. Unfortunately, disaster assistance payments and income from forced livestock sales are usually received in a different tax year. Receiving extra income in a single year increases taxes paid by farmers and ranchers who are already financially handicapped by natural disaster and negates the benefits of disaster assistance.

Farm Bureau supports legislation to allow farmers and ranchers who are forced by disaster to sell livestock early to include sale proceeds in the following year if that is when the sale would have normally occurred. In addition, farmers and ranchers should be able to count disaster payments in disaster years regardless of when the aid is actually received if that is when income from crop sales would normally have occurred. The measure should be retroactive to sales after December 31, 1992, to include victims of the 1993 midwestern flood.

There is some precedent for allowing farmers to report disaster payments as income in a year other than the one in which the disaster payments were received. Currently farmers are allowed to report insurance payments, such as hail insurance, in either the year in which the insurance payment was received or the year in which the commodity would have been marketed.

Farm Family Tax Issues

Farm Bureau supports the creation of a per child tax credit and elimination of the marriage penalty. In addition, we believe there should be an increase in the personal exemption for income tax purposes.

The failure of the personal exemption to fully keep up with inflation and with growth of personal incomes has forced a rapid rise in the income tax load for young farmers and ranchers. The increased taxes for married couples has reduced the value of earnings from spouses who work off the farm. While these tax changes would benefit all farmers and ranchers, they would most benefit young farmers and ranchers who are raising families while also trying to build a farm business enterprise.

Conclusion

Before closing, I would like to mention a tax issue threatening the future of agriculture organizations including Farm Bureau. The Internal Revenue Service (IRS) is attempting to tax the dues of Farm Bureau's associate members as unrelated business income. This is misguided, unprecedented, and a reversal of long standing policy.

Tax policy and the resulting rules and regulations are critical to our members. Policies that are fair and equitable promote both the economic well-being of farmers and our nation's food supply. Our tax system must provide incentives for citizens to pay their fair share of their respective tax liabilities and encourage all citizens to create personal financial safety nets. Provision of the "Contract with America" and other ideas discussed in our statement will benefit farmers and ranchers and our economy. We urge you to adopt these changes. We urge the Ways and Means Committee to examine the issue and pass correcting legislation.

Thank for the opportunity to present these ideas today.

Mr. HERGER. Thank you very much for your testimony, Mr. Kleckner.

Mr. Atkinson will testify.

STATEMENT OF TERRY L. ATKINSON, CHAIRMAN, MUNICIPAL SECURITIES DIVISION, PUBLIC SECURITIES ASSOCIATION; AND MANAGING DIRECTOR AND HEAD OF THE MUNICIPAL SECURITIES GROUP, PAINEWEBBER, INC.

Mr. ATKINSON. Thank you, Mr. Chairman, and members of the committee, good afternoon.

I am Terry Atkinson. I am a managing director and head of the municipal securities group at PaineWebber. I am also chairman of the municipal securities division of the Public Securities Association, and it is in that capacity that I appear here today. I am pleased to be here to represent PSA's views on the capital gains provisions of H.R. 9.

I think, as most of you know, PSA represents nearly all banks and securities firms which deal in municipal and other public securities. Consequently, we take an active interest in issues related to capital formation, savings, and investments. We are encouraged by the considerable attention being paid to these issues of late, and we commend this committee for calling the series of hearings.

I would like to focus this afternoon on PSA's views on two of the capital gains provisions contained in title I of H.R. 9, and also on the need to restore capital gains tax treatment for municipal bonds purchased at a market discount.

Savings and investment are essential for the sustained gains in productivity, standards of living, and economic growth. PSA generally supports responsible proposals to encourage capital investment and savings. In that regard, we fully support the two provisions of H.R. 9 which would effectively reduce the tax rate on such gains and would allow taxpayers to index capital gains for inflation. These two provisions would create powerful incentives for families to save and invest. The result would be a stronger, more productive, and more competitive economy.

I would now like to turn to an issue also closely linked to savings and investment: The tax treatment of market discount on tax-exempt municipal securities. Market discount occurs when bonds trade at prices below face value, usually as a result of increasing interest rates. This is admittedly a complex and arcane issue. The provision in OBRA 1993 which amended the treatment of municipal market discount from capital gain to ordinary income has resulted in a less stable, less liquid market. It has also resulted in tax rules which are complicated and difficult to apply, even for professional tax practitioners.

Let me outline a few of the effects the provisions have had on the municipal market.

First, the liquidity of the market has been negatively affected. Some investors, especially mutual funds and bank common trust funds, have refused to buy market discount bonds altogether. This problem is especially acute in today's market where, as a result of higher interest rates, there are large numbers of discounted bonds being traded.

Second, pricing of discounted bonds has become more volatile, inefficient, and misunderstood. Peculiar interactions between discounted bonds and bonds trading at or above face value occur regularly. As a result, sellers get significantly lower prices for their investments than they should, and buyers face prices that are difficult to understand and evaluate.

Third, higher secondary municipal market yields will ultimately lead to higher costs for States and localities in issuing securities in the primary market to pay for much-needed public infrastructure investment. The ability of States and localities to raise capital for public investment depends on a stable and liquid secondary market for their securities. Since the adoption of new market discount rules, the market has become more volatile and less liquid.

Last, the new rules are not accompanied by any significant economic gain for the Federal Government. Whatever revenue is realized by the Treasury will not come until far into the future. The market effects, however, are immediate.

In short, because they negatively affect municipal securities issuers and investors, the new rules for municipal market discount are a disincentive to savings and investment. They offer little economic benefit and do not effectively address any public policy concerns.

We strongly support the capital gains provisions in H.R. 9. However, we also urge the committee to address a tax provision that is harmful to savings and investment: Restore capital gains treatment for market discount on municipal bonds. Congressman Cardin introduced legislation in the last Congress designed to address this issue, and we urge the adoption of a similar provision as an amendment to H.R. 9.

Thank you for the opportunity to present our views. I look forward to answering your questions.

[The prepared statement follows:]

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PSA

Statement of Terry L. Atkinson, Chairman Municipal Securities Division Public Securities Association

before the House Committee on Ways and Means

January 24, 1995

Thank you, Chairman Archer, and good morning. I am Terry Atkinson, and I am a managing director and manager of the municipal securities group at PaineWebber, Inc. I am also Chairman of the Municipal Securities Division of the Public Securities Association (PSA). I am pleased to be here this morning to present PSA's views on the capital gains provisions of H.R. 9, the Job Creation and Wage Enhancement Act of 1995.

PSA represents banks and securities firms which deal in municipal securities, U.S. government and federal agency securities, mortgage- and other asset-backed securities and money market instruments. Consequently, we take an active interest in issues related to capital formation, savings and investment. We are encouraged by the considerable attention being paid to these issues of late, and we commend Chairman Archer for calling this series of hearings.

My statement this morning will focus on PSA's views on two of the capital gains provisions contained in the Contract with America and in Title I of H.R. 9, a 50-percent capital gains deduction and a provision to index the application of the tax on capital gains to the inflation rate. I would also like to discuss the need to restore capital gains tax treatment for municipal bonds purchased at a market discount.

The Public Securities Markets and Capital Gains

One of the most unique aspects of the markets represented by PSA is that they exist primarily to serve public policy goals. The municipal bond market exists to provide financing for state and local investment in infrastructure and other productive assets. The government and federal agency securities markets provide capital and liquidity for securities issued by the U.S. Treasury and U.S. government agencies. These markets reduce the costs to American taxpayers of funding the federal budget deficit and also finance other government investment. The mortgage-backed securities market helps provide financing for home ownership. By bringing together investors and public sector borrowers, these markets together provide hundreds of billions of dollars in financing each year for investment which is vital to the nation's continued economic strength.

Savings and investment are essential for sustained gains in productivity, standards of living and economic growth. PSA generally supports responsible proposals to encourage capital investment and savings. In that regard, we fully support the two provisions in H.R. 9 which would provide for a 50-percent deduction of realized capital gains — thereby reducing the effective tax rate for such gains — and would allow taxpayers to account for inflation in calculating capital gains subject to taxation (Sections 1001 and 1002 of the bill). Reducing the

tax rate on capital gains and indexing gains for inflation would create powerful incentives for families to save and invest. The result would be a stronger, more productive and more competitive economy.

Capital Gains and Market Discount

An issue closely related to capital gains reform involves the taxation of securities purchased on the secondary market at a discount, securities aptly referred to as "market discount bonds." The budget reconciliation legislation enacted into law in 1993 (OBRA '93) contained a provision that amended the tax treatment of municipal securities purchased at a market discount. The law causes financial gain from the sale of these instruments to be taxed as ordinary income rather than as capital gain. The new market discount rules have had a harmful effect on secondary market liquidity for municipal securities, are overly complex and burdensome to apply, and will eventually increase borrowing costs for state and local government issuers of municipal bonds. Since the principal goal of H.R. 9 is to increase investment by decreasing the taxation of capital gains, restoring the lower, pre-1993 tax rates on gains from the sale of market discount bonds would be entirely consistent with the bill. Such a change would decrease the tax burden on an important investment tool and restore lost market liquidity.

The consequences of the change in tax treatment of market discount to trading and pricing of municipal securities have been enormous. The tax principles involved are technical and complex. The issues surrounding the new treatment of market discount are often misunderstood by professional tax analysts and practitioners, to say nothing of individual investors.

Market Discount and Liquidity

Market discount exists when a bond is purchased in the secondary market at a price below par, or face value. Market discount is the difference between the purchase price of a bond and its stated redemption price at maturity.[1] In most cases, market discount exists because yields have increased since bonds were originally issued. For fixed income securities like municipal bonds, when yields rise, prices fall, resulting in bonds that trade below face value. A *de minimis* rule exists so that if the amount of market discount is small — an amount less than 0.25 percent of the face value of a bond times the number of years between the bond's acquisition and its maturity — the discount is taxed as under previous law.

Before the enactment of OBRA '93, accreted market discount on municipal bonds was taxed as capital gain at the time the bond was sold, redeemed or otherwise disposed of. Under the new law, accreted market discount is still taxed at the time a bond is sold or redeemed. However, accreted market discount is now being taxed as ordinary income, not as a capital gain. The pre-OBRA '93 exemption from the market discount rules for municipal securities was important for one principal reason. Because the interest earned on municipal securities is generally exempt from federal taxation, many municipal bond investors avoid bonds with an element of ordinary, taxable income. The exemption from market discount rules for municipal securities tended to broaden the investor base for state and local bonds, thereby maintaining the liquidity of the market.

For example, suppose an investor buys a tax-exempt bond in the secondary market at a price of 90[2] with ten years left until maturity. (Assume the bond was originally issued at par, or face value — a price of 100.) Five years later, he or she sells the bond at a price of 95. The investor must treat the five-point gain as ordinary income in the year the bond is sold. (Total market discount at the time the bond is purchased is ten points, which must be accreted on a straight-line basis over the ten years until maturity. After five years, accreted market discount totals five points.) Suppose, under the same circumstances, that the investor holds the bond to maturity. Ten points (the entire amount of market discount) are taxed as ordinary income in the year the bond is redeemed.

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[1] In the case of a bond sold at original issue discount, such as a zero-coupon bond, market discount is the difference between a bond's adjusted issue price and its stated redemption price.

[2] Municipal bond prices are quoted here in points, or percentage of face value. A $1,000 bond trading at a price of 90 sells for $900.

These examples highlight the simplest scenarios. In reality, most calculations of market discount are much more complex. If, for example, an investor buys a bond with original issue discount (OID) and then sells the bond prior to maturity, he or she could realize income as tax-exempt interest, tax-exempt OID, capital gain or loss, and market discount taxable as ordinary income, all from a single transaction. The calculations required to distinguish from among these four types of income are complicated and burdensome. The chances of anyone — even professional tax practitioners — correctly calculating their tax liability in such a circumstance are minimal. Although it surely was not the intent of the drafters, the market discount provisions contained in OBRA '93 have resulted in rules that are extremely difficult, and for some nearly impossible, to comply with. The new tax treatment for market discount has also resulted in unpredictable and volatile pricing for discounted municipal bonds.

Market Discount and Volatility

Since the new market discount rules took effect, a two-tier secondary market has existed for municipal securities. One tier consists of bonds where market discount is treated as ordinary income (market discount bonds) and the other of securities where there is no discount or where *de minimis* discount is taxed as capital gain. The interaction between these two segments of the municipal market regularly results in inconsistent, inefficient and misunderstood pricing of discounted municipal bonds on the secondary market. Indeed, discounted municipal bonds can trade at yields of 20 basis points (0.2 percentage point) or more above comparable municipal securities selling at or above face value. In mid-1993, market interest rates were at historical lows. Very few municipal bonds were traded at a discount, and the effects of the new tax treatment were not widely felt. Although PSA strenuously opposed the new treatment of market discount during deliberations over OBRA '93, as a result of market conditions at the time, the municipal finance community failed to focus on the problems generated by the provision. The effects of the change in tax status have been magnified by a drastically different bond market which has emerged over the past year. As a result of changing economic expectations among investors and actions taken by the Federal Reserve, interest rates have increased considerably since the enactment of OBRA '93, resulting in many more bonds trading at discounts. The market effects of the provision are now severe.

As a result of their new tax status, the market for discounted municipal bonds has become significantly less liquid — there are fewer investors, and discounted bonds offered for sale are priced less aggressively. Many tax-exempt bond mutual funds and bank common trust funds have stopped buying discounted bonds altogether, citing specific restrictions against earning ordinary, taxable income or an unwillingness to report taxable income to fund investors. Other investors, especially retail investors, avoid market discount bonds because of the complexity of calculating the amount of discount subject to taxation. In practice, market discount municipal bonds are priced based on an after-tax yield assuming the investor is in the highest marginal tax bracket of 39.6 percent. However, investors do not actually incur a tax liability from market discount until bonds are redeemed, and this often occurs when the bonds mature many years into the future. In many cases, especially when bonds serve as retirement savings, the investor by then is in a lower marginal tax bracket.

In addition, under the new rule, investors can no longer offset gains attributable to market discount bonds with capital losses on other investments. The worst circumstance for a tax-exempt mutual fund, for example, would occur in a year where the market performed poorly and the fund's overall performance was negative. In previous years, any market discount realized by the fund during the year would be offset by capital losses. However, under current law, that fund's shareholders may be subject to ordinary income tax on market discount in a year when the fund actually had an overall negative return. Such a circumstance has a chilling effect on investors in tax-exempt funds, and tends to discourage investment in municipal bonds.

The effects of the new tax treatment for market discount were exacerbated by market conditions in 1994. Historically steep increases in interest rates caused bond prices to fall precipitously throughout the year. As prices of municipal securities fell below face value, secondary market investors began demanding even higher yields to compensate them for the higher rate of taxation of market discount, causing prices to fall even further. Falling bond prices caused many mutual fund investors to exit the market, forcing funds to sell bonds at discounts in order to "cash out" shareholders. Selling by funds resulted in even more market discount bonds in the market for

which the few buyers that remained demanded even higher yields to compensate for the new tax treatment. The market discount rules helped perpetuate market conditions where sellers got significantly lower prices for their investments than they should have, and where buyers faced prices that were difficult to understand and evaluate.

These higher secondary market yields now demanded by buyers of market discount bonds will ultimately lead to higher costs for states and localities in issuing securities in the primary market to pay for much-needed public infrastructure investment. The ability of states and localities to raise capital for public investment depends on a stable and liquid secondary market for their securities. Since the adoption of new market discount rules for municipal securities, the market has become more volatile and less liquid.

The added capital costs for states and localities that will result from the new market discount rules are not accompanied by economic gain for the federal government. Although the new policy was designed to prevent high-income individuals from converting ordinary income into capital gains, no evidence exists that such behavior has ever, or would ever, be widespread in the municipal secondary market. Therefore, the savings to the federal treasury are negligible. Whatever revenue is generated will not be realized until far into the future when market discount bonds are sold or redeemed. The negative effects on the marketplace, however, are immediate.

Summary

The tests of a well-constructed tax law are that it is equitable and easy to apply, that it achieves a policy goal and that its benefits exceed its costs. PSA believes that the capital gains provisions contained in H.R. 9 meet these tests. The goal of the capital gains provisions in H.R. 9 is to encourage savings and investment in order to strengthen the economy. PSA believes that savings and investment are vital to growth, productivity and our standard of living, and for this reason, we support the provisions of H.R. 9 providing for a 50-percent deduction of capital gains and indexing gains for inflation.

The new market discount rules for municipal securities meet none of the tests of a good tax law. It is not equitable: sellers of municipal securities are unnecessarily hurt by inefficient pricing. It is not easy to apply: the calculations required to comply with the new rules are needlessly complex and difficult to understand. It does not achieve a policy goal: investors do not come to the municipal market as a means of converting ordinary income to capital gain. Its benefits do not exceed its costs: the federal Treasury will realize little revenue from the provision, and municipal bond investors and state and local borrowers are being harmed.

The current treatment of market discount is a disincentive to savings and investment. The new market discount rules have resulted in a more volatile and less liquid municipal securities market and will eventually hamper the ability of states and localities to undertake new investment by increasing their cost of capital. Addressing problems raised by the new treatment of market discount for municipal securities is consistent with the goals of H.R. 9. A bill introduced in the 103rd Congress with bipartisan cosponsorship by Congressman Ben Cardin, H.R. 4714, would have repealed the new the new treatment of market discount on municipal securities. We urge the Committee during its deliberations on H.R. 9 to adopt a similar provision to tax market discount as capital gain, rather than as ordinary income.

I appreciate the opportunity to present PSA's views, and I look forward to working with this Committee as the debate over H.R. 9 continues.

Mr. HERGER. Thank you very much.

Mr. Auerbach, please.

STATEMENT OF ALAN J. AUERBACH, ROBERT D. BURCH PROFESSOR OF TAX POLICY AND PUBLIC FINANCE, DEPARTMENT OF ECONOMICS, UNIVERSITY OF CALIFORNIA, BERKELEY

Mr. AUERBACH. Thank you very much, Mr. Chairman.

Let me just say because I am on a panel with others representing different constituencies that I am here testifying on my own behalf.

I am director of the Burch Center for Tax Policy and Public Finance at the University of California. I am an economist and I have studied and testified before this committee on issues of capital formation and the budget many times in the past. My discussion today and my written testimony will be limited to two sets of provisions in titles I and II of H.R. 9 dealing with the indexation and exclusion for capital gains and the NCRS provisions for capital recovery.

Let me begin by summarizing my conclusions.

The combination of the capital gains exclusion of 50 percent and indexing would, for typical assets, easily lead to the equivalent of greater than 60-percent exclusion of gains without indexing. You may recall that in 1978 one of the reasons for increasing the exclusion for capital gains to 60 percent was inflation. If we were ever to go back to the unfortunate inflation rates of the late seventies and early eighties, the combined effect of the 50-percent exclusion and indexing would actually be far greater than 60 percent. So in that sense this would be establishing more generous treatment for capital gains than in the period from 1978 to 1986.

Second, the capital gains reform would cost the Treasury tax revenue in the long run. There are differences in measurement and opinion about the short run. On the basis of the professional evidence, there is little doubt that a capital gains tax reduction will cost revenue in the long run. You may have heard statements to the contrary here today. Those are not based on evidence, and the evidence is all that I can go on.

Taking dynamic considerations into account, that is, looking at macroeconomic feedback effects, would likely increase this revenue loss. That is because the capital gains exclusion that applies not only to newly acquired assets but also to existing assets with potentially large accrued gains has an enormous windfall effect. Windfall effects do not have incentive effects; they do not encourage saving. They encourage consumption, and by providing a very large windfall, a tax change like this would have a much more direct impact on reducing saving than on increasing it. This is particularly so in a full employment economy, as we have now, where increasing consumption is not likely to increase output. That increase in consumption is going to come at the expense of investment, that reduction in investment is going to reduce the growth rate of the economy, and that is going to reduce future tax revenue.

Third, the proposed neutral cost recovery system offers the equivalent of immediate expensing, at least theoretically. Compared to the current system, it is as if you were giving an investment credit

for corporate taxpayers in the 35 percent bracket ranging from 2.4 percent for a 3-year property at current inflation rates to about 8.3 percent for a 10-year property.

Fourth, despite the large tax reduction it provides, NCRS is consciously designed in a way that masks its large revenue costs. As is quite clear from the revenue estimates, the costs are much higher in the long run than they are in the short run, and like the capital gains reform, it is best to look at the longer run revenue implications when deciding whether this is something that the Nation can afford.

If you feel that a program like NCRS is something that should be done, you should be prepared to pay for it in the same way that you would pay for the equivalent investment tax credits ranging from 2.4 to 8.3 percent.

Fifth, the NCRS scheme does not eliminate the distortions associated with the taxation of investment income. While it does provide a zero tax for machinery and equipment, it doesn't go far enough even for those assets in taking care of the way they are financed. In particular, if they are financed with debt, there will be a significantly negative tax rate for that kind of investment. As distortionary as positive capital income taxes are, negative capital income taxes are distortionary as well.

Sixth, and finally, from a macroeconomic perspective this is a particularly inappropriate time to introduce large investment incentives. Investment grew at over 13 percent in the past year. It grew at nearly 13 percent from the third quarter of 1992 to 1993. We are operating near capacity overall and near capacity in the capital goods industry, and increasing demand is not the right way to increase saving right now. The better way to increase saving is to reduce consumption, both by the government and by the private sector.

Thank you.

[The prepared statement and attachment follow:]

Capital Formation and the "Contract with America"

Testimony before the Committee on Ways and Means, U.S. House of Representatives

by

Alan J. Auerbach
Robert D. Burch Professor of Tax Policy and Public Finance
University of California, Berkeley

January 24, 1995

Mr. Chairman and Members of the Committee:

I appreciate the opportunity to give my views of the effects of the "Contract with America" on saving and investment. My discussion will be limited to Titles I and II of H.R. 9, the Job Creation and Wage Enhancement Act, which contain proposals to reduce and index the capital gains tax and increase the value of depreciation allowances on business fixed investment. Let me begin by summarizing my conclusions.

1. By providing both a 50 percent exclusion for long-term gains and inflation indexing, the capital gains reform would sharply reduce the tax burden on capital gains. The combined impact could easily exceed that of a 60 percent exclusion of gains without indexing.

2. The capital gains reform would cost the Treasury tax revenue in the long run. Taking "dynamic" considerations of growth into account would *increase* this revenue loss: because of large windfalls to existing capital, the reform would encourage current consumption rather than saving.

3. The proposed Neutral Cost Recovery System (NCRS) offers the equivalent of immediate expensing of the cost of investment in machinery and equipment. Compared to the current system, NCRS provides the additional incentive to invest that would be provided by an investment tax credit ranging from about 2.4 percent for three-year property to about 8.3 percent for ten-year property.

4. Despite the large tax reduction it provides, NCRS is designed in a way that masks its large revenue costs. Like the capital gains reform, it promises short-run revenue gains due to timing. The long-run losses, however, are a better measure of budgetary impact and should be used as a basis for evaluating the proposals.

5. The NCRS scheme does *not* eliminate the distortions associated with the taxation of investment income. Different assets will face different effective tax rates, and debt-financed capital purchases are likely to face quite negative tax rates, making NCRS property a tax shelter for other capital income.

6. From a macroeconomic perspective, it is a particularly inappropriate time to introduce the large investment incentive embodied in NCRS. Business fixed investment is booming and the economy as a whole is operating near its capacity. Added stimulus to investment is likely to exacerbate supply constraints and inflationary pressures.

In short, neither scheme offers a painless reduction in capital income taxation. In an economy with a terribly low national saving rate, fiscal policy that is out of balance, and production that is operating near capacity, this package is likely to work in the wrong direction on all three counts: to reduce national saving, worsen the budget deficit and stimulate production demand.

Let me turn now to a detailed discussion of the proposals.

Capital Gains Provisions

The capital gains tax provisions of H.R. 9 would introduce a 50 percent exclusion of capital gains and also provide for the prospective indexing of asset bases for inflation occurring after December 31, 1994. Like the exclusion, indexing acts to reduce the portion of nominal capital gains subject to tax. Thus, the two provisions together will exclude more than 50 percent of gains from tax. For example, for an asset held for ten years, yielding a total return of 9

percent annually, and an inflation rate of 3 percent, 63 percent of gains would be excluded from the tax base. This exceeds the 60 percent exclusion rate that existed between 1978 and 1986. At the higher rates of inflation experienced in the late 1970s and early 1980s, the exclusion rate would be even higher because the indexing provision would be more valuable.

There are several arguments offered for reducing capital gains taxes or indexing them in this manner, but as I will explain, I find them generally unconvincing.

Revenue Effects

A capital gains tax reduction would lessen the distortion of the "lock-in" effect that discourages investors from realizing their capital gains. As a result, it would lead to more frequent turnover of capital assets and hence more capital gains being taxed. Some argue that the increased tax base would more than offset the reduced tax rate, leading to increased revenue. Unfortunately, there is little empirical support for this argument. While there is convincing evidence that investors time their capital gains realization to take advantage of lower tax rates -- as they did at the end of 1986 to avoid the impending tax increase -- there is no evidence that realizations increase permanently by enough to raise revenues in the long run. Indeed, as I have illustrated in previous research, such a long-run increase in realizations would require an implausible speeding up of transactions and reduction in assets passed through estates.[1] The most recent studies of investor behavior confirm that, while realizations are extremely sensitive to temporary tax rate variations, they are far less responsive to more permanent ones -- not nearly responsive enough to raise revenues.[2] Hence, capital gains tax cuts do cost tax revenue, and must produce other social benefits to offset the revenue loss.

Increased Capital Formation

Proponents argue that capital gains tax reductions will lead to more capital formation and, as a result, generate further revenue gains. However, while reductions in capital gains taxes (or other taxes on capital income) lower the cost of capital, thereby encouraging investment, they affect saving in a second way as well. By raising the after-tax income of households, capital gains tax reductions encourage consumption. Saving will increase only if the first effect outweighs the former. Unfortunately, the impact on the incentive to save and invest will be relatively small, and a retroactive capital gains tax reduction, as is being proposed, provides large windfalls to the owners of existing assets. Such windfalls will have a much more powerful effect in the opposite direction -- to increase consumption and reduce saving.

For corporate investment, there are several factors that attenuate the effect of a capital gains tax reduction. First, as capital gains even now receive favorable tax treatment (they are taxed only upon realization at a maximum of 28 percent and are not taxed if transferred through an estate), the effect of the rate reduction would be muted. Given my past estimates of the advantages of deferral and basis step-up at death[3], the current 28 percent maximum rate translates into an effective rate of about 10 percent. Based on the same assumption, the combination of indexing and the 50 percent exclusion might reduce this to just over 5 percent, yielding a roughly 5 percentage point reduction the effective tax rate on capital. Capital gains taxes primarily affect the cost of equity-financed investment, to the extent that equity returns are received in the form of capital gains and are received by taxable investors. As a rough estimate, if 1) half of all finance is through equity, 2) half of all equity returns are in the form of capital gains, and 3) half of this equity is held by taxable investors, then the drop in the effective tax rate falls by seven-eighths, to about .6 percentage points. For a real, before-tax rate of return of 6 percent, this is like an increase of 4 basis points in the rate of return to saving.

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[1]Alan J. Auerbach, "Capital Gains Taxation and Tax Reform," National Tax Journal 42, September 1989, pp. 391-401.

[2]Leonard E. Burman and William C. Randolph, "Measuring Permanent Responses to Capital-Gains Tax Changes in Panel Data," American Economic Review 84, September 1994, pp.794-809.

[3]Alan J. Auerbach, "Capital Gains Taxation and Tax Reform," Op. Cit.

By contrast to this very small increase in the incentive to save, offering investors a retroactive tax cut on prior appreciation of existing assets bestows a very large windfall that will increase consumption. To a first approximation, the size of this windfall equals the reduction in the effective capital gains rate, again about 5 percentage points, times the total current value of unrealized gains held by taxable investors. The extra consumption this windfall generates likely will more than offset the small reduction in consumer spending induced by the rise in the after-tax rate of return.

Thus, as currently structured, the capital gains tax reform would almost surely increase consumption and reduce saving. This unfavorable outcome could be mitigated somewhat by reducing the windfall to existing assets. One change in this direction would be to require sale or constructive realization of existing assets in order to qualify for indexing. This change would have the additional benefit of increasing realizations and tax revenues. An even more direct measure would be to limit the capital gains exclusion to newly acquired assets or those constructively realized.

Promoting Venture Capital Investment

An argument often made for reductions in capital gains taxes is that they are needed to promote investment in risky enterprises and new businesses that yield much of their return in the form of capital gains. However, a provision targeted precisely toward this objective is already in force: the Revenue Reconciliation Act of 1993 permits an exclusion for newly issued equity in small businesses. Thus, the venture capital argument does not apply to the current changes.

Insulating Gains from Inflation

The tax system generally measures income on a nominal basis, ignoring the fact that some returns merely compensate asset owners for a decline in the real value of their assets due to inflation. This distorts the measurement of income and raises the effective tax rate on asset returns. While a capital gains exclusion has sometimes been justified to compensate for this overtaxation, this is not the best way to alleviate the distortion of nominal taxation. Indeed, the current proposal includes the most straightforward approach, indexing of asset bases, so the 50 percent exclusion cannot also be justified by the need to compensate for inflation.

While basis indexing is the right way to protect capital gains from inflation, there is no reason to single out this one form of capital income when indexing. Since capital gains already receive favorable tax treatment, the inflation tax weighs less heavy on them than on the return to fully taxed capital income such as payments on interest-bearing assets. Failure to index interest not only leaves out an important class of assets, but also keeps in place the *benefits* that inflation provides to interest deductions. Given that borrowers are likely to be in higher tax brackets than lenders, this means that, under the indexing provisions, borrowing to invest in capital assets will actually be encouraged by higher inflation. While indexing is desirable, I see no justification for limiting it to capital gains, particularly when capital gains are already tax-favored and about to become more so. Indexing depreciation allowances, as would be done under the Neutral Cost Recovery System, is another step in the right direction, but does not address the mismatch in the treatment of interest deductions and capital gains.

The Neutral Cost Recovery System

As just noted, the Neutral Cost Recovery System would index the bases of assets for purposes of calculating depreciation allowances. Assets currently written off over three, five, seven or ten years using the 200 percent declining balance method would also effectively receive interest, at the rate of 3.5 percent, on any undepreciated basis, while having allowances shifted to the 150 percent declining balance method. For this group of assets, the new scheme would be approximately equivalent to immediate, first-year expensing of the entire cost of investment.[4]

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[4]The equivalence is based on the assumption that the real discount rate is 3.5 percent. If the appropriate rate is lower, the scheme is more generous than expensing. If the appropriate rate is

At an inflation rate of 3 percent and a real discount rate of 3.5 percent, NCRS gives investors facing the corporate tax rate a benefit equivalent to an investment tax credit ranging from a 2.4 percent (with a 50 percent basis adjustment, as during the period 1982-86) for three-year property to 8.3 percent for ten-year property.

The Timing of NCRS Deductions

Since both expensing and investment tax credits are familiar concepts in the tax code, then why does NCRS take the form it does, rather than simply expanding the scope of existing expensing provisions or reintroducing the investment tax credit? There can be only one answer: timing. By shifting from 200 percent declining balance to 150 percent declining balance and then grossing up deductions for inflation and interest, NCRS greatly increases the present value of allowances while shifting them into the future.

Figure 1 illustrates this. It shows the annual deductions for a dollar of investment in ten-year property under existing law and NCRS, assuming a 3 percent inflation rate. During the first three years, deductions are actually higher under current law. Combine this project with projects starting in years 2, 3, 4 and 5, and you could well raise revenue in each of the first five years -- the relevant budget window. You would almost certainly raise revenue in the five years combined. Indeed, all the provisions of NCRS taken together, including those affecting other assets, have been estimated by the Treasury to raise revenue during the period 1995-2000.[5]

Thus, this new system of depreciation would be very costly in terms of revenue. From the perspective of responsible budget policy, we should be prepared to make the same offsetting budget adjustments in terms of added revenue or reduced spending as we would to finance a system of investment tax credits ranging from 2.4 to 8.3 percent.

Ironically, this backloading of incentives may actually make the policy less effective. By offering businesses the equivalent of expensing but only providing payments over time, the government is giving firms an IOU. To the extent that businesses face restrictions in credit markets, it would make more sense for the government to borrow the cash needed to provide immediate payment of the IOU, rather than forcing cash-constrained firms to borrow until the IOU is paid off. Even with its current budget problems, the federal government faces less difficulty raising funds than many businesses do. This is one reason why, in the past, proposed investment incentives have either taken the form of an investment credit, as in President Clinton's original 1993 package, or accelerated depreciation, as in President Bush's 1992 proposal for a 15 percent investment tax allowance.

Is NCRS neutral?

If tax neutrality means equal treatment of different assets, then NCRS fails by giving more generous treatment to machinery and equipment than other assets. If neutrality means a zero tax rate on investment income, then NCRS fails again, even for machinery and equipment. While expensing or its equivalent imposes no net tax on the returns to investment, there are additional provisions that may impose positive or negative taxes on the same returns. For example, as already mentioned, debt-financed investments will still provide full, nonindexed interest deductions. As long as interest is received by those in a lower bracket than the borrower, the combined tax on borrower and lender will be negative. Combined with the zero tax on asset returns produced by NCRS, the result is a net negative tax rate on debt-financed investment in NCRS property. While lower capital income tax rates may make sense, negative tax rates are hard to justify and produce distortions of their own, including new tax shelter opportunities.

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higher, than expensing is more attractive.

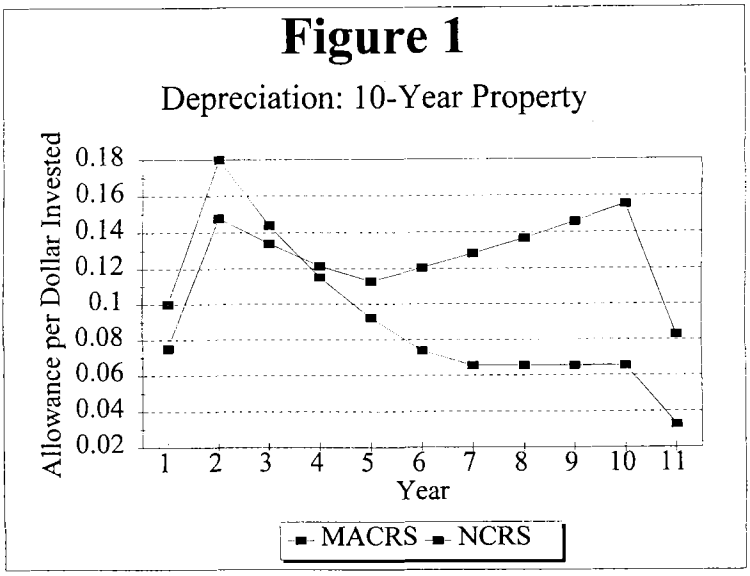
[5]Statement of Assistant Treasury Secretary Leslie B. Samuels before the Committee on Ways and Means, January 10, 1995, Table 1.

NCRS and the Macroeconomy

In the past, investment incentives were introduced as a way of stimulating investment and economic activity out of recession. This type of countercyclical policy is hard to practice because it often comes too late and may even exacerbate investment fluctuations by leading investors to hold off investing during a recession as they await yet another investment incentive. However, from the perspective of countercyclical policy, it is difficult to imagine a worse time than the present for the introduction of investment incentives.

With an unemployment rate of 5.4 percent, the economy may well be operating at a capacity above that sustainable at a stable inflation rate. Business fixed investment is growing briskly; it grew in real terms by 12.6 percent between the third quarters of 1992 and 1993, and by another 13.7 percent between the third quarters of 1993 and 1994. For machinery and equipment, the growth rates over the same two years were 17.6 percent and 17.3 percent. An added stimulus for equipment purchases, particularly one not sufficiently balanced by offsetting deficit reductions, would push further against capacity constraints in capital-goods-producing industries and the economy as a whole, adding considerable fuel to present inflationary pressures.

The United States needs more national saving. However, with aggregate demand already strong, a better way to meet this objective is by reducing consumption -- by government as well as households -- rather than trying to increase investment. A serious deficit reduction policy is the most direct way to accomplish this objective.



Mr. HERGER. Thank you very much, Mr. Auerbach.

I am just curious, you had somewhat of a different type of seeing the results of our policy than what perhaps several other members of the panel would agree with. Is there anyone who would disagree with Mr. Auerbach who would like to comment on the panel?

Mr. HUARD. The rest of us here are all at something of a disadvantage, none of us are economists. I think you obviously have a difference of opinion. Most of you were here for the prior panel, and I think you really have to decide on the issue of things like capital gains tax cuts whether it is the right thing to do, whether it makes economic sense.

I have been testifying before this committee for nearly 15 years, and the only thing I could say with confidence when econometric estimates are thrown around, and this is going to lose $x billion and this is going to raise $y billion, is that you know for certainty that those estimates are going to be wrong, and they are going to be wrong by billions of dollars. About all they can tell you that is helpful is orders of magnitude and trend lines, but the actual numbers themselves imply a precision which, frankly, doesn't exist.

Mr. HERGER. Thank you very much.

Mr. Kleckner, I would just like to comment on your comments, being from an agricultural area myself, I thank you very much for your testimony, and specifically I would like to ask you if you could explain to our committee concerning the increase of maximum exemption for special use from $750,000 to $1.5 million.

My colleague, Mr. Thomas, has legislation that would do that, and I have introduced legislation that would help index land, special use land, particularly for agriculture. And we see so often in our communities where so many of our farms have been out away from the cities at one time, but as the urban area grows we find ourselves that the urban areas now encroach where it is right on top of us but yet our land is valued for what it might be for industrial use perhaps or for building homes on rather than the family farm, and I wish—would you mind commenting a little bit more on how important these two aspects of indexing and raising the special use from $750,000 to $1.5 million—I believe you mentioned $2 million in your recommendation—would be to the family farmer?

Mr. KLECKNER. Yes, thank you, Mr. Chairman. It is extremely important, and you are surely right, that many people were in the country years ago but now the city is moving out. Land valuations have skyrocketed for the new potential use as compared to the use for agriculture that they are now valued at.

We would prefer that there be no exclusion at all, that it be entirely valued at agricultural use. However, we will certainly support the raising from $750,000 to $1.5 million or whatever the proposal might be revised to be.

We think your proposal to index it is extremely important, also. I think indexing in this whole area, this area as well as capital gains, is a key to the future. We will support increasing the exemption up to the $1.5 million. If there is a maximum at $1.5 million, it should definitely be indexed.

It seems to me the government loses nothing in the end. There may be a bit of delay, but in the end if that land is converted to houses, as you mentioned, taxes will be paid on it at that time.

Let's take a $1 million piece of property for farming valued at $5 million, raising the exclusion from $750,000 to $1.5 million, while very helpful still might cause that person to have to sell the farm and get out of farming. So whatever it can be raised to will be of great benefit.

The three-quarters of a million to a million and a half would be extremely helpful. I would hope that the committee would look at even going further than that. But at all costs, your proposal to index needs to be in there.

Mr. HERGER. Thank you very much. Mr. Levin will inquire.

Mr. LEVIN. Thank you very much.

Let me ask those of you, other than Professor Auerbach, who favor these proposals, do you favor them if in the end they are not part of a deficit neutral package? Do any of you favor that or is your position conditioned on over 5 years, it would be 10 in the Senate and I think the 10-year standard would be discussed here, there would have to be no negative impact on reduction of the deficit?

Mr. HUARD. Well, the NAM has consistently taken the position that any tax cuts adopted as a part of the Contract should be financed fully with spending cuts. We don't think you should be playing shell games and financing them with offsetting tax cuts on somebody else. That is basically not going to do anything for economic growth, but we do think if you fully finance any spending cuts adopted as part of the Contract with offsetting spending cuts you will get very positive benefits and that is the way you ought to do it.

Mr. LANE. We would agree with that at NAEA. I think that the purpose of our support for all the initiatives in the business aspect of this bill are going to support a growth in the economy and growth in the profitability of businesses and if that is offset by an increase in the deficit of the government, it just cancels it out, so we would like to see the economy expand, at the same time government revenues will expand, but it would have to be coupled with spending reductions so we don't wind up in a negative position 5 or 10 years out.

Mr. LEVIN. And you don't outline cuts in your testimony, not that you are before the Appropriations Committees. I was a little bit concerned about the response that you can never be sure of predictions, economic predictions. I take it we have to have some reasonable estimation of the likely effect on revenues of any tax cuts.

Mr. HUARD. Well, I think that is correct. My comment was intended to convey the fact that frequently these numbers are tossed around with what appears to be a marked sense of precision and certitude, and I just think they ought to be taken occasionally with a grain of salt.

Mr. LEVIN. Occasionally? The problem is this morning Allen Sinai, who I don't think has an ax to grind, estimated the revenue losses for the next 5 years at, I think, $183 or $193 billion. The estimate of the Treasury Department is $205 billion for 5 years; for 10 years, the estimate of the Treasury Department is $725 billion, which is a considerable chunk of change.

Let me ask Professor Auerbach, what do you see as the economic reasons, in a capital gains proposal, to include a change in rate for existing assets?

Mr. AUERBACH. Well, I think the only justification from an economic perspective would be that you would generate so much additional unlocking of capital gains that the revenue gains from the reduced distortion would essentially pay for itself.

I don't think that is true. I also think that there is an additional issue. People talk about capital gains tax cuts as a savings incentive. The capital gains tax certainly is a tax on capital income. If we are talking about the prospective capital gains tax that people are going to pay, then to a certain extent that will weigh on their decision to save. But I fail to understand how telling people who have appreciated assets that those assets are now worth more, because of a tax reduction, will increase national saving. It is certain to increase consumption. Revenue estimates may differ, and indeed economic estimates may differ, but I don't think there is very much controversy over the statement that people who are wealthier will consume more.

Mr. LEVIN. My time is up. Thank you.

Mr. HERGER. Thank you. Mr. Shaw will inquire.

Mr. SHAW. Thank you, Mr. Chairman.

Mr. Atkinson, I particularly enjoyed listening to your remarks, how it impacts on municipal borrowing. In my own State of Florida almost $8 billion a year is financed in long-term bonds. This has become very important for the building of bridges, roadways, waterways, sewer sanitation plants, all types of things that we want to encourage to be built and taken care of at the local level.

You speak of some complications and restrictions in regard to the exchange of those particular bonds. Could you be specific in your recommendations as to what changes should be made, and also comment particularly on those provisions that were contained in the 1993 tax bill?

Mr. ATKINSON. OK. Actually, prior to the tax change in 1993, all market discount bonds were treated in a uniform fashion. Bonds that trade below par—using 100 as par—a bond trading at 90, the market discount—or the difference between 90 and 100 was treated as a capital gain. The market was very efficient in how those bonds traded.

The change in the 1993 Reconciliation Act created another function because that discount now can be treated, depending on a couple factors in a rule, as capital gains, as ordinary income, or it can be treated as both in the same bond. You basically have investors looking for tax-exempt income, not for ordinary income. If they were, they would be investing in some other vehicle, taxable bonds, stocks, real estate, or some other investment. So what has happened is that people are avoiding bonds that have ordinary income as a result of the rule. In addition, some mutual funds which are large institutional investors, as well as trust departments, and indeed even individuals, are not as concerned about the credit quality of the bond or its yield, but rather whether or not it will be taxed as ordinary income as opposed to tax-exempt income. As a result, market liquidity has changed rather significantly. If you look at the blue list, a publication used in the industry that lists all the bonds

owned and for sale, you will see that a majority of those bonds are discount bonds. That is a reflection of the fact that people aren't that interested in those bonds.

I think that the change we propose is a very simple change. It would go back to the pre-1993 level when we had the gain on the sale of discount bonds treated as capital gains.

As I said, I think the revenue impact on the Treasury is very minimal. I think the impact on the market, as a positive factor, would be immediate and reasonably dramatic.

Mr. SHAW. Do you know the revenue figures on that?

Mr. ATKINSON. I don't have the revenue numbers. As I recall, Congressman Cardin asked for an estimate last year from the Joint Taxation Committee and I don't know if that was ever done. Intuitively, I would think it is small, and far out in the distance.

Mr. SHAW. Have the restrictions, do you feel impaired the ability of municipalities to get favorable interest rates from their customers?

Mr. ATKINSON. It is an iterative process. New bond issues are always priced based upon yields in the secondary market. So as secondary market prices get cheaper and cheaper with higher yields, when a local government borrows anew, it will have to pay a higher rate. So new treatment of market discount will have an impact. It hasn't had an impact yet but we have only had 1 year to deal with this.

Mr. SHAW. So you feel whatever revenue we give up would be more than compensated by decreased expenditures for interest by municipalities.

Mr. ATKINSON. I think your savings cost is optimum when there is the most market liquidity and the most market participants. Anything that reduces either liquidity or investors has a tendency to raise rates over the course of time.

Mr. SHAW. And therefore make it more expensive for municipal governments to——

Mr. ATKINSON. Yes.

Mr. SHAW. Thank you, Mr. Chairman.

Mr. HERGER. Thank you. Mr. Hancock will inquire.

Mr. HANCOCK. Thank you, Mr. Chairman.

Mr. Auerbach, the last paragraph in your statement would indicate to me that you are not very well impressed with the idea of a capital gains tax reduction. Am I correct?

Mr. AUERBACH. Good reading, yes.

Mr. HANCOCK. I guess we can ignore the rest of your testimony then, can't we? I think it is pretty much a general consensus that capital gains, at least among most of the people in the private sector and the business community, is a way to generate economic activity; to let people benefit from the risk that they take.

The situation that Mr. Atkinson was talking about, the change that gave the authority to the Secretary of Treasury last year to determine what is capital gains when it comes to bonds, there was a lot of resistance to that. When did we get to the idea that you make an investment, you make a profit on it and it takes over 6 months that that is not a capital gains?

Where did that theory come from? Can you tell me?

Mr. Atkinson was addressing that issue especially on municipal bonds.

Mr. ATKINSON. I am not sure where the theory came from, but it is important. While I don't have the legislative history, I believe the capital gains treatment on the market discount has been out there and well established and results in a very effective marketplace. But the change that took place in 1993 has made that a very difficult marketplace and probably has had more unintended consequences than anybody thought about in 1993.

Mr. HANCOCK. Actually, it was a major change in the way people calculated their tax, especially with the new rates, an effective rate of 39 percent on the individual compared to 28 percent.

Mr. ATKINSON. Exactly. In 1993 interest rates were quite low, the long Treasury bond was as low as 5.75 percent, and you didn't have a wealth of bonds trading at a discount. But the change in the marketplace in 1994 going along with much higher rates with the long Treasury bonds at 8 percent, resulted in large percentages of the marketplace now trading at a discount.

So perhaps in 1993 no one was thinking about it as much, but currently over 50 percent of the market is trading in at a discount and it has been a major impediment to the overall marketplace.

Mr. HANCOCK. What about possibilities of some capital losses on municipals? We have a situation that the public is interested in now. What is the tax treatment going to be on that?

Mr. ATKINSON. With the new rules, an investor may lose the ability to offset gains with losses, so it is a worse situation than existed in the past. Indeed 1994 is a good example where many large mutual funds have had negative returns on their funds but they have had to pass through to the investors an actual tax bill for ordinary income which certainly was not intended nor desired.

Mr. HANCOCK. In fact there are a lot of individuals right now, especially this year, that either know the value of their mutual fund investment is going down or having to pay income tax on capital gains that was declared to them during the year even though if they liquidated they would be able to take a loss. I don't think the tax structure was designed to create a problem when there wasn't a profit but that is what we ended up accomplishing.

That is why we have to get back to capital gains where that is simple. You make an investment, if you hold it 6 months or longer and you make a profit, that is a capital gain, doesn't matter whether it is a piece of real estate, a stock or bond or anything else.

Thank you, Mr. Chairman.

Mr. HERGER. Mr. Rangel.

Mr. RANGEL. Mr. Sinclaire, I assume the Chamber has looked over the entire Contract With America, and after analyzing it, you don't see this as any threat to increasing the deficit?

Mr. SINCLAIRE. The Chamber has examined the Contract. We have focused on the business provisions of it. The Chamber, as I am sure you are aware, has called for a balanced budget amendment. Our members feel that that is the second most important item. Based upon a survey we did, the most important is unfunded mandates.

We sent a letter out to every Member, sent one to you last week I believe, and in the overall context we see that the provisions will open up the economy and the incentives will expand the economy.

Mr. RANGEL. Mr. Sinclaire, are you satisfied after reading the Contract that it will not be a negative impact on the deficit? I know you are here to testify about the taxes and I support the tax cuts too, but after all, businesspeople look at the entire economy.

All I am asking is that the package as is, and after reviewing how it is going to be balanced, are you satisfied it would not have a negative impact on the economy? I assume the answer would be yes because you wouldn't be advocating these things if it did.

Mr. SINCLAIRE. The short answer is yes. It will expand the economy in the long run.

Mr. RANGEL. In your testimony you talked about this creating plants and equipment, efficiency and competition, productivity and high-paying jobs. Are you satisfied that in this country we are producing the type of labor market that our industries will need in order to truly be competitive and effective and having the technology and the training for these high-paying jobs?

Mr. SINCLAIRE. We have a base for it, but by getting some of these provisions, we feel we will expand that base. One of the items we would like more done on is the research and experimentation credit.

Mr. RANGEL. Now, I am talking about the labor force, not the technology. God knows America is out front in leadership with that, improving our capabilities even more every day, but I am asking as relates to those people that have to have these high skills, are you satisfied that our labor market has kept up with the technology or is that an issue for your organization at all?

Mr. SINCLAIRE. We feel they work hand-in-hand. As the economy expands, as these new technologies develop, the people will be trained.

Mr. RANGEL. When we talk about the global economy, you are familiar, we have 1 million people in jail, we have 1 million waiting to go to jail, we have people that are drags on society, they are on welfare, they are making children, they are unemployable. All of this is a part of the economy just like you say with plant and equipment.

If you make an investment in plant and equipment, you expect to be more competitive, more productive and it will pay off. I assume that is how you reach the fact that it is neutral as relates to the deficit, and I would assume the Chamber would feel the same about educating and training the work force, it is important so that they too can be competitive against the European common market—you do, don't you?

Mr. SINCLAIRE. We believe it is a combination. We can't segregate and have the training and have the investment. Both will work together.

Mr. RANGEL. Exactly. So you are clear on the investment part here with the tax provisions?

Mr. SINCLAIRE. That is a fair statement, yes.

Mr. RANGEL. I am asking, what are your thoughts about what we should be doing as relates to the training of the individuals so we have the economic incentives and the technology and the research

and development and then we have the work force, because you know low-skill jobs are gone with what is left of GATT and NAFTA.

So the people are here and there is a gap, an increase in high school dropouts—what would the U.S. Chamber of Commerce recommend so that we will have a bird with two wings, one with investment for equipment and research and the other in a labor market that understands what to do?

I understand. I have no further questions.

Mr. HERGER. Thank you, Mr. Rangel.

Mr. Camp.

Mr. CAMP. Thank you, Mr. Chairman.

Mr. Kleckner, thank you for being here today and for your testimony. As a Michigan Member representing a district that has agriculture as its number one industry, it is refreshing for me to hear a witness come and testify about the views of our agricultural community, especially on tax issues.

Last week I was pleased to introduce a farmer from the Fourth District of Michigan and he did an excellent job of sharing his concerns and the concerns of the American family farmer, and you further elaborated on some of his points that he brought up and I appreciate that.

I want to draw attention to the taxing situation that you mentioned involving the IRS and the possible taxation of associate member dues. I want you to know that I and my colleague on this committee, Mr. Payne of Virginia, intend to reintroduce the Tax Fairness for Agriculture Act within the next week. Our bill will ensure that farm organizations are not unfairly taxed as the IRS appears to be determined to do at this point. I can assure you of our commitment to bring this issue before the Committee on Ways and Means and to resolve the matter.

In your statement, you talk about the importance of a tax deduction for health insurance premiums paid by the self-employed, and that is a critical matter, and it is a critical issue of importance to the Fourth District and to farmers in that area and one that I continue to hear about as I go home.

If you could tell us, in your view, what have been the results of the delay by Congress to address the renewal or a permanent extension of the health care deduction, premium deduction on the agriculture industry, and is it one of the most helpful things Congress can do to help increase health care coverage for farmers?

Mr. KLECKNER. Thank you, Mr. Camp. No question it is causing great consternation and concern in the country. As you all know, business can deduct 100 percent of the health care costs for their employees. In fact, many farm spouses have gone to work mainly to get health insurance, because on the farm as private businesspeople, private entrepreneurs, they have to pay their own with no deduction at all. It had been 25 percent—which is grossly unfair. It ought to be 100 percent as business has, but the 25 percent has been helpful.

I am sure it is true in Michigan, as it is in my State, farmers are paying anywhere from $3,000 or $4,000 at the minimum for just their family, up to $10,000 to $14,000 to get somewhere in the 80 percent coverage. It is costing that much. Health insurance is

one of the largest expenses that farmers have to pay today, equal to seed and fertilizer and chemicals and the other production aspects of farming. No health insurance expenses are deductible as a business expense.

The 25 percent, please hurry and get that done and made retroactive. For many farmers March 1 is when they pay their taxes, not April 15, the tax day that many people think about. So time is of the essence. If it can be done at any time, even up to April 15, we will file an amended return but it is costly and time consuming. But the long-term goal ought to be 100 percent simply for fairness reasons to put us at the same level as the rest of the country.

Mr. LANE. Mr. Chairman, could I comment as well. Speaking as a tax preparer, the fact that that first expired in July and then was brought back in and extended to December for that year caused thousands of self-employed people to go to additional expense after they had filed their return to do an amended return just to get a deduction they should have been entitled to in the first place. Now we are going to go into this year without having the ability to deduct it at all.

So I would urge you to do it in time for the farmers to get it in by March 31 and for the rest of the world to do it by April 15 because the additional cost it imposes upon small business is incredible because you have to redo the entire tax return.

Mr. HERGER. I want to thank the testimony of Mr. Kleckner and Mr. Lane. Those of us who represent agricultural areas, the farmer, independent employer have been getting a raw deal for years, have not been treated as the corporations or the large businesses who have been able to deduct this health insurance for years. So we appreciate your testimony.

Mr. English will inquire.

Mr. ENGLISH. Thank you for appearing here today. I was unfortunately unable to attend a portion of this hearing, but I have reviewed your testimony and I appreciate the opportunity to question you. Specifically, Mr. Sinclaire and Mr. Huard, earlier in the first panel we heard some agreement on the notion that investment in equipment is currently the single most important factor in stimulating economic growth and development in this country.

Do you concur with that?

Mr. SINCLAIRE. I can concur to the extent that it is a major factor. Not being an economist, I am not sure if it is the first factor, but it is up there as a very high factor.

Mr. HUARD. I would agree, generally. Again, it is—I guess the term "most significant" is one that people doing econometric analyses might quibble with. Certainly it is extremely important and, from the standpoint of the National Association of Manufacturers, we view improving the climate for investment in new plant and equipment to be one of our top priorities in terms of tax policy.

Mr. ENGLISH. In terms of your—I should say in terms of the position of your membership, those that are internationally competitive, those that are involved in exports, to what extent are they put at a competitive disadvantage with exporters from other countries competing in international markets by the Tax Code?

Is this a common complaint among your membership? Do you have anecdotal evidence to support that?

Mr. HUARD. That is not only a common complaint; it is a widespread complaint. It goes well beyond—I am glad you used the words by the Tax Code, because it goes well beyond having inadequate depreciation systems. It extends to a whole range of issues, particularly the taxation of foreign source income, the fact that for revenue scrounging purposes, ever since the mideighties, we have been building fences around the availability of the foreign tax credit, which is a simple device intended to eliminate double taxation. But in order to squeeze more juice out of the lemon, we penalize multinational U.S. firms doing business overseas and that have overseas operations by constantly chipping away at the availability of the foreign tax credit.

This has been a wonderful development if you are a tax accountant or tax lawyer because nobody understands the foreign source income provisions of the code anymore so everybody pays three consultants to figure that out. But from the standpoint of the taxpayers, it has been an unrelieved disaster.

Mr. SINCLAIRE. There are particular areas of the code which are detrimental in the foreign area such as the AMT. The steel industry which has been down, it has foreign competition, it has a problem modernizing and it cannot take advantage of the tax incentives. By being taxed under AMT, they cannot use the tax incentives, the various investment credits that are allowed. They are down to start with.

We are beating them a second time, they have to pay a tax, and they can't take the incentives. They can't modernize, so they are at an extreme disadvantage. This also applies to startup companies. They also cannot take advantage of the various aspects of the code, the advantages, the incentives, because of the AMT, and that affects our international trading aspects, it does not give them a level playingfield with our international competitors.

Mr. ENGLISH. Thank you. Mr. Kleckner, I particularly enjoyed reading your testimony because I think you vividly brought out a lot of the concerns of agricultural people in my district in regards to the capital gains tax.

I would like to address Mr. Sinclaire and Mr. Huard with regard to the capital gains tax. I know that a large portion of business starts are capitalized by individuals, individuals who are going out into the credit market perhaps based on their own credit but are frequently using their own assets to start a business.

We have had a lot of discussion here today about what impact the capital gains tax would have on the economy. I wonder if you can quantify again, anecdotally, or from discussions with your membership, to what extent the capital gains tax is a substantial deterrent for business starts by entrepreneurs who are trying to use their own resources, who are selling an asset to come up with the capital to launch a business?

Mr. SINCLAIRE. I think the problem is not just their own assets; they have to look for money a lot of times from other sources and also their own money. The question is: Is it more profitable? Do they have an incentive to invest in this business? Should they take

that money and invest it for 30 years or should they put it into a Treasury bond which is now in the area of 8 percent?

They do to get something beyond that 8 percent. They could lose everything they put into it, so there has to be that incentive not just in the rate of return, there has to be a built-in advantage such as a capital gain, the reward for the risk taken.

Mr. HUARD. I think the major impediment is the lock-in effect. I am not a trained economist and I haven't run this over a bunch of models but, to the extent that I talk to entrepreneurs, a major obstacle to converting assets to other uses is the fact that they are not willing to pay the capital gains tax.

If you are talking about perhaps liquidating a piece of land that has been in the family for years, they are afraid to sell it because you will pay more taxes than you have made because basically your gains are all inflationary and all paper and the government will confiscate your money so you just sit on it and don't sell it.

Mr. ENGLISH. I have other questions but I know we are running late. Thank you very much.

Mr. LANE. One problem of the hangover of this S&L debacle is that it is still very difficult for a small business startup to get any kind of financing, and so they have to go to other sources. The thing that impedes capital formation for small businesses is this capital gains tax. People have the asset locked up and are not willing to use it. I think if there is a change and if those assets become unlocked, it will be easier to finance startups.

Mr. KLECKNER. Going back to your previous question concerning international competitiveness, agriculture is an international market today. A capital gains tax rate at 28 percent ties up capital, keeping farms from modernizing as father and grandfather hang on because they don't want to pay the 28 percent on the inflation increase. Over a period of a generation or two generations, farms become uncompetitive with our competitors in many countries of the world that have a zero capital gains tax rate or much lower than our 28 percent route.

Even our friends, social service happy neighbors to the north, have a maximum capital gains tax rate of 17.5 percent. I know of no other nation that has a capital gains rate as high as the United States and I think that is absurd.

Mr. HERGER. Thank you.

Mr. Payne.

Mr. PAYNE. I want to thank you, Mr. Kleckner, for coming and speaking on behalf of the farmers of America and I look forward to working with you and with Mr. Camp on ensuring that the unfair treatment of associate membership dues is solved through legislation, not only for your organization, but for organizations like yours throughout the country. Thank you for the testimony.

I have one question having to do with neutral cost recovery. It will take a minute to get there because I need to put it in perspective.

This week we will be voting on the balanced budget amendment and likely will pass that amendment from all indications. That will mean, according to the CBO, if we pass it and the Senate passes it and the States ratify it, that by 2002, in order to balance the budget, we will have to find $1.2 trillion. Having a balanced budget

is an objective I think many of us share but it will be very difficult to achieve.

Treasury has come and testified, and Dr. Sinai's numbers seemed to be somewhat similar, that by the year 2002, the tax items in the Contract will add $0.4 trillion to the $1.2 trillion. So now we are looking at $1.6 trillion that we will have to find between now and the year 2002 in order to find our way to a balanced budget. Most people seem to agree that that is the order of magnitude of those numbers.

As I look at these proposals that we are considering today, I see that in the 5-year period the neutral cost recovery shows positive figures but, beyond that, as you move to the year 2002 and beyond, it seems almost to explode in terms of its cost to the Treasury. Consequently the numbers of things that we may have to do and decisions we may have to make to make up for the revenue that may be lost to the Treasury increase as well.

I understand and have voted for in the past capital gains tax reductions. Various people differ about the unlocking effect and how much money that may bring into the Treasury, but certainly I think there is a good case to be made about what reduced capital gains taxes can do in terms of generating positive economic activity.

My question is: As we move through this process and as we have to make decisions that are tradeoffs between our budget and providing incentives to creating more economic activity, it certainly seems that neutral cost recovery is one that we might need to look at very closely to see if this provision is a sensible one on the list.

I would like any of you to comment on this particular proposal, neutral cost recovery, and tell me where you would put it in terms of the order of priority of things that need to be considered by this committee.

Mr. HUARD. My inclination would be to put it fairly low on the order of priority. As Dr. Auerbach has pointed out, there are some problems with it. In connection with the availability of interest deductions, you could actually get negative tax rates. I think the goal of adequate capital recovery, at least from the standpoint of the NAM, ought to be expensing. But you can't get there from here in the context of the current system and you probably have to look at overall tax reform, because expensing, for instance, will work reasonably well in a system where you don't get a deduction for interest paid or dividends paid and the recipient of interest or dividends doesn't include them in income.

Under the current system where a business taxpayer gets an unlimited interest deduction and you combine that with something like accelerated recovery of any kind, you do get some distortions that are probably not desirable.

Mr. SINCLAIRE. I can't indicate where on the list it would fall. For a long time the Chamber has supported a neutral cost recovery system with the point of view of getting the true cost back to the investor or the business.

Looking at the neutral cost recovery system and speaking with various members, they have raised some issues. Where everybody comes down on it, we are not sure yet. Everybody is optimistically cautious about it. One problem is, immediate is, it costs a business

if they elect it. Right now they can take 200 percent depreciation, they will have to go back to the 150 percent rate, and the first 5 years will get less of an advantage or a lower tax deduction because of that.

Another concern that I hear is, if you look at the history of congressional action, the word is that this may not be around when it will come into effect to help them. It is going to cost them immediately, will not give them an incentive immediately, and over the long term they are worried about congressional action.

Mr. HERGER. Mr. Christensen will inquire.

Mr. CHRISTENSEN. Mr. Kleckner, I want you to know that as a fellow Farm Bureau member, I look forward to working with colleagues on both sides of the aisle to make sure we get equity back to the farmer on the 25-percent deduction for health care and eventually get that up to 100 percent.

Mr. Auerbach, I wanted to ask you, what did you do prior to your service at the University of California Berkeley?

Mr. AUERBACH. I was a professor of economics and law at the University of Pennsylvania.

Mr. CHRISTENSEN. Prior to that?

Mr. AUERBACH. I was at the University of Pennsylvania for 11 years. For 1 year during that time, in 1992, I was Deputy Chief of Staff of the Joint Tax Committee. I took a leave of absence from the University of Pennsylvania.

Mr. CHRISTENSEN. Have you ever been in the private sector?

Mr. AUERBACH. Briefly after getting out of college before graduate school.

Mr. CHRISTENSEN. I support a capital gains tax reduction. Is there any reason why we couldn't restore the 25-percent deduction to self-employed farmers and move it up to 100 percent? Should they be treated any differently than corporations?

Mr. AUERBACH. You are asking me for an opinion far afield from the current subject. I personally think that it is inequitable. There are many, many problems with the current treatment of health care and this is one of them.

Mr. CHRISTENSEN. Mr. Atkinson, you mentioned that the new tax treatment might make it more expensive for local municipalities to raise capital; is that right?

Mr. ATKINSON. Correct.

Mr. CHRISTENSEN. What other changes to the code could we make to potentially help local governments raise more investment?

Mr. ATKINSON. First, if you repeal the market discount rule, which rolls it back to 1993, that affects this topic. In a wider context, the tax reform bill of 1986 limited rather dramatically what uses tax-exempt bonds can be applied to. I know you have a lot of other things to focus on, but 8 or 9 years after the 1986 Tax Reform bill might be time to look at some of the areas that were eliminated or restricted for tax-exempt municipal bonds. That would help some of the localities, especially if the Congress plans to shift a lot of projects back to the State and local governments. I think a reexamination of the 1986 act is something whose time has come.

Mr. CHRISTENSEN. I want to thank this panel, Mr. Chairman.

Mr. HERGER. I want to thank each of our panel members for outstanding testimony. We will at this time recess for 10 minutes, at which time we will resume with our final panel.

Thank you.

[Recess.]

Mr. HERGER. The Ways and Means Committee will reconvene and if our final panel, Mr. Hiatt, Ms. Kerrigan—we will resume.

Ms. Kerrigan, would you like to begin?

STATEMENT OF KAREN KERRIGAN, PRESIDENT, SMALL BUSINESS SURVIVAL COMMITTEE

Ms. KERRIGAN. Thank you, Mr. Chairman, and members of the committee. I would like to thank all of you today for inviting the Small Business Survival Committee to testify, giving us the opportunity on the important issues of the savings and investment provisions in the Contract With America.

We would also like to congratulate the committee on your leadership for holding hearings on ways that we can further unleash entrepreneurship in America to sustain and encourage long-term growth and economic opportunity.

The Small Business Survival Committee is a 40,000-member nonprofit, nonpartisan advocacy organization. Our membership is as diverse as the small business sector itself, from home-based businesses to small manufacturers to traditional mom and pop enterprises to 1995 entrepreneurs. It represents a wide variety of different types of small businesses in America.

Unfortunately, when we asked a lot of our members, and of course many small businesses across the country what their most daunting obstacles are in running their business, they cite their major problems as being government imposed; namely higher taxes, burdensome regulations or both.

Not surprisingly, more and more Americans, especially small businessowners, are viewing the government as an opponent rather than a partner in their pursuit of the American dream. If there is anything in America that represents the attainment of the American dream, indeed it is owning and operating your own business. So rather than punish investment entrepreneurship and savings in America, the Federal Government needs to encourage entrepreneurship, risk taking and savings.

These components are the foundation for a dynamic opportunity economy. The Contract With America provisions begin to chip away at these government imposed roadblocks that are locking up our true entrepreneurial capacity.

While my written testimony expands on all the elements in the Contract With America which we believe will be helpful to entrepreneurship, I will focus on a few items which zero in on encouraging private sector investment as well as increased savings. Beyond the twin burdens of taxes and regulations which small businesses cite as being their major obstacles, most entrepreneurs seeking to start up or expand an enterprise will tell you of another major obstacle and that is raising capital.

The risky nature of such ventures scares off bank lending officers; therefore, venture capital, whether raised from family and friends or from professional investors, remains a critical source of

funding for entrepreneurial enterprises. The current nonindexed Federal tax rate of 28 percent on capital gains remains a formidable obstacle to economic expansion, especially considering the risky nature of investing and starting and operating a business.

The capital gains tax is a direct levy on investment and entrepreneurship, a direct tax on wealth creation. By taking the first step in the Contract With America and indexing and reducing the capital gains tax rate, Congress and the administration would greatly strengthen incentives for investment in entrepreneurship, boosting economic growth and activity. Investment in small entrepreneurial ventures carry significant risk. High risk ventures must at least present the opportunity for rewards. The U.S. Tax Code, especially in its treatment of capital gains, should not impede risk taking and therefore economic growth.

As was mentioned in previous panels, if you look at internationally where we stand on the capital gains tax front, we are not competitive internationally. In the new and continually expanding global economy, it is imperative that the United States be competitive with other nations as it relates to capital gains.

The current nonindexed capital gains tax rate is not competitive internationally. The fiercest competitors of the United States have zero or lower capital gains rates than the United States. While our organization fully supports eliminating the capital gains tax, the Contract With America proposal which, combined with indexation, reduces the top capital gains tax rate to 19.8 percent could be the most progrowth step taken by the new Congress.

Other components in the Contract we also support. We think they will be very critical for small business and entrepreneurial growth.

The clarification of the home office deduction recognizes the changing nature, the tremendous shift in workplace preferences and needs.

Increasing the estate tax exemption from $600,000 to $750,000 only begins to help families who wish to pass on a family-owned enterprise. The U.S. Tax Code should not penalize families who want to do this.

The expensing provision for small businesses in the Contract encourages investment in entrepreneurial ventures, and the American dream savings account provision encourages increased savings, which provides needed capital for investment in small business and the future of America.

All the previous mentioned are good steps to help prime the pump for small business growth.

I will close and thank the committee for inviting the Small Business Survival Committee. We look forward to working with you on these and other issues to help encourage investment and savings and keeping America's entrepreneurial spirit alive.

[The prepared statement and attachment follow:]

Testimony Before the United States House of Representatives
Committee on Ways and Means
Karen Kerrigan, President
Small Business Survival Committee
January 24, 1995

Savings and Investment Provisions in the Contract With America

Chairman Archer, I would like to thank the Ways and Means Committee for inviting the Small Business Survival Committee to testify before you today on the future of small business in America, and how the new Congress and the Administration can begin to further unleash investment and entrepreneurship in America to sustain long term economic growth and opportunity.

The Small Business Survival Committee (SBSC) is a 40,000-member nonpartisan, nonprofit advocacy organization fighting against the growing burden of taxation and regulation on American small business and individuals. Members of SBSC represent a diversity of small businesses and enterprises across America. From home-based businesses, to traditional "mom and pop" businesses, to small manufacturers, to 1995 entrepreneurs and others -- SBSC's membership is as diverse as the small business sector itself.

If there is anything in America that represents attainment of the American Dream, it is owning your own business. Unfortunately, most small business owners and entrepreneurs cite their most daunting day-to-day obstacles of running their business as government-imposed -- namely, taxes and regulations. We hear little about traditional business-related hurdles regarding sales, marketing, motivating employees, or topics that also require tremendous time and resources from the owner. Government has become the main obstacle to small business prosperity, and not surprisingly more and more Americans do not view their government as protector of our great free enterprise system.

Beyond the twin burdens of taxes and regulations which are slowly strangling productive entrepreneurial activity, the United States non-indexed capital gains tax creates another impediment for entrepreneurs wishing to start-up or expand an enterprise. The federal government needs to encourage, not punish, private-sector investment.

Eliminating Capital Gains Taxes:
Lifeblood for an Entrepreneurial Economy

Most entrepreneurs seeking to start up or expand an enterprise will tell you of a major obstacle -- raising capital. Encouragement for private-sector investment in small business needs to be enhanced. *While SBSC fully supports eliminating the capital gains tax, the Contract With America proposal which, combined with indexation, reduces the top capital gains tax rate to 19.8 percent, could be the most pro-growth step taken by the new Congress.*

There is no more important economic task than investing both sweat and capital in new ideas, innovations, and enterprises. Yet the risky nature of such ventures scares off bank lending officers. Therefore, venture capital, whether raised from one's family and friends or from professional investors, remains a critical source of funding for entrepreneurial enterprises.

The capital gains tax is a direct levy on investment and entrepreneurship. Investment and entrepreneurship are the lifeblood of a vibrant economy and remain the engines of economic growth and job creation. The current, non-indexed federal tax rate of 28 percent on capital gains remains a formidable obstacle to economic expansion, especially considering the risky nature of investing, and starting and operating a business.

The potential benefits of reducing and indexing the capital gains tax are clear. Venture capital investment was on the rise as the U.S. capital gains tax rate declined up to 1986; followed by a dramatic downturn as the rate was hiked 40 percent in 1987, from 20 percent to 28 percent. Since the 1986 Tax Reform Act raised the capital gains tax rate by 40 percent, venture capital investment has nose-dived, and federal capital gains tax revenues have consistently run well below government expectations. In fact, according to CATO economist Steve Moore, 1991 revenue realizations (most recent available) equaled $108 billion versus a late-1980's Congressional Budget Office prediction of $269 billion and a Joint Economic Committee prediction of $285 billion.

How the U.S. Stacks Up Internationally -- In the new global economy, it is imperative that the United States be competitive with other nation's on the capital gains front -- the U.S. needs to be a haven and magnet for capital. The current non-indexed capital gains tax rate is not competitive internationally. Belgium, Germany, Hong Kong the Netherlands all have a zero rate on long-term capital gains. Canada, France, Italy and Sweden have lower capital gains than the U.S., with Japan's rate equalling 1 percent of sales price or 20 percent of net capital gain. Even the two nation's with higher nominal rates than the United States -- Australia and the United Kingdom -- allow for capital gains to be indexed for inflation. Hence, the U.S. *real* capital gains tax rate often will exceed the rate in Australia and the U.K., depending on U.S. inflation.

Given the critical and risky nature of investment and entrepreneurship, and the importance of maintaining a competitive environment in a global economy, capital gains should be excluded altogether. A zero capital gains tax rate would ensure that entrepreneurial risk

taking, so crucial to economic growth, would not be impeded by the U.S. federal tax code. The steps taken in the Contract With America to reduce and index the capital gains tax rate is a good start.

Indexation -- The nominal rate of federal taxation is 28 percent. However, when inflation is factored into the capital gains equation the *real* capital gains tax rate rises substantially.

The lack of indexation creates additional disincentives for investment and entrepreneurship, restraining small-business growth and job creation. In fact, some individuals can wind up paying taxes on real capital losses. That is, after factoring inflation into the equation, a nominal profit on a transaction can turn out to be a real loss, yet the investor still pays taxes on the nominal gains. *Real rates* of capital gains taxation represent severe impediments to keeping America's economy vibrant and growing.

Figure 1 below offers an example of how inflation can impact capital gains tax rates. Listed below are the real capital gains tax rates from 1977 through 1993 on three-year investments yielding a total nominal return of 30 percent. (It is assumed that the investment is closed out at the end of the stated year, for example, the 1985 real capital gains tax rate to an investment made at the beginning of 1983 and sold at the end of 1985.)

The Small Business Survival Committee

Figure 1: Real Capital Gains Tax Rate on Three-Year Investments Yielding a Nominal Return of 30 Percent

Year	Nominal Capital Gains Tax Rate*	Real Capital Gains Tax Rate
1977	35%	191%
1978	28	114
1979	28	175
1980	28	494
1981	20	**Tax on a Real Loss**
1982	20	286
1983	20	71
1984	20	41
1985	20	34
1986	20	54
1987	28	42
1988	33	48
1989	28	47
1990	28	50
1991	28	50
1992	28	45
1993	28	40

* Source: The American Council for Capital Formation

A 28 percent capital gains tax rate acts as a considerable disincentive to investment, while *real* rates ranging from 40 percent to 494 percent to even paying taxes on a real capital loss, amount to economic suicide. Indexation would eliminate inflation as a factor in capital gains determination -- equalizing state and real capital gains tax rates. The lower real rate would reduce uncertainty, and generate investment, economic growth, and job creation.

Who Benefits? Opponents who engage in class warfare rhetoric to dismiss lowering and eliminating capital gains tax rates are employing tactics which the American public, quite frankly, is sick of hearing. "Soak-the-rich" schemes and "fair-share" arguments will continue to backfire on those who feel they can defeat the issue on these divisive grounds. Not only does reducing/eliminating the capital gains tax make sense, but capital gains tend to be spread across a wider income spectrum than many believe. Based on 1992 federal income tax returns, 56 percent of returns claiming capital gains were from incomes of $50,000 or less, including the capital gain. Fully, 83 percent of returns with capital gains were from total incomes of less than $100,000.

Wages and Interest vs. Capital Gains -- In addition to false assumptions about the identification of capital gains just with the wealthy, opponents of cutting or eliminating capital gains taxes often argue that no reason exists for differing tax treatments between capital gains and, for example, wage or interest income.

In fact, there is a distinct difference between wage or even interest income and capital gains -- risk. Capital gains come from growth and appreciation of investments, which tend to carry greater risks than those associated with earning wages or even interest. In particular, investments in small, entrepreneurial ventures carry significant risk. As already noted, high-risk ventures must at least present the opportunity for rewards.

Conclusion on Capital Gains -- Small business is the engine of economic growth and job creation. In order to undertake and/or expand a small business, one needs capital. Without adequate capital, new ideas and businesses either never make it to the marketplace or they die a premature death. With such deaths go products, services and jobs. By taking the first step in the *Contract With America*, and indexing and reducing the capital gains tax rate, Congress and the Administration would greatly strengthen incentives for investment and entrepreneurship -- boosting economic growth and activity.

History shows that class warfare does not make for good economic policy. In fact, during the 1980's, while tax rates declined, upper-income individuals paid a greater share of total income taxes, as the benefits of tax shelters declined and the rewards for working, saving and investment rose. In this environment, from 1980 to 1989, 18 million jobs were created.

The 1986 Tax Reform Act made positive strides by reducing personal and corporate tax rates, but went awry by trying to "pay" for these reductions with an increase in the capital gains tax rate. Indeed, the economy paid a price for this capital gains tax hike in the form of reduced venture capital investment.

The time has come to unleash entrepreneurial capitalism by first reducing and indexing, and then eliminating the capital gains tax.

Entrepreneurial Incentives in the Contract With America

As noted extensively in addressing the importance of reducing, eliminating and indexing the capital gains tax, individuals respond to tax and savings incentives having a profound impact on robust and sustained economic growth. Policy makers need also to look a the changing nature of the economy. Home-based businesses, for example, are booming. Clarifying the deduction for home-offices recognizes our changing work force while reducing questions regarding who qualifies and who does not.

Increasing the estate tax exemption from $600,000 to $750,000 helps small businesses pass on a family-owned enterprise to the next generation -- the U.S. tax code should not penalize families for wanting to keep a business in the family.

The small business expensing provision in the *Contract* encourages investment by allowing small businesses to deduct the first $25,000 in equipment and inventory. All of the above are good steps to help "prime the pump" for small business growth.

The U.S. tax code needs to encourage savings in America -- increased savings provides more capital for investment in small businesses and the future of America. The American Dream Savings Account provision in the *Contract* permits individuals to contribute up to $2,000 into a special savings account. Promoting savings in America will strengthen our country's economic base and encourage savings.

Small business, and the entrepreneurial spirit that drives America, continues to be a constant in our economy -- past, present and future. The U.S. government, whose job it is to protect and preserve America's free enterprise system, has unfortunately become a foe of the private sector. Reforming the tax system so businesses and individuals make decisions on economic merit rather than tax law is an essential component of free enterprise.

The Small Business Survival Committee salutes the 104th Congress and the Ways and Means Committee for its leadership in not only determining how the government can further encourage savings and investment, but also for beginning to look at America's tax system in its entirety and how the government can efficiently and fairly collect taxes from its citizens without eroding individual freedom, or America's free enterprise system.

Mr. HERGER. Thank you very much, Ms. Kerrigan.
Mr. Hiatt.

STATEMENT OF J. DREW HIATT, EXECUTIVE VICE PRESIDENT, DIRECTOR OF GOVERNMENT AFFAIRS, NATIONAL BUSINESS OWNERS ASSOCIATION

Mr. HIATT. Thank you, Mr. Chairman, and members of the committee. My name is Drew Hiatt, executive vice president and director of government affairs for the National Business Owners Association. We appreciate very much the opportunity to appear before the committee and to present our views on the tax and business incentives that are contained in the Job Creation and Wage Enhancement Act, particularly as they affect American small business men and women.

Our members support these changes in the belief that they can and will set the stage for a new American era of expanded economic growth, opportunity, and prosperity. Small businessowners can lead this new era if their representatives on this committee and in the Congress at large will give them the chance.

As the powerhouse of our economy, small businesses know how to lead. America's nearly 22 million small businessowners generate about 40 percent of our GNP, provide more than half our goods and services, and employ 6 in 10 Americans. Over the last 5 years, they have created all of our net new jobs and they continue to help our economy go and grow.

We encourage you as members of this committee and the Congress at large to enact the policies necessary for the small business community to create the economic growth that America needs. Unless this committee and this Congress remove the roadblocks and reform the policies that hold back small businesses, they will never achieve their true economic potential and all Americans will suffer the consequences—in lost opportunity, lost growth, and lost jobs.

It is true that small businessowners are succeeding in spite of these restrictive policies, but they are succeeding against the odds and obstacles because of their determination, hard work and tenacity. If Congress removes the obstacles, there is no limit to what they can achieve.

We believe there is a historic opportunity now to abandon these limiting policies. The goal should be to create an economic climate in this country that is conducive to investment. It is investment that fosters economic growth, prosperity and job creation.

Judging from the way in which revenues from investors and investments are taxed in this country, investment may not be as high a priority as some believe or declare it to be. Our Tax Code punishes, not rewards the very thing and people—risk taking and risk takers—that Congress professes to support. This undermines and even destroys the investment businesses seek to make and nurture. Even worse, it punishes the entrepreneurial risk takers who would launch new ventures or expand new businesses and thereby denies hundreds of thousands of other Americans jobs, opportunities, and wages.

Investment fuels productivity, economic growth, and job creation. Maintaining high taxes or increasing taxes on investment does not. Congress needs to examine whether the sole goal of U.S. tax policy

is to raise revenue to finance government services and programs or whether an equally valid objective of tax policy should be to encourage investment.

This policy debate must focus on whether it is better to raise more revenue to support an inefficient, wasteful, bloated government that consumes wealth or to encourage investment by allowing those who create our wealth to keep more of what they earn to invest. We believe that a dollar left in the hands of entrepreneurs can do more good than one sent to Washington and consumed with little or no result.

A new direction in tax policy is needed to ensure that American businesses, particularly entrepreneurial small businesses, will be free to create the growth in jobs our Nation needs. We need an investment-driven tax policy, and one that will promote investment by lowering taxes on profits and creating more capital formation and increased investment.

Disincentives for savings and investment that are ingrained in our current Tax Code must be replaced with incentives for savings and investment. This will put our Nation on a path of growth and economic security in the years ahead. The current tax treatment of capital gains, for example, is an obstacle to the formation of additional capital entrepreneurs need for investment in jobs and growth.

High capital gains tax rates discourage venture capital and risky investments and harm small firms and new enterprises. These investments are critical to our Nation's growth and economic success. A lower capital gains tax rate would help channel more capital to new and growing small entrepreneurial companies—the Nation's leading source of economic growth and job creation.

Of all the negative effects of taxing capital, perhaps none is more pernicious or harmful than that of inflation. The current tax treatment of capital gains is discriminatory and confiscatory since taxes are paid on inflated and illusory, not real and actual gains. Inflation erodes gains.

Capital gains in our view must be indexed for inflation to halt the taxation of gains based solely on exaggerated values. Many charge that cutting the capital gains rate will disproportionately benefit taxpayers in higher income brackets. Underlying much of the opposition to reducing the capital gains tax is a false belief about our economy: That is, if one individual wins, the other must lose.

Investors who save and invest their income and plow it into productive investments not only help themselves but also countless more who share in the benefits from the initial investment. The direct benefits of investments include economic growth, increased productivity, new jobs, higher wages, and improved living standards, to say nothing of additional revenues that government realizes.

To paraphrase President Kennedy, "A rising tide of investment lifts all boats." The National Business Owners Association supports the neutral cost recovery provisions contained in H.R. 9. This will help businessowners recover the full value of an investment in new machinery, equipment or technology over the useful life of an asset.

Moreover, this change recognizes the importance of capital to small business and its ability to invest for future growth.

We also support the proposal to increase the expensing amount for small businesses. This will also fuel investment and job creation.

We also believe it is important to restore the home office deduction that was restricted by the U.S. Supreme Court decision in *Commissioner* v. *Soliman* when the Court denied certain deductions and imposed two additional tests for determining eligibility for deductions. The *Soliman* decision, in our view, penalizes many small businessowners because they choose their homes as their business location rather than a storefront, office building, or industrial park.

Mr. HERGER. Mr. Hiatt, if you could conclude your comments.

Mr. HIATT. Thank you, Mr. Chairman, and members of this committee.

We believe that the Contract With America and its tax and business investment incentives will go a long way to create a new era of economic growth for this Nation and its citizens, and we are in support of those provisions and believe that they will accomplish those worthy goals.

[The prepared statement follows:]

STATEMENT OF
MR. J. DREW HIATT
EXECUTIVE VICE PRESIDENT
DIRECTOR OF GOVERNMENT AFFAIRS
NATIONAL BUSINESS OWNERS ASSOCIATION
ON
THE JOB CREATION AND WAGE ENHANCEMENT ACT
BEFORE
THE COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
JANUARY 24, 1995

Mr. Chairman, Mr. Gibbons, and Members of the Committee, my name is J. Drew Hiatt, and I am Executive Vice President and Director of Government Affairs for the National Business Owners Association. We appreciate very much the opportunity to present our views on the tax and business investment incentives contained in the Job Creation and Wage Enhancement Act of 1995 (H.R. 9), particularly as they affect American small business men and women.

The National Business Owners Association represents nearly 5,000 small business owners, and has an active and rapidly expanding membership. Its philosophy is based on the belief that a vibrant and robust private sector and a strong and competitive free enterprise economy are essential to create and increase economic growth, opportunity, jobs, and prosperity for all Americans. NBOA vigorously represents the interests of its members before Congress as well as federal, state, and local government. It also works to influence and enact national policies that promote economic growth and entrepreneurship. As part of its efforts to advocate and adopt beneficial laws and regulations, NBOA consistently communicates the concerns and legislative priorities of business owners to lawmakers, government officials, the public, and the media.

We commend you, Mr. Chairman, for your leadership in convening this hearing today to examine how changes to the tax code proposed in the Job Creation and Wage Enhancement Act will create a more favorable economic and entrepreneurial climate. Your support of this legislation underscores your longstanding commitment to promoting and enacting sound fiscal and tax policies -- workable policies that are based on common sense and the common good. We gratefully recognize your commitment. As a strong advocate for small business, you understand the daunting challenges that confront entrepreneurs, especially the financial consequences that taxes impose on hard-working small business owners. We appreciate your efforts as well as the understanding and concern you have shown for them over the years as demonstrated most recently by your introduction of H.R. 9. Our members support the tax and investment provisions of the Job Creation and Wage Enhancement Act in the belief that they can and will set the stage for a new American era of expanded economic growth, opportunity, and prosperity.

Small business owners will lead this new era -- if their representatives on this Committee and in Congress will give them the chance. As the powerhouse of the economy, small businesses know how to lead. America's nearly 22 million small business owners generate about 40 percent of our gross national product and provide more than half our goods and services. Small business is the nation's leading employer. Today, six in 10 Americans take home a paycheck from a small firm.

Small business is not only the nation's leading employer, it is also the major provider of new jobs. Over the last five years, small firms have created nine of 10 net new jobs. In fact, according to the U.S. Small Business Administration, they are expected to create more than three-quarters of the 43 million new jobs needed over the next 25 years.

We encourage you, as members of this Committee, and the Congress at large to enact the policies necessary for small business to create the economic growth America needs. Unless this Committee and this Congress remove the roadblocks and reform the policies that hold back small businesses, they will never achieve their economic potential and all Americans will suffer the consequences -- in lost opportunity, lost growth, and lost jobs. It is true that small business owners are succeeding in spite of these restrictive policies. But they are succeeding against the odds and obstacles because of their determination, hard work, and tenacity. If Congress removes the obstacles, there is no limit to what they can achieve. We believe there is a historic opportunity now to abandon these limiting policies. Lawmakers of both parties should work together to lay the groundwork that will help create the new American era of economic growth.

What's Wrong with Our Tax Policy?

On average, the U.S. economy invests 15-20 percent of its income in a given year. Is it enough? Our goal should be to create an economic climate in this country that is conducive to investment. It is investment that fosters economic growth, prosperity, job creation, and wage growth. We say that we are serious about and committed to investment. We say this is one of our highest national priorities, one our highest public policy goals -- but is it really? Judging from the way in which revenues from investors and investments are taxed in this country, investment may not be as high a priority as some in Congress believe or declare it to be. Our tax code punishes, not rewards, the very thing and the very people -- risk-taking and risk-takers -- that Congress professes to support. At best, it is a logical inconsistency and, at worst, a glaring contradiction to say that Congress, as a whole, encourages investment as a matter of public policy and national priority. It is an economic contradiction for some lawmakers to say they support investment in business startup, expansions, in jobs, and economic growth and then to enact tax policies that discourage investment by levying higher -- and some might argue excessive -- taxes on investment. This inconsistent practice undermines and even destroys the investment businesses seek to make and nurture. Even worse, it punishes the handful of entrepreneurial risk takers who would launch new ventures or expand businesses, and thereby denies hundreds of thousands of other Americans jobs, opportunities, and wages.

Investment fuels productivity, economic growth, and job creation. Maintaining high taxes or increasing taxes on investment does not. Congress needs to examine whether the sole goal of U.S. tax policy is to raise revenue to finance government services and programs or whether an equally valid objective of tax policy should be to encourage investment. This policy debate must focus on whether it is better to raise more revenue to support an inefficient, wasteful, bloated government that consumes wealth or to encourage more investment by allowing those who create our wealth to keep more of what they earn to invest. We believe that a dollar left in the hands of entrepreneurs can do more good than one that is sent to Washington and consumed with little result.

Savings and Investment: Keys to Productivity, Economic Growth, and Job Creation

Increased investment benefits the economy. But the United States has not always followed this formula for economic growth. In fact, the U.S. has devoted a smaller percentage of its gross national product to investment than almost any other industrial nation. Over the last three decades, Japan has invested 31 percent of its output and boosted productivity growth by more than five percent per year. Germany and France have earmarked slightly more than 20 percent of their output for investment, achieving annual productivity growth of more than three percent. In contrast, the United States has invested about 18 percent of its output and increased productivity growth just a little more than one percent.

Why has U.S. investment been so low? The answer is high capital costs. Savings provide funds needed for investment, and are an important source for investment capital. The problem has been that Americans do not save as much as many foreigners do. Consequently, our national rate of savings is one of the lowest worldwide.

An international survey conducted by the American Council for Capital Formation Center found with regard to personal saving incentives that the United States ranks among the lowest on a list of twelve countries. The U.S. capital gains tax rate on long-term gains on portfolio securities is higher than that of all other countries except Australia and the United Kingdom and even these countries index the cost basis of an asset for inflation. Four of the twelve nations tax interest income at rates below the U.S. maximum rate. Total income taxes (individual plus corporate) on dividends are lower in most countries than the United States because most other countries have some form of dividend tax relief. With respect to individual retirement account deductions, these were found to be more generous in five of the twelve countries than they are in the United States. The study also found that half of the twelve countries allow deductions or tax credits for life insurance premiums, while the United States does not. And individual social security contributions to government-sponsored plans are deductible in most of the twelve countries, while they are not in the United States.

In view of weak U.S. savings incentives, it is no wonder that the U.S. personal savings rate, which averaged nearly 7 percent of disposable income over the 1975-1991 period, is far below that of our major competitors. The study found that Japan, for example, had a personal savings rate for this period of 17.3 percent; Germany's rate was 12.7 percent, Canada's was 12.5 percent. The increase in personal savings rate is important in promoting U.S. economic growth and providing funds for investment.

In recent years, private savings have been diverted away from investments and used to finance public deficits and government spending. This has also contributed to higher capital costs. The resulting problem is that less money is available for investment or, where it is available, its cost is prohibitive.

Today, the great debate focuses on the best way to encourage investment. The best strategy for boosting investment would appear to be to create incentives for private investors. Cutting the tax on capital gains is one example of an incentive that would work. Reducing the tax will encourage investors

to buy stocks of companies that retain earnings. This will lower the firms' cost of capital, while providing incentives for saving. Investment income that is taxed encourages consumption at the expense of savings. What we need is to promote investment and savings for the long haul. This is the key to productivity, job creation, and economic growth.

Investing for the short-term is short-sighted. Entrepreneurs need to invest today for the future. They need "patient" capital, long-term capital. Because entrepreneurs need "patient" capital, it is critical to eliminate the obstacles that often discourage investment for the long haul. Business owners and aspiring entrepreneurs must have capital in adequate supply to grow companies and launch new ventures. Congress' goal should be to create a highly favorable investment climate that will enhance and accelerate economic growth, business expansion, and job creation on an unprecedented scale.

Due to realities of a global economy, it is necessary to encourage higher levels of investment and spending in the U.S. economy. American businesses and workers will continue to compete for customers against major competitors in Japan and Europe as well as in the strong and emerging economies of the developing nations. Increased investment generates more productivity, which is the cornerstone of true economic wealth. Throughout our history, we have led the world because of our willingness to invest in new ideas, new opportunities, and people. This has helped us create the world's largest and richest economy. We will always reap the reward of investment today, but the United States must continue to be a nation that saves and invests for the future if it is to continue to be the world's economic leader tomorrow.

A New Direction for U.S. Tax Policy: Toward A More Investment-Driven Policy and Economic Growth

A new direction in U.S. tax policy is needed to ensure that American businesses, particularly entrepreneurial small businesses, will be free to create the growth and jobs our nation needs. Maintaining and or levying higher taxes on investors and investment are contrary to the national objective of long-term economic growth and employment. That is why we need an investment-driven tax policy, one that will promote investment by lowering taxes on profits and creating more capital formation and increased investment.

Small business owners are leading the nation in economic growth and job creation. Yet, the tax code offers very little help in the form of deductions and write-offs that would assist small business owners in creating more jobs and growth through investment. It is important to remove additional disincentives to investment. A new direction in U.S. tax policy would recognize that the sole purpose of tax policy is not only to fund government services and programs, which is merely a collection of revenues, but that an equally important priority is to encourage promote investment that will contribute to economic growth, job creation. and prosperity for all Americans.

We must encourage Americans to save more to promote capital formation for investment and growth in jobs. We must remove the disincentives for savings that lead to consumption of income and instead provide incentives for Americans to save more of their income. Ideas such as American dreams savings accounts, as proposed in the Contract with America, take a step in the right direction toward creating an environment in this country that will encourage savings. Unless Americans begin to save more, American businesses will continue to pay the price for the high cost of capital and this price will be reflected in lower levels of productivity, less economic growth, and fewer jobs for all Americans. Lowering the capital gains tax rate and adjusting gains for inflation would help increase investment. This would create large pools of capital for companies -- both start-ups and existing companies -- to tap for economic growth. It would also create a tremendous potential for enormous economic expansion, for risk-taking, and for new technological development, which is what we need to become more competitive with foreign countries. Congress needs to remove the obstacles, the barriers in the tax code which make it more attractive to consume income rather than to save and invest it.

We need to provide additional incentives for entrepreneurs to invest in their businesses and to recover the full and real cost of their investments. At present, small business owners who invest in their companies are unable to recover the full cost of their investments in depreciable property because inflation erodes the present value of their investments and the time value of money is not accounted for in current write-offs. It is important to remove this obstacle to increase investment.

Disincentives for savings and investment that are ingrained in our current tax code must be replaced with incentives for savings and investment. This will put our nation on a path of growth and economic security in the years ahead.

THE JOB CREATION AND WAGE ENHANCEMENT ACT

Cutting Capital Gains and Indexing Them for Inflation

The House Republican Contract with America includes three capital gains incentive provisions: (1) a 50 percent capital gains deduction, (2) indexation of capital gains for inflation, and (3) allowing

homeowners who sell their homes at a loss to deduct that capital loss. The 50 percent capital gains deduction and the home sale capital loss provision would apply to sales on or after January 1, 1995. The capital assets indexation would apply to inflation (and sales of assets) after December 31, 1994.

Fifty Percent Capital Gains Deduction

The bill would allow taxpayers -- both individual and corporate -- to exclude one-half of capital gains from income tax, with the effect of cutting the capital gains tax rate to one-half the rate of ordinary income, which currently is capped at a rate of 28 percent. The new effective capital gains tax rates would be 7.5 percent, 14 percent, 15.5 percent, 18 percent, and 19.8 percent for individuals, depending upon the individual's tax bracket. Corporations would be subject to a top effective tax rate of 17.5 percent. The measure would not change the 1-year holding period requirement for long-term capital gains.

The 50 percent capital gains deduction would be taken against gross income. This change would ensure that the excluded half of the capital gain would not increase Adjusted Gross Income (AGI). Because capital gains are currently included in AGI, many taxpayers must forfeit personal exemptions and itemized deductions if they are above certain income thresholds. This change would have the effect of reducing the effective tax rate on capital gains by easing the impact of the personal exemption phaseout and the limitation on itemized deductions.

The capital gains deduction would not be a preference under the Alternative Minimum Tax (AMT). Therefore, the 50 percent deduction would be excluded from the AMT. This exclusion helps taxpayers avoid another tax rate on capital gains.

The bill would also reinstate the pre-tax Reform Act of 1986 rule for capital losses: only one-half of net long-term capital losses, to the extent that they exceed net short-term capital gains, would be deductible.

Capital Gains Indexation

The bill would halt the practice of taxing individuals and corporations on inflated capital gains. Under current law, taxpayers must pay capital gains taxes on the difference between an asset's sales price and its basis (the asset's original purchase price, adjusted for depreciation and other items), although the increase in value may be the result of inflation and not real gain. The measure calls for increasing the basis of most capital assets to account for inflation after 1994. Taxpayers would be taxed only on real, not illusory, gains.

Loss on the Sale of a Home

Under the bill, taxpayers who sell their principal residence at a loss may deduct that as a capital loss. Current law does not allow homeowners who sell their homes at a loss to take this deduction.

Why a Cut in Capital Gains Is Needed and Why Gains Should be Indexed

Capital is the lifeblood of enterprise and economic growth, yet too often risk-takers -- energetic entrepreneurs with promising ideas and practical dreams -- encounter obstacles in obtaining the capital they need to launch a new venture. Even well-established business owners -- with strong track records and profitable companies -- can run up against the same problem when seeking additional sources of financing to expand their operations. Our nation's future success depends on entrepreneurs and small business owners who can help fuel our growth and drive our economy. They create our jobs and contribute to our growth and prosperity. But without the capital to start and expand businesses, they cannot succeed and ultimately we all will pay a price for their lack of success. It is time that Congress address the need for increased capital availability within the context of efforts to encourage increased business formation and expansion through investment. The current tax treatment of capital gains is an obstacle to the formation of additional capital that entrepreneurs must have access to for investment in growth and jobs.

The Effects of Taxing Capital Gains

Reduced Savings and Its Effect on Capital Formation and Investment

Subjecting capital gains to taxation penalizes those who save and invest, forcing them to pay tax not once but twice on the same income. From the standpoint of tax fairness and equity, the capital gains tax is punitive and discriminatory. High tax rates on capital gains tend to discourage savings because they lower the after-tax rate of return on savings. Such rates can distort individual decisions about savings. Faced with a choice between saving income -- with a lower rate of return later -- or spending it now, many Americans elect to consume income now rather than defer future consumption through

savings. Since savings is essential for capital formation, the individual preference for current consumption as compared to saving for future consumption stymies capital formation. Reduced availability of capital equates to lower levels of investment in business startup, plant and equipment as well as in labor, with the consequence that productivity suffers and workers' wages can drop.

Decreased Risk-taking and Investment

High capital gains tax rates discourage venture-capital and risky investments and harm small firms and new enterprises. These investments are critical to our nation's growth and economic success. Over the last several years, entrepreneurial small companies have contributed to and accounted for much of the economy's growth and job creation. Growing and emerging new companies need steady infusions of risk capital to nurture, support, and sustain expansion. Entrepreneurs and small business owners need investors to buy stock and to invest in their companies. But investors will only commit their capital to such investments if they can be assured of a fair and reasonable return on their investment.

The taxation of capital gains acts as a significant drawback to riskier investments in new startup companies or those undertaking expansion. A lower capital gains tax rate would help channel more capital into new and growing small entrepreneurial companies -- the nation's leading source of economic growth and job creation. This, in turn, would create a tremendous potential for increased economic expansion, encourage risk-taking on a larger scale, spur innovation, boost productivity, and add more Americans to company payrolls.

The Threat to U.S. Competitiveness

Higher capital gains tax rates undermine U.S. industrial competitiveness and threaten to challenge our longstanding role as the undisputed economic leader of the world. Capital is the key ingredient of investment and investment fuels growth and expansion; however, when capital costs too much, investment declines and productivity and economic growth suffer. Higher capital gains rates tend to discourage savings and investment, raising the cost of available capital. The effect of higher capital costs -- either because of reduced supply or increased demand -- means lower levels of investment in plant and equipment, technology, and labor. As a result, goods and services that are produced under this scenario cost more to produce. These costs must be reflected in higher consumer prices, making products less price competitive in the marketplace.

The United States already faces significant competitive challenges around the globe. In many cases, our competitors benefit from more favorable tax treatment of capital gains and savings, combined with lower labor, raw materials, and overhead costs as well as reduced regulatory and paperwork burdens. This strengthens their advantages and increases their opportunities in the marketplace. Congress needs to stimulate investments in technology, plants and equipment, and people to maintain our technological superiority, boost productivity, and increase our global competitiveness. That is why a lower capital gains tax rate is needed to reduce the cost of capital and to increase its availability.

Locking in Investors and Investments

Investors who contemplate selling assets or changing their investments understand the effect capital gains taxation has on anticipated profits from asset sales. They must weigh whether the expected return from a sale of an asset will result in a desired profit after the capital gains tax has been levied. When it is clear that the profit is less than expected, investors will generally forego or postpone the sale of an asset. This phenomenon of investors holding onto assets because the expected net return derived from the sale of an asset after the payment of capital gains tax is less than desired is known as the "lock-in" effect.

Taxing capital gains often saddles investors with assets they do not want but cannot afford to liquidate because of the undue financial consequences of such a decision. This can cause capital to idle in non-productive assets. Moreover, the lock-in effect deters the redeployment of capital to more useful and productive investments. Since the lock-in effect caused by higher capital gains taxation can distort and influence behavior, many investors seek out investments that will minimize tax liability. In such cases, tax avoidance becomes a major strategy in considering investments rather than pursuing investments that make good economic sense and, while riskier than others, also provide higher rates of return.

Lowering capital gains taxes would unlock a huge amount of wealth in homes, land, farms, stocks, bonds, and other assets; free investors to pursue new investments; and increased realizations of capital gains would generate new revenues.

Inflation

Of all the negative effects of taxing capital, perhaps none is more pernicious or harmful than that of inflation. The current tax treatment of capital gains is discriminatory and confiscatory, since taxes are

paid on inflated and illusory, not real and actual, gains. Inflation erodes gains. Under current law, capital gains taxes are applied to nominal gains, which are gains that are not adjusted for inflation. This means that the effective tax rate on real capital gains is actually higher than the current prescribed legal rate. Since the appreciation in value of most assets, particularly those held for longer periods, is attributable to inflation, taxing nominal gains destroys the wealth of entrepreneurs, individuals, and families.

Capital gains must be indexed for inflation to halt the taxation of gains based solely on exaggerated values. This would help investors who currently avoid selling their capital assets to take advantage of higher risk investments -- the chief source of economic growth. Further, it would allow investors to buy assets based on their true merits without regard to the effect of inflation on future returns or planning sales of assets based on artificial holding periods. Indexing capital gains for inflation also would help small business owners who want to sell assets to create or expand a business or sell their company.

In Defense of a Capital Gains Tax Cut: Answering the Critics

Critics of reducing the rate of capital gains have attacked the proposal on many fronts.

Argument: A Capital Gains Tax Cut Only Helps the Rich

Many charge that cutting the capital gains rate will disproportionately benefit taxpayers in higher income brackets. They contend that at least half of the direct benefits of a cut in capital gains will go to the top two percent of taxpayers nationwide. Opponents are concerned that this will result in a windfall to America's richest individuals and corporations at a time when there is a growing disparity between the country's poor and rich.

Underlying much of the opposition to reducing the capital gains tax is a false belief about our economy: that is, if one individual wins, the other must lose. Investors who save and invest their income and plough it into productive investments not only help themselves, but also countless more who share in the benefits from the initial investment. The direct benefits of investments include economic growth, increased productivity, new jobs, higher wages, and improved living standards, to say nothing of additional revenues that government realizes. Thus, investments produce a strong multiplier effect within the economy, helping investors and those who are beneficiaries of their investments. To paraphrase President Kennedy, 'a rising tide of investment lifts all boats.' But when higher capital gains taxes punish investors by devouring the value of their investments or diluting them through the taxation of inflated gains, they respond by saving and investing less. Ultimately, their reluctance -- or refusal -- to save and invest hurts the economy and everyone in it.

If Congress wants to create more jobs, expand the economy, improve income and wage opportunities, it must encourage more investment. To foster greater investment, Congress must first remove the disincentives to savings and investment -- for rich, middle-class, and lower middle-class investors alike. Individuals respond positively to investment incentives but they react negatively and predictably to investment barriers such as higher capital gains rates. Congress must create incentives for risk-taking, job creation, and expansion, and lowering the capital gains rate is a first step. This reform would help all income classes because it would improve the economy's performance and growth potential. It is a tenet of sound economic policy that economic growth increases when the cost of activities that foster it are lowered.

Critics of lowering the capital gains tax deride it as a boon to rich taxpayers. They labor under a false assumption; namely, that not all those who pay capital gains taxes are rich. Low- and middle-income taxpayers bear a significant share of the cost as well. The reality is that many Americans with limited incomes have investments in stock, rental properties, and small businesses. They face the capital gains tax when they sell such assets. Michael Schuyler, Ph.D., of the Institute for Research on the Economics of Taxation, found that:

" Most distributional tables purporting to show who pays the capital gains tax overstate the wealth of people with capital gains because they include in a taxpayer's income the entire capital gain in the year in which the person realizes the gain. Since gains are typically realized irregularly, people tend to have unusually high incomes in the years when they realize their gains. A better measure of income is found by averaging the gains over several years' before adding them to income. And these corrected tables indeed show that the middle-class forks over a significantly higher share of the capital gains tax than is usually acknowledged. In addition, as politicians in Washington have sought higher taxes to finance more government spending, they have frequently found it convenient to redefine "wealthy" at lower and lower income levels."

Cut The Capital Gains Tax To Help All Income Classes
IRET Byline. September 22, 1989 No. 79

A high capital gains tax rate should not be used to extract more taxes from income earners in the top tax brackets any more than it should be used to punish those who are lower and middle-class income brackets. Lowering the tax on capital gains has the potential to help Americans in all income classes by sparking greater growth in the economy.

Argument: A Capital Gains Tax Cut Will Break the Treasury and Increase the Deficit

Opponents of a lower capital gains tax rate maintain that reducing the rate could cause the budget deficit to rise unless Congress offsets the tax cut with spending cuts. They say that Congress must find the cuts or risk further interest rate hikes from the Federal Reserve. Opponents also argue that a cut would kill prospects for improved economic growth that Republicans say they want to stimulate. The Congressional Joint Committee on Taxation estimates that the Republicans' proposed capital gains tax cut would cost $56 billion in lost tax revenue over the next five years. After that, it predicts, the cost of a capital gains tax cut would rise, mostly due to proposed adjustments in future capital gains to offset inflation. Opponents point out that Congress cannot dismiss the fact that the $160 billion deficit will begin rising again next year, and that the costs of the capital gains tax cut would add to that cost without offsetting spending cuts

Republicans have vowed to cut spending to make room for the cuts they propose. The capital gains tax cut will not be a revenue loser as critics contend; in fact, it could prove to be a net revenue gainer. Mr. Gary Robbins, President of Fiscal Associates Inc, a leading proponent of dynamic estimating, predicts that the capital gains tax cut would produce $126 billion in new revenues by fostering widespread economic growth. We believe this could result in a windfall to the U.S. Treasury. A lower capital gains rate could boost tax revenues by encouraging investors to realize their gains sooner. A cut would encourage investors to liquidate assets and put their money into productive investments to such a degree that the cost of a capital gains tax cut would pay for itself in higher tax revenues later.

Critics say that is an unproven economic hypothesis. Yet, Warren T. Brookes, a respected journalist and economist, recounts in his book, *The Economy in Mind*, that the opposite is true:

"When the top marginal tax rate on capital gains was 46% (1946-63), or nearly double Mellon's maximum range of 25%, the taxes paid on capital gains steadily declined from 1961 through 1963. Then, as a result of the Kennedy across-the-board tax cut of 1963-64, the top marginal tax rate on capital gains was reduced from 46% to 35% -- a cut of 24%. The revenues from this tax steadily rose, by 25% in 1964 and 27% in 1965. By 1968 they had nearly tripled in constant dollars, at a substantially lower marginal tax rate.

Unfortunately, this growth in capital gains and investment was hit hard, first by a surtax in 1968-69, and then by an increase on capital gains put through by Senator Edward M. Kennedy in 1969, which had the effect of raising the top marginal tax on capital gains to its highest level in U.S. history, 49% in 1970. The results were immediately destructive. Tax revenues from capital gains plummeted, and over the next eight years remained consistently at a level nearly $1.5 billion lower than they were in 1968.

Within a year of this tax increase, the entire equity capital market for small companies (which account for over 80% of all new jobs and 65% of new inventions) fell apart; and it continued to disintegrate over the next eight years. In 1969, before the tax hike, there were nearly 700 new stock offerings by small companies, with a total 1980 value of nearly $3 billion. But by 1977 this equity market had shriveled to only 13 offerings and less than $55 million -- a compound annual decrease of nearly 40%, the worst collapse in equity sales in modern U.S. history.

For all intents and purposes, Senator Kennedy's innocent little tax hike had virtually killed off the small-business equity market and countless thousands, even millions, of jobs along with it."

The Economy in Mind, pp. 59-61

Later in the same chapter, Brookes describes the effort involved in trying to reverse the increase on capital gains.

"It was perhaps the best illustration of the Laffer Curve in action -- so good, in fact, that a young Republican congressman, the late William Steiger of Wisconsin, decided in 1977 to try to convince an overwhelmingly Democratic Congress to repeal this massive mistake [sic: Senator Edward Kennedy's bill to raise capital gains] by showing his colleagues that as much as half of the new equity capital for the nation's fast-growing high-technology industries was, by now, coming from overseas rather than from our own equity markets.

The dramatic fall, both in capital-gains tax revenues and in equity-investment, convinced the Congress to turn down President Carter's own surprising plan to increase the capital-gains tax rate still further (to 52.5%) and instead to adopt Congressman Steiger's amendment, which cut the rate from the 49% level down to 28% -- a 43% tax reduction.

The Carter administration, in an unsuccessful attempt to block this bold move, had warned that the Steiger Amendment could reduce Treasury revenues by more than $2 billion during the first year. Instead, the Steiger cut actually *raised* capital-gains tax revenues modestly in 1979, the first year

following the 43% reduction, as the number of new equity offerings suddenly jumped from 20 per year to 81 in 1979. Then, during 1980, a recession year, 237 companies offered stock to the public for the first time (the greatest number since 1972) and sold $1.4 billion in shares -- a huge increase from the 81 new companies that had sold $506 million in 1979."

The Economy in Mind, pp. 61-62.

NBOA Position on Cutting Capital Gains and Indexation

The National Business Owners Association strongly supports the capital gains tax cut and indexation provisions contained in Job Creation and Wage Enhancement Act as introduced and as originally proposed in the Contract with America. We asked our members in a survey whether they would favor a capital gains tax cut. Respondents overwhelmingly expressed support for legislation to reduce the rate of taxation on capital gains. NBOA believes that the capital gains relief incentives included in the bill will create a climate that will encourage investment; promote increased growth in the economy, jobs and wages, and strengthen U.S. competitiveness.

Neutral Cost Recovery

The House Republican Contract with America includes a "neutral cost recovery" proposal. This proposal would increase depreciation deductions to approach the economic equivalent of expensing. Currently, the tax code does not allow businesses to recover fully (on an economic basis) the cost of investments in depreciable business property. The proposal would increase depreciation deductions to account for inflation and the time value of money. The neutral cost recovery provisions would generally apply to property placed in service after December 31, 1994.

Current law prohibits company owners from taking an immediate write-off for the investments they make in depreciable assets such as plant, equipment, and other assets. Consequently, they must spread the write-offs over longer periods. This practice hurts small business owners in several ways. It reduces the real present value of the write-offs since they do not account and compensate for the twin effects of inflation and the time value of money. By not allowing business owners to factor in the costs of inflation and time value of money and to adjust their write-offs on depreciable property to reflect these costs, business owners are unable to recover the full costs of their investments.

Under the neutral cost recovery proposed in the Job Creation and Wage Enhancement Act, businesses would be allowed to recoup the cost of their investments. The plan would allow companies to adjust their depreciation write-offs yearly by applying a 3.5 percent discount rate and the rate of inflation. This would make the write-off amount equal to the full purchase price of an asset.

NBOA Position on Neutral Cost Recovery

The National Business Owners Association strongly supports the neutral cost recovery provisions contained in H.R. 9. This bill will give business owners and entrepreneurs a powerful new investment incentive, allowing them to recover the full value of an investment in new machinery, equipment or technology over the useful life of an asset. Moreover, these changes recognize the importance of capital to small business and its ability to invest for future growth. We believe further that this provision will exert a positive influence on investment and wages as it seeks to correct an inequity in the current tax code that harms small business. These changes will also help promote rapid economic growth by spurring increased investment. We believe that such growth will fuel business startup and expansion as well as spark new job creation.

Increasing the Expensing Level for Small Business

The House Republican Contract with America also proposes an increase in the amount of property that a small business can "expense" or deduct in the year of purchase. Current law allows a small business (a business purchasing $200,000 or less of eligible property) to take an immediate deduction on the first $17,500 of property it acquires. Remaining property is generally subject to regular depreciation rules. The proposal would allow small businesses to fully deduct an additional $7,500 from each year's earnings for purchases of equipment and inventory up to $25,000, compared with $17,500 now. The provision would be in effect for taxable years beginning after December 31, 1995.

Expanded write-offs for investments in plants and equipment for small business are needed to ensure that small firms have access to capital to invest in growth and expansion. Entrepreneurs need to invest today for the future, and that long-term investment must be nurtured. Yet, the present tax treatment of investments in plant and equipment has not favored long-term investment as it should nor favored the investments of small business men and women who are driving our nation's growth.

NBOA Position on Increasing Expensing for Small Businesses

The National Business Owners Association strongly favors the proposal to increase expensing amount for small businesses as contained in the Job Creation and Wage Enhancement Act. This legislation provides an important investment incentives for small business owners, while enabling them to recover more of the cost of their investments. This, in turn, will increase the availability of additional capital for future investment.

Clarifying the Home Office Deduction

H.R. 9 would clarify the home office deduction by making two changes. First, an office in the home would qualify as a principal place of business if the office is the location where the taxpayer's essential administrative or management activities are conducted on a regular basis by the taxpayer and the office is necessary because the taxpayer has no other place to perform those activities. Second, qualifying home office expenses would also include those allocable to the storage of product samples. The changes to the home office deduction generally would be effective for taxable years beginning after 1995.

The home office deduction was restricted by a 1993 U.S. Supreme Court decision in *Commissioner v. Soliman,* when the court denied certain deductions and imposed two additional tests for determining eligibility for deductions. To qualify now, a business owner must: meet clients or customers in the home office; and second, earn the firm's revenue there as well. The Soliman decision penalizes many small business owners because they choose their homes as their business location rather than a store front, office building, or industrial park. This ruling fails to recognize the fundamental realities of American business today, including its changing nature; how, when, and where business is conducted; as well as the needs of entrepreneurs who are leading our economy.

The bill would restore the deduction for home office expenses to pre-Soliman law. Taxpayers would not be required to meet the criteria determined by the Court. Rather, the bill allows a home office to meet the definition of a principal place of business if it is the location where essential administrative or management activities are conducted on a regular and systematic basis by the taxpayer. To avoid potential abuses, the bill would require that taxpayers have no other location for the performance of the administrative or management activities of the business.

The home may be the best incubator for fledgling businesses that are struggling to survive and succeed. Few new small business owners, if any, can afford the luxury of rented office space. That is because a major problem facing new enterprises is cash flow. Many entrepreneurs launch new firms on a shoestring budget, enduring long hours, limited resources, and lean or no profits before they become successful. For these business owners, the home office deduction can boost the chances that the company they have started and worked hard to build will be a success. That is why the loss of the deduction represents a major blow to those whose success often hangs in the balance and hinges on taking advantage of every break that can keep the company financially afloat and growing.

The Soliman decision ignores the changing face and needs of business. The advent of advanced and ever-improving computer and telecommunications technology has empowered millions to work from their homes. Entrepreneurs are no longer tied to an office or to a store front. Now, thanks to technology, they can work from their homes. Technology has changed the way we think, communicate, work, and do business -- and where we do these things. New technologies are revolutionizing business and helping us to realize huge improvements in productivity and service. As technology becomes cheaper due to innovation, more Americans can afford to work for themselves and from their homes. U.S. tax policy should not discriminate against home businesses because a taxpayer chooses to operate a business out of the home.

NBOA Position on Clarifying the Home Office Deduction

The National Business Owners Association strongly supports efforts to restore the home office deduction. Restoring the home office expense deduction could affect between 20 and 40 million Americans who work from their homes.

Increasing the Estate Tax Exemption

The Contract with America would raise the estate and gift tax exemption equivalent to $750,000. The current $600,000 exemption has not been increased in several years and has been eroded by inflation. The increase in the exemption would be phased-in. The exemption would be $700,000 for estates of persons dying, or for gifts made, in 1996. The exemption would be $725,000 in 1997 and $750,000 in 1998 or later. The $750,000 exemption amount would be indexed for inflation.

Estate taxes are hurting family-owned businesses, especially smaller firms. Funds that could be retained in a business to invest in growth and create jobs are going to pay taxes on the assets of the deceased owner or the owner who desires to exit his or her firm and hand over control to the next generation. The accounting firm of Arthur Andersen estimates that the transfer taxes on business assets above the current $600,000 exemption range from 38 percent to 60 percent, depending on amount. Surviving family members frequently must sell part of the company to pay the estate taxes. According to Mr. Drew Mendoza, program director of the Family Business Center at Loyola University-Chicago, meeting this tax burden forces many family businesses into sale or foreclosure. A survey found that nine of 10 family successors' businesses failed shortly after the original owner's death, due to the difficulty of paying estate taxes. Seventy percent of all family businesses will not succeed to the second generation and only 13 percent will make it to the third generation.

According to a recent research study conducted for Massachusetts Mutual Life Insurance Company, 57 percent of owners say they intend to pass on their ownership positions to a close relative. This represents an eight percent drop-off from the 1993 study, when 65 percent of those surveyed said they intended to keep the business in the family. It is an alarming statistic, and points to a possible disturbing nationwide trend: we are losing family-owned businesses. Higher estate taxes may be the culprit or only a single factor contributing to the decline of America's family-owned businesses. These firms are important to our nation's economy. It is estimated that there are 10 to 12 million family-owned businesses nationwide. These companies may account for as much as half our gross national product and 60 percent of all wages paid.

With all the daunting challenges and obstacles already facing small business owners, the tax code should not add to the burden of family business owners by making it more difficult for them to keep their companies in family hands. We need to preserve family businesses by removing obstacles -- such as higher estate taxes -- that threaten their prospects for continued survival and success.

The last estate tax reform occurred in 1981, when the high inflation of the 1970s forced Congress to alter the existing law. The tax rate was reduced from 70 percent to 50 percent, the tax exemption was raised from $200,000 to $600,000, and further taxes were deferred on the portion of the estate the spouse inherited. These changes were only adequate for a short time. Small business owners say they have not kept pace with the state of the economy and they need to be overhauled again.

NBOA Position on Raising the Current Estate and Gift Tax Exemption

The National Business Owners Association strongly supports raising the current estate and gift tax exemption to $750,000 and adjusting it for inflation. This change will help ease the burden of estate taxes for many small business owners, keep family firms financially stable, and preserve them for generations to come.

CONCLUSION

We appreciate this opportunity to offer our views on the tax and investment incentives contained in the Job Creation and Wage Enhancement Act. These incentives will set the stage for a new American era of economic growth led by small business owners. The real growth in all major economies worldwide is coming from smaller, more entrepreneurial companies. That is especially true of the U.S. economy. The importance of entrepreneurs and small business owners to the economy cannot be underestimated. They drive the American economy, fueling its growth, adding new jobs, and creating wealth.

Congress must help unleash the entrepreneurial spirit to spur economic growth and encourage individuals with promising ideas and the courage to take risks to start and expand businesses. Too often government creates obstacles to growth -- as it has with disincentives for savings and investment. Small business owners deserve policies that promote economic growth -- policies that reward, not punish, risk-taking and hard work. The tax and investment incentives in the Contract with America are a bold and promising step in the right direction.

Mr. Chairman, we look forward to working with you and the Members of this Committee over the coming months to develop and enact the policies that will help America's nearly 22 million small business owners bring about a new American era of economic growth and prosperity.

Mr. HERGER. Thank you both for your comments.

I noted in your testimony, Ms. Kerrigan, that you did mention the importance of raising the estate tax exemption. In our Contract With America, it is raised from $600,000 to $750,000. I might note that statistically only 23 percent of family farms or businesses are able to be passed on from the parents to the children and less than 10 percent onto the third generation.

I might maybe direct my question to you, Mr. Hiatt. Do you feel that this is a concern among the small businessowners?

Mr. HIATT. Yes, sir, it is. Let me tell you why we believe it is especially important that we raise the exemption. It was raised from $200,000 to $600,000 and that gave some relief but not enough because of inflation and other things that have eroded that kind of wealth.

It is also important to note that a study has found that when small businessowners pass on their companies to their children, that because of estate taxes, 9 out of 10 of those businesses fail. It is also disturbing to note that many small businessowners are choosing not to pass on their businesses to keep them in family hands, and we think it is very important to preserve family-owned businesses. We encourage this committee to look at perhaps even raising the current threshold beyond the $750,000 limit that is proposed in the Contract.

Mr. HERGER. Thank you.

Mr. English will inquire.

Mr. ENGLISH. Thank you.

I noticed, Ms. Kerrigan, in your testimony that you would like to see us address the issue of raising the threshold for expensing of equipment for small business. Now, I know from my experience in my district, we have a lot of small manufacturers who are internationally competitive who are having to invest more or less constantly in new plants and equipment to stay competitive.

As you have polled your membership, where is this in their order of priorities, and do you think there is a long-term objective here of raising that threshold beyond even the $25,000?

Ms. KERRIGAN. Indeed. Our membership clearly supports the issue of small business expensing and concurrently increasing that level to $25,000. But unfortunately, in today's marketplace, $25,000 does not buy that much, especially if you are talking about a small or larger than small or say a small manufacturer or medium-sized business. Certainly one of the alternatives that we would support is perhaps a phase-in to a $100,000 expensing limit. We do see a need to increase that.

Mr. ENGLISH. Very good. As we have reviewed some of these proposals, obviously one of the ones that has attracted the most attention is the proposed cut in the capital gains tax, and you have offered in your testimony, I think, the most onpoint comments on the correlation between capital gains taxes and business starts.

Have you found that many of the small businesspeople starting up have to use their own resources and are deterred from finding the capital from selling assets by the existence of a capital gains tax much higher than you find in other countries?

Ms. KERRIGAN. Absolutely. If you look at where the United States stacks up internationally, we are not close to even our fierc-

est competitors. Many of our competitors have zero or lower rates. Even those that have higher nominal rates, Australia and the United Kingdom, at least index for capital gains and, therefore, our rate, depending on U.S. inflation, could be much higher than Australia and the United Kingdom.

The question remains, I guess, in terms of where small businesses go to seek startup capital. Since they are—since bank lending officials are scared off by such risky ventures, they do seek out venture capitalists, friends and families, and those folks have to make the determination beyond the risk of the business, are they going to sell off current assets and receive—you obviously have to pay some high capital gains tax rate on that asset versus what the return will be on investing in a business, and this is very difficult for any investor to do, even if it is a family or a friend of that person that is seeking that startup capital.

Mr. ENGLISH. You had mentioned that in other countries capital gains are indexed to inflation for tax purposes. There has been an argument here today by a number of the panelists that indexing capital gains to inflation would be a serious reduction in tax simplicity.

Now, many of your members, I would imagine, do their own tax returns. Is this a cause of concern for you?

Ms. KERRIGAN. If it was indexed to inflation?

Mr. ENGLISH. Yes.

Ms. KERRIGAN. I think this would be a positive cause for concern as opposed to—if you look at the U.S. Tax Code and what small businesses have to do to comply with, the Tax Code is absolutely a mess. I mean, there is no doubt about it, and we are definitely for making complying less complicated, less costly. I mean, if you are adding a whole series of changes to the Tax Code, then that might make a big difference, but I don't see this as being one of those major concerns.

Mr. ENGLISH. So your membership would not be concerned about the tax simplicity argument against changing the capital gains tax?

Ms. KERRIGAN. No.

Mr. ENGLISH. Finally, distributional issue, if I could just ask this last question, Mr. Chairman, let me get a quick answer from you.

There has been a lot of criticism of cutting the capital gains tax as providing tax cuts for the rich. Obviously you represent a grassroots constituency of individuals who are not affluent, who are very concerned about this issue. Would you care to comment on the equity side of this issue?

Ms. KERRIGAN. Even if reduction in capital gains did benefit the rich exclusively, which it does not, it doesn't mean that everyone else loses if you reduce the capital gains tax rate. But, you know, it is spread across a wider income spectrum than I think is reported by the media and those that oppose reducing or eliminating the capital gains.

In 1992, 56 percent of those reporting a capital gain had incomes of $50,000 or less, including the gain; 83 percent of those reporting a capital gain had incomes of $100,000 or less, including the gain. So I think there has been a misrepresentation of who will benefit and who will not.

But, you know, our position is and I think most of our small business members is that class warfare does not make for good economic policy, and so that is not a problem, you know, with our membership. And most of our small business members, I would say, make in the $30,000 to $50,000 and $60,000 range. They are not rich.

Mr. ENGLISH. Thank you very much.

Thank you, Mr. Chairman.

Mr. HERGER. Thank you very much.

Mr. McCrery will inquire.

Mr. MCCRERY. Thank you, Mr. Chairman, and thank both of our witnesses for coming and bearing with us today through a long series of testimony.

Both of your testimonies were excellent, I thought, particularly bringing home the value of some of these tax proposals to small business. Ms. Kerrigan, you have talked particularly about the importance of expensing to small businesses, and I certainly agree with your analysis.

There is one thing that I want to mention and get your thought on that I am aware of, particularly because I have an automobile manufacturing plant in my district, but I am also aware of it because a number of small businesspeople who depend on an automobile for their livelihood basically complain that they cannot expense the cost of that automobile. They can expense a tape recorder or a fax machine or, you know, all kinds of things like that, but if they don't need those things, but they have to have a car to do their business, whether it is a plumber that has to have a truck to drive to do his jobs or a door-to-door salesman that needs to have a car to keep his samples in, you know, they find that their primary business investment, as far as a depreciable asset is concerned, is an automobile, and yet they can't deduct it as they would be able to deduct other purchases of business equipment.

Would you comment on that? And do you think that is something for us, for this committee to look at as we change the rules with respect to depreciation and expensing?

Ms. KERRIGAN. Oh, indeed I do. I think that a vehicle should be a part of small business expensing. And a little known fact is that they are not, so mobile entrepreneurs, those people who use vehicles to transport themselves, their products, their goods, their services on a daily basis are not allowed to significantly expense what sometimes is their largest capital acquisition, and this occurs largely because of the luxury depreciation cap which, you know, blocks this type of expensing. So I think it would be very important for the committee to make, if they can, that tax change to make vehicles part of small business expensing.

Mr. HIATT. Mr. Chairman, could I respond to that?

I have driven from Shreveport all the way down to New Orleans. We have a lot of members in your district, and that is about a 6-hour drive depending on traffic. We have a lot of members in that area who do business in Baton Rouge and New Orleans on a daily basis, and their personal automobile is also used for business.

This is an absolutely essential component of their business and of their work, and we think that that would probably be a good proposal to look at. I think there is a potential here for abuse, but I

think that can be looked at and any abuses can be mitigated against in the long run.

Mr. McCrery. Thank you. Also, on the question of the estate taxes, both of you have mentioned estate taxes and how that is a problem for small businesses, particularly closely held, family-owned small businesses where the heirs find that they have to sell their business in order to pay the estate taxes and therefore the business is gone, the employees who worked for the business don't have jobs, and that is a tremendous problem.

You have both said that the increase from $600,000 to $750,000 is a nice step in the right direction. Do you think that this committee should consider going further with respect to lessening the burden on heirs of owners of small businesses?

Ms. Kerrigan. From our perspective, we think the increase is important, and we support it, and perhaps it may cover the inflation costs over the past 15 years, but we still see that even with this increase that many of these family-owned businesses that pass on the business to the next generation will probably, even with this increase, have to sell part of the family business to cover the costs of the estate tax bills.

And what this does is punishes capital accumulation and hard work, and the hard work of a lifetime of a family, so we would like to see it increase beyond the $750,000 range. I think the American Farm Bureau even, their proposal puts it up to $2 million, so an increase beyond $750,000 is indeed important.

Mr. McCrery. What about eliminating it?

Mr. Hiatt. Eliminating it?

Mr. McCrery. Eliminating it, what about that? What do you think about that for small businesses?

Mr. Hiatt. We could certainly support that.

Ms. Kerrigan. We will support that, capital gains, a few other things.

Mr. Hiatt. What is interesting on that very point is that a survey found that 70 percent of all family businesses will not succeed to the second generation and only 13 percent will make it to the third, and another survey found that 9 of 10 family successor businesses failed shortly after the original owner's death due to the difficulty of paying estate taxes.

So what we see is that family-owned businesses in this country are an endangered species, and if we believe that it is important to preserve the tradition of family-owned businesses that really helped build this country, then we certainly need to remove the obstacles to keep them in family hands.

Mr. McCrery. Thank you very much.

Mr. Herger. Thank you very much, and thank you, Mr. McCrery, for some good questions.

Mr. Collins will inquire.

Mr. Collins. Thank you, Mr. Chairman.

I don't really have any questions because I fully support everything these representatives of small business have discussed. I would just like to say, though, that I am a small businessperson, I still have a small business, in fact I employ about 35 people. I consider one of the greatest stumbling blocks or competitors of my

business is the U.S. Government. The Federal tax policy along with regulations pose significant barriers.

Often I feel like we are victims of the judicial system because of tort and tort actions against us as small businesspeople. We are employers and we are entrepreneurs, and I see the government using us as collectors of taxes. We do the best job for them in collecting and paying into the system, and then all too often I think we are the targets of many of those inspectors for regulatory agencies because they know that with being small, we don't have a lot of the personnel around and a lot of the wherewithal to pay for the personnel to cross every "t" and dot every "i" for us as far as our operations, especially in the area of OSHA. So I think we are often abused in that area.

Despite all those stumbling blocks we as small businesspeople, employ the majority of the people in this country. But as a small businessowner and one who often visits with many small businesses when I am back in Georgia, a common thread of thought is it just isn't worth it anymore. I am sure that you find this sentiment among the people you represent.

But, again, we appreciate you being here. We appreciate you representing the small businesses of this country and the backbone of our employment. Thank you.

And thank you, Mr. Chairman.

Mr. HERGER. Thank you, Mr. Collins.

Mr. Houghton will inquire.

Mr. HOUGHTON. Hi. I am sorry I am late. I appreciate your being willing to take my inquiry.

This session has concentrated on investment and savings and there has been an awful lot of talk about how do you churn things and how do you get benefits into usable hands so that increased investment could take place. There has also been passing references about savings, but very few concrete examples of how savings can increase.

The IRAs are a possibility, but it is not a sure thing, capital gains appear not to give any savings increase whatsoever. As far as the investment tax credit, I am not sure that is going to do the job because you can take money from overseas and bring it in rather than stimulate the savings itself.

Now our savings rate, if I understand it, is something like the 1 percent range of GDP as contrasted to, I don't know what it is in Japan, 10 to 15 percent or in Germany maybe half that or something like that. But if the savings rate is critical to everything, including investment, how do we get it up because there is no specific program I see on the shelf that is going to generate the savings we need.

If we have, for example, a gross domestic product of, let's say, $6.8 or $7 trillion, whatever it is, and you want to get it up part way to what Japan is, you have got to produce another $650 to $700 billion in savings. I don't see that coming along. I don't see that anything we have been talking about helps that process.

How do you comment on that?

Mr. HIATT. Well, I think that is the $64 million question. We think, first of all, what is important is tax policy, and this commit-

tee is expert in this regard. You can certainly influence behavior by the incentives or the lack of incentives that you put in the code.

We have seen disincentives in the code for savings investment. We think it is very important overall, and we didn't mention this in the testimony, we think that one of the most important contributions that this committee can make to savings and to overall economic growth would be an income tax cut that would, as we have seen before, helped basically jump start our economy. Several years ago such a cut created millions of jobs.

Mr. HOUGHTON. If I could just interrupt a minute. You do have the option to take that money and spend it rather than save it. There isn't the incentive, when you cut a tax, that it will go into a savings account.

Mr. HIATT. Yes, sir, and that is my point. We don't know exactly how consumers would use that. I think a great number of them, if they could, would probably put that into IRAs and to other investment vehicles, savings vehicles that we have.

I do agree with you overall that we probably have a low rate of savings in this country for several reasons. Number one is the disincentives that are in the code, but also because we have a huge public debt and a huge budget deficit that is attracting vast amounts of capital and diverting it away from savings, and we are funding this budget spending, this deficit spending that is eating up private savings in this country.

So I think the answer is we just can't deal with creating incentives for savings, we also have to deal with some of these other structural problems like the deficit, and also government spending overall and why it is diverting huge amounts of private savings, and if that is really the direction we need to go in.

I don't really know what we should do in terms of savings incentives. I like the IRA, the increased IRA provisions that are being discussed. I don't have a firm answer.

Mr. HOUGHTON. If I could interrupt just 1 minute, I would like to yield to Mr. Collins of Georgia, but before I do, I would just like to say this, that here we are trying, through the Tax Code, to help investment and savings, and I don't see us doing that as far as savings is concerned.

Mr. HIATT. I would agree with you.

Mr. HOUGHTON. You are a citizen, you both are citizens, as we are. How can you help us sink through this process. Business doesn't save, they either pay out to their stockholders or they put it into some sort of a capital investment. Lower income people don't save, so it is the middle cut, and they are not able to handle this thing.

I yield to Mr. Collins.

Ms. KERRIGAN. I would just like to make one remark.

I think some continuity in the Tax Code, and if indeed IRAs become part of this package, I mean, is that going to be a short-term thing or 4 or 5 years down the road are IRAs going to be stripped away? So if you take away sort of consistency and continuity in the entire Tax Code, then people are apt to say, well, gee, I will spend it, you know, because I don't know, you know, what tomorrow is going to bring. So I think there has to be some consistency in the Tax Code on the Federal Government's part.

Mr. HOUGHTON. Thank you.

I yield to Mr. Collins.

Mr. HERGER. I yield time to Mr. Collins.

Mr. COLLINS. Thank you, Mr. Chairman, and thank the gentleman for yielding.

I just wanted to inject this thought. The purpose of tax reform or tax reduction and the purpose of the Contract With America is to leave more money in the cash flow of the private sector to stimulate the economy. When you do that, you are going to increase the bottom line of a number of small businesses as well as large businesses in this country.

When you increase the bottom lines or increase the cash flow you increase savings and investment. In my little business, if I have a few bucks left at the end of the weekly cash flow, some of those funds go into money market accounts. They are put away for when I have to withdraw to make some type of tax deposit or some type of note payment on a large note or even equipment notes. But those are funds that go into a money market savings account.

Also, a large number of businesses have pension programs or have 401(k) plans. They have something set aside for the employees whereby they contribute to and the employee contributes to. If the company's bottom line is better, they make better contributions. This is a small savings that will significantly increase the savings accounts across the country. Those are just a couple things I wanted to inject as an owner and operator of a small business today.

I thank the gentleman for yielding.

Mr. HERGER. Thank you very much, Mr. Collins.

I want to thank both our witnesses on our final panel, Ms. Kerrigan, Mr. Hiatt. As representatives of small business, I believe that you have represented them well. It never ceases to amaze, I might say, those of us who do have small business backgrounds of how we have examples of small businesspeople not being able to expense out their transportation, not being able to deduct their health insurance on themselves at a time when we are trying to encourage them to have health insurance. This is only a couple items. But, again, I do thank you very much.

And with that, this committee stands adjourned. Thank you very much. We are adjourned until 10 a.m. tomorrow.

[Whereupon, at 4:05 p.m., the hearing was adjourned, to reconvene at 10 a.m., Wednesday, January 25, 1995.]

TAX PROVISIONS IN THE CONTRACT WITH AMERICA DESIGNED TO ENCOURAGE SAVINGS AND INVESTMENT

WEDNESDAY, JANUARY 25, 1995

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, D.C.

The committee met, pursuant to call, at 10:03 a.m., in room 1100, Longworth House Office Building, Hon. Bill Archer (chairman of the committee) presiding.

Chairman ARCHER. Today we will continue our hearings in consideration of the savings and investment provisions of the Contract With America. Yesterday, we heard from witnesses on the need to make the Tax Code less hostile to people who want to save and invest, and today's hearing is going to be devoted specifically to capital gains.

The capital gains tax cut in the Contract consists of a 50-percent deduction on all capital gains, the indexation of the basis of assets for inflation, and a capital loss deduction on the sale of a home. It is interesting that over the years the Tax Code has levied a tax on homeowners who sell their homes for a gain, but refuses to let them take any sort of a tax loss if the home is sold at a loss.

This is sort of emblematic of what has happened too often with the Federal Government, and that is heads the government wins, and tails the taxpayer loses. We want to change that. I have looked forward for a number of years to chairing a hearing of this sort because throughout my congressional career, I have taken a lead role in attempting to get capital gains taxed at a lower rate.

And I have spent years in refining the proposal that is before the committee today, particularly that of the indexing of the basis for inflation. I support a capital gains tax cut because I believe it will create jobs and more opportunities for working Americans.

Lower capital gains taxes means more capital is available to an entrepreneur who wants to start a business, to a businessman or businesswoman who wants to expand and hire more workers, to a corporation that wants to modernize its equipment to make its employees more productive so that they can be paid higher wages.

We have heard a lot about the so-called fairness issue. And I think we should talk about fairness. What is fair about taxing people on gains that are strictly due to inflation so that in the end they have less real money in their pockets than they did when they bought the capital asset? What is fair about having a lower rate for capital gains recognized by those in the higher tax brackets, but

not for those that are in the 15 and 28 percent bracket? And, what is fair about a system in which you can be taxed when you sell your home with a gain, but never can deduct the loss? What is fair about a tax that punishes people who sacrifice and forgo consumption, pay the income tax on their income, take the net and invest it, save it, and then get punished by being taxed on the appreciation and value of those savings? And what is fair about a tax system that gets in the way of people who want to go out and create jobs?

I am confident that this committee will cut the capital gains tax rate this year. As a result, we will not only help people to keep and save the money that they make, we will also help America's workers find more high-paying jobs thanks to the entrepreneurs and businesses that will be able to get increased access to capital necessary for growth.

The only way that we can increase the aggregate real wages of Americans is to have higher productivity, and the only way we can have higher productivity is to continue to advance in the purchase of tools and technology to increase the output of every worker. And that is why capital savings are necessary in our society.

Those who criticize this vital tax provision would pluck the feathers off the goose that lays the golden egg. Cutting capital gains helps average Americans to get ahead and to stay ahead. Today's witnesses have been in the economic trenches and they know how hard it is to start a business and to keep it going. They know the uncertainty of making an investment and not being able to know for years whether they have been successful.

A tax code that doesn't reward entrepreneurs and long-term investors is a tax code that must be changed, so I look forward to the testimony today. Charlie, are you going to make the statement?

I recognize my colleague, Mr. Rangel for the statement for the minority.

Mr. RANGEL. Thank you, Mr. Chairman. I think this is an area that we have a bipartisan concern. You will agree that we have to concentrate on savings rather than consumption. We have to make certain that American investors are able to be competitive with foreign investors.

We also have to not rely on foreign sources of capital and to be more independent if we are really going to be leaders in the global competition. There is a serious question as to how do we score the reduction in capital gains taxes, whether we are talking about static- or whether we are talking about a dynamic-type of scoring.

The question is not what we can accomplish because of the number of our votes, it is what is going to be considered by the financial market as to whether we are cooking the books, whether we have a reliable position as it relates to the revenue question and, of course, as all of us have said, Republicans and Democrats, and it was emphasized by the President last night, we must know how we are going to pay for each and every tax—every revenue loss, rather, before we move on and do the things that all of us want to do.

And so I would like to say publicly, Mr. Chairman, that I have just been interviewed by a national newspaper and they asked how were we getting along with you, and I said that this is probably the most nonpartisan committee historically that we have on the

Hill, that we have enjoyed a mutual respect over the years and, notwithstanding the difference of political opinion we may have, that we look forward to working with these matters as other matters in a very cooperative way.

Thank you, Mr. Chairman.

Chairman ARCHER. I thank the gentleman for his statement and certainly that feeling is shared.

Any members who wish to make an opening statement in writing may submit it for the record without objection.

[The opening statement of Mr. Ramstad follows:]

OPENING STATEMENT OF HON. JIM RAMSTAD

Mr. Chairman, as we hear from today's distinguished witnesses, it is important to keep in mind how reducing the capital gains tax rate and indexing it to inflation will help all Americans.

As a recent Reader's Digest article pointed out, "In a nation built on the premise that today's poor man can be tomorrow's rich one, a high capital gains tax is neither good politics nor good economics." The article went on to quote highly respected economist Gary Robbins, who explained that the capital gains tax affects the size of the income pie, regardless of how it is divided.

We've heard about how the current high capital gains tax rate deters individuals from selling less productive assets in order to invest in others. However, some taxpayers are forced to sell because they face certain circumstances—job loss, divorce, the birth of a child—and cannot wait for a lower rate. These are not wealthy families, but they are being punished by the Federal Government for saving and investing.

As we hear from our witnesses, I hope we will all steer clear of the class-warfare rhetoric that has too often surfaced in recent months. This is a real problem, affecting real people, who have worked and saved to improve their lives. We owe it to them to take this important step to get our nation back on the right economic track.

Mr. Chairman, thank you for assembling such a distinguished panel. I look forward to their testimony.

Chairman ARCHER. Our first two witnesses today are a bipartisan panel of our own colleagues, both from the west coast, and we are pleased to have you with us today, and Hon. Ken Calvert from California is our first witness and we would be pleased to hear your testimony. The rules of the committee are that we ask that you keep your oral testimony to 5 minutes or less, and you will have permission to submit an entire written statement into the record in full without objection.

Congressman Calvert.

STATEMENT OF HON. KEN CALVERT, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Mr. CALVERT. Thank you, Mr. Chairman. And thank you for holding these hearings on the Contract With America and for giving me the opportunity to testify today on the provisions regarding the capital gains tax. I know you will hear from many people, so I will keep my remarks brief and ask that my statement be entered into the record.

In the past couple of weeks, we have heard from many taxpayers' rights groups, economists, think tanks, and businesses all advocating a reduction and indexation of the capital gains tax. They have given you the numbers and statistics supporting this, so I will refrain from repeating this data, other than to add my voice as one who knows that reducing the capital gains rate will spur economic growth, create jobs, and improve our global competitiveness.

I am not an economist or statistician theorizing on the merits of particular economic models. Before coming to Congress, I owned and operated my own businesses. My father was a small businessman who owned and operated his own restaurants. Our businesses prospered when the capital gains rate was lowered in the seventies and the eighties because it gave us an incentive to invest and expand our businesses. It encouraged expansion and growth.

Mr. Chairman, reducing the capital gains rate and indexing it to the rate of inflation is not just a campaign promise, it is just plain common sense. This is not just a tax break for the rich, this is much needed relief for the middle class small businessowners of America.

The constituents of my district, the 43d in California, are not rich billionaires who are trying to take advantage of the government. They are hard-working folks trying to achieve a bit of the American dream. They support our efforts to reduce the capital gains rate. They write and call my office and tell me to keep my promise on the Contract.

Last weekend, as most weekends, I went home to Riverside County and a constituent came up to me telling me how difficult it was to expand his business and that if Congress would fix the capital gains rate, it sure would help. A retired woman from my hometown wrote me to explain when she had been working and saved, she bought five acres of land. This property could be developed, jobs could be created, though she does need the money and realizes her property could be put to good use, she won't sell because of the current rate on capital gains.

One man from Mira Loma wrote me telling me his kids have moved out of the house, he would like to sell it and move into a smaller one, but because he is not 55 yet, he won't sell his house for fear of being taxed to death. That is just not right and it just doesn't make sense.

I am sure you have heard many other stories and these are just a few examples of what my constituents and yours, I am sure, are telling you. And it is their voice I want to share with you today. We have a historic opportunity to help these folks and I appreciate your tireless efforts, Mr. Chairman, in seeing that we succeed in these efforts.

Again, thank you very much for letting me testify.

Chairman ARCHER. Thank you, Congressman Calvert.

Our next witness is Hon. Ron Wyden from Oregon. Congressman Wyden, we would be pleased to hear your testimony.

STATEMENT OF HON. RON WYDEN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OREGON

Mr. WYDEN. Thank you very much, Mr. Chairman. I thank you for this opportunity. Maybe I can spare you the filibuster this morning, and I would ask unanimous consent that my statement be put into the record.

Chairman ARCHER. Without objection.

Mr. WYDEN. Mr. Chairman, I was one of the Democrats who voted for your capital gains proposal last time out. And I have been a strong supporter of it for many years.

But I think that this Congress we have a different kind of challenge and that is to see if we can come up with an approach to addressing this capital gains issue that could bring my friend from New York, Charlie Rangel, and you as the leaders of the Ways and Means Committee together on a unified basis, and I think I have a proposal that moves us in that kind of ballpark, and let me just say for 1 minute why I think it is so important.

You know the mythology on this issue is essentially Republicans are supposed to be for a capital gains tax cut and Democrats are supposed to be against it, even though Jack Kennedy was essentially the first major proponent of a capital gains tax cut. There is this notion that the major recipients of a capital gains tax cut are Ivan Boesky or Michael Milken or something like that, but what a lot of us are seeing in our districts is it is essentially the premier growth issue for small businesses, for retired people who may have a duplex in their backyard and want to sell it and finance their retirement.

I have union workers in my State who work in a mill during the day and have a Christmas tree farm on the side, and they want to be able to get capital gains treatment for that Christmas tree farm so they can finance their youngster's college education. But we are up against this kind of mythology, and I would like to suggest a way that we could possibly bring the parties together and get my friend, Charlie, and yourself and people like me and other Republicans together on this.

I think we ought to look at treating capital gains like we do home ownership in our country. What we have said is that home ownership is special and that means that if Bill Archer sells his home in Texas and takes those proceeds and rolls them over into another home purchase, we will say the taxman will not cometh. You will not be taxed because we value home ownership.

I think we ought to look at the same sort of thing with respect to capital gains. If somebody owns a business in America and sells that business and is willing to take a portion of those proceeds and roll them over into another job-producing investment, so that Charlie could see in New York if somebody sells a business and takes a portion of those proceeds and brings them back to the community in another job-producing kind of investment, for that, we should say there should be no capital gains tax cut.

I think that something like that will allow us to incent the private sector, as you have wanted to do for so many years, and at the same time meet the kind of litmus test that many of my colleagues on the Democratic side of the aisle legitimately are concerned about. They want to see reinvestment. They want to see the private market recycle investment and earnings into job-producing sectors, and the bill that I have introduced has been cosponsored by one of your members—Congressman Matsui of California, Congressman Spratt of South Carolina has been for it as well—I think would be a beginning to try to bring the parties together on this issue, get something that the President would actually sign rather than continue this polarization on the capital gains issue, possibly get a veto.

One last point, and I see my light is on. We are very pleased that Congresswoman Dunn from the Northwest has joined your commit-

tee. She and I are cochairs of what is known as the Forestry 2000 Task Force. We are particularly interested in working with you on some growth-oriented incentives that will address the need for sustainable growth on private timberlands, very important jobs-producing issue. My statement goes into that as well and I thank you for the chance to come.

[The prepared statement follows:]

Statement of the Honorable Ron Wyden
U.S. House of Representatives

Testimony before the Committee on Ways and Means
January 25, 1995

Mr. Chairman, thank you for the opportunity to appear before the committee this morning.

Today, I want to talk about the Entrepreneurship Promotion Act, legislation I have introduced to provide targeted capital gains tax relief to boost small, fast growing, job creating companies.

These companies will be crucial components of sustained job creation in the 1990's. Small firms have consistently led America's technological charge, creating new technologies and products and high wage, high skill jobs. In my home state of Oregon, perhaps the most predominantly small business state in the country, 98% of the businesses employ fewer than 100 workers, and the state projects that fully 70% of the state's job creation in the 1990s will come from those small firms.

My legislation will create a tax rollover, similar to the one available to homeowners, to enable an investor who sold his or her stake in a qualified small business to reinvest the money in another qualified small business and defer paying taxes on the capital gain.

With this bill, investors will have an incentive to keep their money in the productive sector of the economy, rather than simply cashing out their investment. Moreover, the bill would target the incentive at investments in firms with less than $20 million in annual sales -- those companies with the fewest financing alternatives and therefore most in need of venture funds.

At some point, nearly every small business faces a crisis in finding the capital necessary to finance continued growth. Nearly every company gets caught in the awkward position of being too large to be financed internally, but not yet large enough to tap the public capital markets or adequate bank financing. Capital is the lifeblood of every small company, and without sufficient capital, an otherwise healthy small company with a great product line will be doomed to wither away.

In Oregon, for example, with its fast growing software, computer, environmental, biotech, wood products and other industries, numerous companies that could be global competitors and create thousands of jobs are at risk, simply for want of sufficient capital to fund early growth.

Let me share with the Committee a recent Oregon example. One firm, after three years and $8 million in start up funding, ran out of money just as it sought government approval for its product. According to the CEO, "No one else in the world had a comparable product, and the market was there." Thus, with no capital available, this Oregon firm went from potentially being a $40 million company to zero. I hear similar stories at home in my District on a regular basis. And I am sure, Members of this Committee have also heard this tale of lost potential, lost innovation and lost jobs.

It is imperative to pump more funds into the venture capital pipeline and to direct more of those funds to the companies that really need them. The Entrepreneurship Promotion Act is designed to do that by creating a tax incentive to get more investors involved -- and keep them involved -- in starting and growing job-creating small businesses.

There is no doubt that adequate venture capital is key to job creation. According to a Coopers and Lybrand survey, venture backed firms created more jobs and invested a greater portion of equity in research and development than the Fortune 500 companies of America between 1988 and 1992.

- Venture backed firms expanded their workforces by 19 percent a year, on average, while the Fortune 500 cut their workforces by .08 percent.

- 55 percent of the positions created by venture backed firms were skilled jobs, nearly four times the 14 percent formed in the U.S. economy overall.

- Venture backed firms invested $14,000 per employee on research and development, double the per employee expenditure of the Fortune 500 firms.

- Venture backed firms also invested more than twice as much of their revenues in plant and equipment than the Fortune 500 companies.

Venture capital has been instrumental in the development of leading edge technologies in this country. Microsoft, Intel, Genentech, Apple, Digital Equipment, Federal Express and Lotus Development all relied on venture capital financing. Today, the founders of these firms are some of America's premier venture capitalists.

My legislation is not about the search for the next Microsoft. The Entrepreneurial Promotion Act is about the other thousands of small developing firms in this country who make everything from paper bags to the newest computer games.

Mr. Chairman, there is precedent for my legislation. Specifically, the precedent is a small provision with the Omnibus Budget Reconciliation Act of 1993 allowing investors to rollover capital gains on the sale of stocks and bonds into Specialized Small Business Investment Companies or SSBIC's. My rollover proposal is similar in principle but less regulatory burdensome. Further, it will offer capital gains tax referral to a broader spectrum of businesses in the early stages of start up, development and production.

The Entrepreneurial Promotion Act will provide significant relief to those small businesses with good products and good management but are starving to death for lack of capital.

On a final note, I would urge that the Committee, in considering its broader capital gains proposal, ensure that we have a formula that encourages better forest management and more private timber production. At the moment, we have a tax code that does neither.

In Oregon, for example, we have some 22,000 small woodlot owners growing trees on approximately 3.5 million acres of woodland. This resource is quickly becoming the backbone of our timber resource in the state. Thousands of mill jobs will depend on whether these lands stay in timber production. Unfortunately, because we have removed the capital gains differential and other adjustments for inflation on an investment that takes 50 to 75 years to mature, these lands are being converted to other uses. The timber resource is being lost, forever. As a co-chairman of the Congressional Forestry 2000 Task Force -- an organization representing 150 of our colleagues -- this loss of resource in both the Northwest and the Southeast, and the tax code which encourages it, has for several congresses been our number one target for tax reform. We must remove unreasonable disincentives for critical, very long term investments like growing trees. I note that this position is supported not only by the industry, but also by all of the major environmental organizations, including the Audobon Society and the Sierra Club.

Mr. Chairman, I know the committee is taking a hard look at these issues. I do believe that your proposal for a <u>50 percent exclusion</u> addresses the legitimate complaints of these timber growers very effectively.

Capital gains tax policy has been caught in fearsome partisan debate for many years. I believe it is time to move beyond old divisions and I stand ready to work with the Committee to craft job creating legislation that is good for small business, good for investors and good for the federal government.

Thank you.

Chairman ARCHER. My compliments to both of you for your testimony today.

Following up, Congressman Wyden, on what you just suggested, I have rolled this around in my own mind about whether we should eliminate any tax on a capital transaction if the money is reinvested in another capital asset. And I believe that there are a lot of constructive, positive results that could come from that.

Have you given any consideration, though, because I have thought a lot about this, to the complexity that would be involved in maintaining the records over a lifetime for each small sale of stock or mutual fund and a conversion into another capital asset?

I know that many of us have done it on our homes, but the sale of a home is probably going to occur maybe a couple of times in a lifetime and it is really not a very easy process. I know because I do my own tax return, and I know what it means to have to prepare the form that is necessary to keep up with the IRS in order to be able to trace the transactions during a lifetime when you convert from one home to another. And I just wonder if you have given any thought to that, whether that is practical.

Mr. WYDEN. I have, Mr. Chairman, and what I would say is I think that we can do this frankly in a less burdensome way than some similar approaches that are already on the books. For example, as you know, the Budget Act of 1993 essentially applied this principle to what is known as SBICs, the small business investment companies.

The bill that I have introduced with Mr. Matsui, I think, involves less bureaucracy than what we have already got on the books right now. What we are essentially saying is, look, you have 18 months to roll it over. You have to be able to show that it gets to job-producing activity.

We obviously would want to work with you all. You all are the experts, but we have consulted the Service, and I think that we could produce something in this area that would be less burdensome from a regulatory standpoint than some of the stuff that we have on the books right now. I think your committee has also done this in the real estate area as well.

Chairman ARCHER. I don't know if you paid any attention to the testimony that the committee has already received, but we had two outstanding and nationally recognized economists before our committee, and I asked them the question of whether there was a study as to what percent of capital transactions ended up being reinvested in other capital assets. They said they didn't know of a definitive study, but that they expected that it would be between 95 and 99 percent of all of the sales of capital assets. I am just wondering if that percentage is already not so high that we don't have to go into this question of exempting on rollover because the practical results are that almost every transaction does get rolled over.

Mr. WYDEN. I guess I am a little skeptical of those figures. I haven't seen the study because we have so many of our constituents pushing us for this incentive in the first place. In other words, if things were so good right now, that people were just automatically rolling things over, I kind of question why we would have everybody pushing us to get this incentive in the first place.

So I question whether that incentive is there. But what I think we really want to do is try to target something like this to the kind of job-producing agenda so that we can stand up at townhall meetings in our district. Charlie Rangel can in Harlem. I can on the west coast and say that when Congress looked at incenting the private marketplace, particularly the business sector, that we were showing that what we cared about most was reinvestment and recycling the winnings from a successful business, and I think we need to really target this in that kind of fashion.

Chairman ARCHER. Thank you.

Are there any other questions by members of the panel for these two witnesses?

Mr. RANGEL. Mr. Chairman.

Chairman ARCHER. Mr. Rangel.

Mr. RANGEL. Let me thank both of the witnesses, our colleagues for their contribution and Ron for your effort to bring us closer together.

I really have no problem with targeting the Tax Code so that we can encourage investments and create new jobs and jobs, as you said, that we can actually see. I think it was Rev. Jesse Jackson that said that the tide doesn't raise all boats if yours is stuck on the bottom. And I know that it takes time for these type of investments to create the incentives for people to come and the jobs will be coming.

It is just difficult for me to believe when I see the schools are not producing, the kids are on the street, the hope and dreams are not there, and there is no reason for them to be there, and then they fall into this despondency of drugs and babies and violence and crime, and, I, for the life of me, can't see how you can provide incentives for people to invest in this environment.

However, as Chairman Archer noted, I have no problem if you showed the same commitment of investing in human and intellectual capacity to be able to meet the challenges of the future, then I think that this is a marriage that we can move forward on. But it is a disgrace, as Speaker Gingrich says, when a kid can't read his diploma, when children are attending more funerals than graduations, and all I am saying is that this is a good bridge, but we have to think of ways to invest in people to make them strong enough to cross that bridge as all Americans can.

And you have made a great contribution in terms of the economic incentives, and the Speaker can join with me and others in seeing how we can get a return on our investment in people so that entrepreneurs will know that our labor force is just as good and indeed we hope better than any abroad, we are home free. And I want to thank you for your contribution.

Mr. WYDEN. Well said.

Chairman ARCHER. Mr. Bunning.

Mr. BUNNING. Thank you, Mr. Chairman. I would just like to put something into the record so that there is no misunderstanding about who generally files capital gains tax returns.

It is my understanding that nearly 50 percent of all returns are filed by taxpayers with less than $40,000 adjusted gross income. And nearly 60 percent of capital gains tax returns are filed by taxpayers with less than $50,000 adjusted gross income.

May I ask the two Members if that figure would put those returns, in your opinion, in the middle-income taxpayer range? Do you consider $40,000 adjusted gross income or a $50,000 adjusted gross income middle-income people in the United States?

Mr. CALVERT. Well, that is easy. Yes. I would say in California, in Southern California, $75,000 family income or less would be in the middle-income bracket.

Mr. BUNNING. I am not talking about average because now we know if we put in average income, we come down and we get an awful lot of people who are below that average, but I am talking about middle income, the workers of the day. Ron?

Mr. WYDEN. Jim, what I remember from the last time we went through this and, as I say, I was one of the Democrats who voted for Bill Archer's proposal, is that you can debate the figure whether it is $40,000 or $50,000 or $60,000, but the fact is there is an extraordinarily large number of Americans who are middle income, they are retired, they are small businesses, they are entrepreneurs trying to start a biotech company who would benefit from this.

I think we should face the fact that most Americans do not believe that, however. There is this perception in America that the capital gains issue will help, you know, somebody who is clipping coupons and working out of a highrise building in Manhattan and will not, you know, essentially be a benefit to the kind of people that you are talking about. I think it is mythology.

I think we have to deal with it, and one of the ways I think that we could deal with it is that if we could establish this tight connection between getting the capital gains tax break and in some fashion plowing it back to reinvestment, I think we can start chipping away at the mythology that I think you and I would agree on.

Mr. BUNNING. There is also a very strong statistical basis that people that are claiming a capital gain on their return will only claim it one time. In other words, they are going to be rich for 1 year. Someone who has a capital asset or has a family business or has a home, that is, someone under 55 that has a home and sells a home with a capital gain will be rich for 1 year.

Do you in your research on capital gains find that necessarily to be true or not to be true? Ken?

Mr. CALVERT. Well, in my experience with capital gains from a business perspective, if I sold a restaurant, as was mentioned earlier, more than likely somewhere down the road, I ended up buying another restaurant or if I sold a property and ended up buying another property, I think it is true that most people who invest continue to invest and grow and expand and hire folks along the way, and I think that is the important thing that we need to bring out here, that 95, 99 percent of the money is already reinvested, and to make the system more complex by having a dual capital gains rate. One based upon selling a business and transferring it to another business and it is going to just make the tax system more complex than it already is.

I think people out in the country want a system that they can understand, and I think that the tax proposal that is being brought forward to the committee is something that I think everyone can understand.

Mr. BUNNING. Joint Tax has done a study that says that generally in a 5-year period, nearly 44 percent of tax returns claim a capital gain during a 5-year period only. One time.

And I think if we update that study up until 1994, I think that would still be true because of the reluctance of people to claim a capital gain unless they are over 55 who sell homes. Thank you for your testimony. I deeply appreciate it.

Chairman ARCHER. Ms. Dunn.

Ms. DUNN. Thank you, Mr. Chairman. And welcome, gentlemen. Mr. Wyden, I would like to take advantage of your background by asking you to focus us on the disincentives that exist right now in the Tax Code and what the effect of these disincentives would be unless we make changes on the critical long-term investments, like the timber industry.

Mr. WYDEN. Well, I would say that who Mr. Bunning essentially described are people who are sitting on their investments, which is really the great detriment to the American economy. What we have is a lot of people, particularly in forestry, that we would like to keep in that sector from generation to generation, but a lot of them are seeing that they can't make it any longer. They don't have those investment incentives, so instead of staying out there in the timber sector, particularly looking at managing their lands for the long term in a sustainable kind of fashion, they might say, well, let's just have a quickie sale here.

We will do it once and sell it to somebody who is going to put up a shopping center, and I think that if we really want to have families that are willing to make a long-term commitment to staying in forestry and particularly private forestry, we are going to have to incent them with some of the ideas that you have been talking about. Our staffs have been talking about the question of making sure there is expensing so that people who work on these private lands can get a writeoff when they are generating these business expenses and the capital gains tax cut.

I think if we don't have these kinds of incentives, we are going to see a lot of families say this game isn't worth the trouble and pack it in. We are going to lose the opportunity for sustainable growth in private forestry. I would also like to point out to our colleagues that the environmental community has been overwhelmingly in support of the kinds of things that we have been trying to do in terms of the capital gains incentive and expensing.

Ms. DUNN. Thank you very much. Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Collins.

Mr. COLLINS. Thank you, Mr. Chairman. I want to refer to the gentleman from New York, Mr. Rangel's, comments. I have heard him make these statements and ask these questions a number of times because of his intense concern for the inner city.

I have expressed that I have a real concern for inner city, too, probably coming from a little different perspective. The gentleman from New York, I am sure, he is concerned about constituents. I, too, am concerned about constituency, a number of constituencies in the inner city for those Members who represent inner cities are on some type of government subsidy. The constituency that I represent in the Third District of Georgia are the taxpayers who are

paying into the coffers that help subsidize those constituencies who are trapped in welfare.

We have a consensus among most Members of Congress that capital gains reduction would be beneficial in stimulating the economy and creating jobs. On behalf of the interests of Mr. Rangel and myself, I would like to see us focus on those inner-city areas. Perhaps zeroing out the capital gains tax in those areas as an incentive, especially for small business that would employ a number even up to 100 or 150, 200 people, encouraging those manufacturers, or entrepreneurs to go to those areas and invest.

I appreciate both of you being here. Mr. Wyden, you made a comment and I wonder if this is a declaration. You said, "I and other Republicans." Was that a declaration of coming across the aisle or was that just a figure of speech?

Mr. WYDEN. Absolutely not. I think what I want to say is Democrats and Republicans have an opportunity to work together and there has been so much mythology around this issue. Mr. Bunning talks about all the small investors that are in this. I think if we go at this thing carefully, we could come across with something that Charlie Rangel and you could both go along with that would produce that kind of inner-city investment that people could actually see and would employ our constituents.

Mr. COLLINS. Well, I think you are exactly right. This does cross all lines. I was very concerned a couple of months ago when I heard our President make a comment about low-skill, low-income jobs when we were talking and discussing the trade issue. The trade issue threatened a lot of low-income jobs, and he indicated we shouldn't worry about that because we are going to lose those jobs anyway.

I don't share that thought. I don't think we need to lose one job to any other nation. We have the wherewithal here in this country to encourage investment in all areas of this country, including the inner city. I think we should put our shoulder to the wheel and push for that type of investment with those types of jobs to help people get out of the trap that we have so gallantly put them into.

Thanks again.

Chairman ARCHER. Mr. Levin.

Mr. LEVIN. Thank you, Mr. Chairman. I don't think the fairness issue, if one wants to call it that, is the only issue and it may not even be a major issue. I think there are issues of fiscal responsibility, the impact of any proposed cut on the deficit and issues of growth, whether a proposed tax cut will truly promote growth.

And let me say on the first point, as we look at the capital gains tax proposal, we have to look at its projected impact on the deficit. The Republican staff suggest it will be a $56 billion loss over 5 years, the Treasury estimate is over $180 billion over 10 years.

And in terms of growth, I think we have to look at a variety of economists, and there are many both so-called conservative and so-called liberal economists who urge that a capital gains cut will not promote growth. We have to look at those views in part because in effective tax terms, capital gains already are taxed at a considerably lower rate than others.

But I want to say a word and my friend, Mr. Bunning, maybe you would listen in on this because there has been some discussion

about the impact on fairness, the impact on the progressivity of the code, and let me just cite a few statistics, and this isn't mythology, just a few facts.

According to the 1991 Internal Revenue Service returns, 65 percent of the dollars realized in capital gains go to families making $100,000 or more. Those were just the facts in 1991. Sixty-five percent went to families making $100,000 or more. And also in terms of the realization for those who report every year or frequently, here are the facts from the Joint Committee on Taxation:

Sixty percent of the realizations from 1979 to 1983 went to families with incomes of $75,000 or more who reported capital gains 3, 4, or 5 years out of 5. It is true that a substantial portion of taxpayers reporting capital gains reported them only 1 year out of 5, 43.7 percent. But in terms of the realizations, those who report 1 out of 5 get a relatively small amount of the actual realizations. And I repeat, 60.7 percent from 1979 to 1983 who realized gains, realized them 3, 4, or 5 years out of 5, and these were families who had incomes of $75,000 or more and the largest bulk of that went to families with incomes greater than $200,000.

Now, I am not saying that this is the only issue. I think there are issues other than fairness, issues of the fiscal impact, fiscal integrity, and also of the impact on growth. But isn't it fair to say that it is mythology that there is an uneven impact of capital gains realizations in terms of income? There is an income distribution aspect to this that we need to consider in addition to the impact on the deficit and growth.

If I could see a very major impact on growth, and no negative impact on the deficit, then I think it would pay to have an impact, a negative impact on progressivity. But let's not deny the facts here that there is an uneven impact by income group. I would be glad to yield to my colleague.

Chairman ARCHER. The gentleman's time is expired. We have got a very, very long day today. We have got more panels, more witnesses than we have had, so I am going to invoke the rule precisely on the time or we will never get through today.

Mr. Ensign.

Mr. ENSIGN. Thank you, Mr. Chairman. Mr. Levin mentioned that capital gains are taxed at a lower rate and there is a differential when you look at it on the surface, but when you look at inflation over time in most capitals held, you know, for long periods of time, if you just keep up with inflation, I mean it can be up to an 80 percent tax on capital gains. So Mr. Levin's comments that there is already a differential in favor of capital gains, I think is fairly erroneous.

I wanted to mention this concept about somebody benefiting more than another, and that gets into this whole class warfare that we need to get away from. We need to quit talking about what is going to benefit the rich and the poor. I mean, if there is 60 percent that are getting a benefit above a certain income, that means there is 40 percent getting it below, and that means everybody is benefiting.

And the other thing we have to look at is capital gains because it creates jobs. I mean everybody benefits from creating jobs. Policies, in my opinion, and I would like to get your comments on it,

that are going to benefit Americans are going to be win-win situations similar to what American management is doing now instead of having labor against management. We know we can have policies in management that benefit labor and management.

I think that we as representatives of the people of America have to look at policies that are going to benefit the rich, the poor, the young and the old, and get away from this idea of class warfare.

Mr. CALVERT. I think something that is important to bring out is that a capital gains tax, whatever that tax may be, is on top of what regular tax a normal individual will pay, so typically those who pay capital gains taxes pay more than anyone else generally in total tax paid out.

A person who makes $200,000 a year in California is paying over 50 percent of their income—of their income in tax, and then they pay a tax on their capital gains also. So there is a tremendous amount of tax being paid by those individuals who are taking up the burden of employing people and creating growth in the economy.

Mr. WYDEN. If I could respond because I think you are hitting the number one issue to actually getting this resolved. What you saw between Sandy and Jim is what has kept this issue from being resolved over the years. Sandy takes the statistics that have been produced in a number of reports that talk about, you know, wealthy people benefiting.

Jim takes the statistics that talk about the number of middle-class people that benefit. I happen to believe that Jim's numbers are better than Sandy's, but I don't think that is the way we ought to approach it.

I think what we ought to say is let's break out of both of those molds and say that the capital gains incentive should be targeted on reinvestment. Let us make a special effort to incent those people who sell a business and reinvest so that we plow those dollars back into the community and get out of this old mold of just duelling kinds of statistics.

Mr. ENSIGN. To follow up on that, I may not have followed it properly. You mentioned in your testimony about a percentage being reinvested. Is that the percentage that would avoid capital gains or do you have a percentage in your bill?

Mr. WYDEN. In my legislation we talk about the deferral applying to the portion of investment that represents new money in these qualified small businesses. But I am obviously prepared to work with all of you.

I think more than anything what I would like to see this Congress do is break that mold that you saw between the debate with Sandy and Jim and say we are going to incent the private sector. It is important, but we are going to tie it in some way to reinvestment so that our constituents can see that it goes to create jobs.

Mr. ENSIGN. You know I applaud your efforts for the reinvestment. I share Chairman Archer's feelings about that. Being a small business, and specifically a veterinarian building a new animal hospital and later selling one. It would be nice to have that for reinvestment.

I like the idea of the reinvestment, but if we can do it in a way that isn't going to make the Tax Code even that much more complex, I think it is a great idea.

Thank you, Mr. Chairman.

Chairman ARCHER. If there are no further questions? Thank you very much, gentlemen. I appreciate your testimony.

The next panel will take their seats at the witness table. Robert Johnson, James Mann, George Hatsopoulos, Mr. Hoak, and Mr. Schler.

I assume you gentlemen are aware of the operating procedure of the committee, which is that we ask you to keep your oral testimony to 5 minutes or less. Your entire written statement without objection will be inserted into the record. We are delighted to have you with us today and our first witness will be Robert Johnson, chairman and president, chief executive officer of Black Entertainment Television. Mr. Johnson, welcome to the committee. You may proceed.

STATEMENT OF ROBERT L. JOHNSON, FOUNDER AND CHIEF EXECUTIVE OFFICER, BET HOLDINGS, INC.

Mr. ROBERT JOHNSON. Thank you. Mr. Chairman, members of the House Ways and Means Committee, my name is Bob Johnson. I am the founder and chief executive officer of BET Holdings.

BET Holdings' principal business is the operations of the Black Entertainment Television Cable Network, a basic cable programming service that reaches 40 million cable households. In 1991, BET Holdings became the first black-owned company to be publicly traded on the New York Stock Exchange. From an initial investment of $500,000 in 1980, BET Holdings celebrates its 15th anniversary with a market capitalization of approximately $330 million and annual revenues in excess of $100 million.

I am pleased to have the opportunity to share my views on the question of should there be a significant change in our capital gains tax policy and the current capital gains tax rate. My response to both questions is absolutely yes. When John Malone at TCI and Jerry Levin at Time Warner invested in the idea of BET, the furthest thing from their minds was what would be the return on that investment.

In fact, when John put his first $500,000 in BET, I asked what business advice could he give me. His simple but to the point reply was, "Bob, keep your revenues up and your costs down." I followed Dr. Malone's advice and added a lot of hard work, not because I was dreaming about what the return on my sweat equity would be, but because both John and I firmly believed then and still do that if you work hard and take risks, you ought to reap the full and just reward of your efforts and initiatives.

Members of the committee, as an entrepreneur, I believe that our tax policy should encourage rather than discourage the creation and accumulation of wealth. A policy that taxes entrepreneurial gain at 28 percent, in my opinion, discourages wealth generation by hindering wealth utilization that can create additional economic opportunity and income redistribution. As a minority entrepreneur, I see the creation and accumulation of wealth as the critical compo-

nent to the social and economic betterment of African-American society.

Let me share with you an alarming statistic. If you were to compare today the net worth at liquidation of the average white American household and the average black American household, you would discover a tenfold disparity in net worth, with whites at about $30,000 and blacks at about $3,000.

The primary reason for this gap is the lack of home ownership and accumulated savings among most black families. I submit that if you never own your own home, it is unlikely you will attain the basics of wealth building in this society and consequently you will never be able to pass the benefit of that to your children.

We must break this cycle. Yes, we need more better paying jobs, equal opportunity for employment advancement, and a commitment to individual initiative and responsibility. However, in my opinion, what we need more of is a fundamental belief among black Americans that we can generate wealth and accumulate wealth by combining our human and intellectual capital with available financial capital.

By changing and targeting our capital gains tax policy to make locked-up capital available to stimulate wealth creation, I am convinced we can make that belief an economic reality.

Following are my recommendations for targeting our capital gains tax policy: Target reduction to those individuals or companies that invest, either equity including stock purchase or debt in companies that are headquartered in economically depressed areas or areas designated as enterprise zones; target a reduction in capital gains to individuals or corporations that invest $25,000 in small or startup businesses. For example, when BET went public, I personally sold $6 million in stock and paid about $2 million in capital gains because I had no basis in the stock. During that same period of increased visibility, I was asked to invest various amounts in a number of startup companies that didn't qualify for bank loans.

If I had been able to reduce my capital gains tax by say 50 percent, I would have had $1 million to invest in debt or equity in startup businesses, and I believe I could have made a difference in up-and-coming entrepreneurs like myself seeking $75,000 or $100,000 to help launch their businesses.

Another point, target a capital gains tax reduction to anyone that provides a downpayment in the form of second trust financing for first-time home buyers. We have a number of people who work at BET who are able to pay the mortgage note on a home. In fact, they are paying it now for apartments, but they don't have the accumulated savings or the families don't have the savings to help them get that initial downpayment. If you could target the capital gains tax in such a way that people could use their money to put—to help young people buy their first home, I am convinced that many people would take advantage of this. And if this particular tax advantage became institutionalized by the participation of banks and mutual funds, you could see a great deal of money flowing to help black Americans obtain their first home.

I believe as a minority businessman and entrepreneur, I can use my wealth to stimulate the economy in my community, create new opportunities for individuals left out of the system far better than any government handout or subsidy.

In short and in conclusion, let the people who make the money have a direct voice in how their money is to be spent.

Thank you.

[The prepared statement follows:]

TESTIMONY OF ROBERT L. JOHNSON
BET HOLDINGS, INC.

Mr. Chairman, Members of the House Ways and Means Committee, my name is Robert Johnson. I am the Founder and Chief Executive Officer of BET Holdings, Inc.

BET Holdings' principal business is the operations of the Black Entertainment Television Cable Network, a basic cable programming service that reaches 40 million households with a mix of music, entertainment, news and public affairs programming targeted to the viewing interest of black cable subscribers. BET also owns two magazines with a combined circulation of 250,000.

In 1991, BET Holdings became the first black-owned company to be publicly traded on the New York Stock Exchange. From an initial investment of $500,000 in 1980, BET Holdings celebrates its 15th Anniversary with a market capitalization of approximately $330 million and annual revenues in excess of $100 million. I have 55 percent voting control and own 41 percent of the shares of BET. Approximately 25 percent of BET is owned by the public and BET's two original investors, TCI and Time Warner own 18 percent and 15 percent, respectively.

I am pleased to have the opportunity to share my views on the question of should there be a significant change in our capital gains tax policy and the current capital gains tax rate. My response to both questions is absolutely yes.

When John Malone at TCI and Jerry Levin at Time Warner invested in the idea of BET, the furthest thing from their minds was what would be their return on investment. In fact, when John wrote me the first check for $500,000, I asked him what business advice could he give me to protect his investment. His simple, but to the point reply, was "Bob, keep your revenues up and your costs down." I followed Dr. Malone's advice and added a lot of hard work; not because I was dreaming about what the return on my sweat equity would be, but because both John and I firmly believed then and still do that if you work hard and take risks, you ought to reap the full and just reward of your efforts and initiatives.

Members of The Committee, as an entrepreneur, I believe that our tax policy should encourage rather than discourage the creation and accumulation of wealth. It is widely quoted that African Americans comprise 12 percent of the U. S. population but have less than 1 percent of the personal net worth of our country. A policy that taxes entrepreneurial gain at 28 percent, in my opinion, discourages wealth

generation by hindering wealth utilization that can create additional economic opportunity and income redistribution. As a minority entrepreneur, I see the creation and accumulation of wealth as the critical component to the social and economic betterment of the African American society.

Let me share with you an alarming statistic. If you were to compare today the net worth at liquidation of the average white American household and the average black American household, you would discover a 10-fold disparity in net worth with whites at about $30,000 and blacks at about $3,000. The primary reason for this huge gap is the lack of home ownership and accumulated savings among most black families. I submit if you never own your home, it is unlikely you will attain the basics of wealth building in this society and consequently you will never be able to distribute that benefit to your children. The end result of this failure to reach even the first rung of the American dream -- home ownership -- is having a devastating impact on the black family structure.

Let me explain. No home ownership, no home ownership deduction on income taxes and no savings on earned income. No home ownership, no ability to borrow against the equity for an education for your children. No education, no job. No quality employment, particularly for black males, a decline in the quality of black family structure. A decline in family structure, no family value system to prevent crime, teenage pregnancy, dependency and ultimately institutionalized poverty.

We must break this cycle. Yes we need more and better paying jobs, equal opportunity for employment and advancement, and a commitment to individual initiative and responsibility. However, in my opinion, what we need more is a fundamental belief among black Americans that we can generate wealth and accumulate wealth by combining our human and intellectual capital with available financial capital. Our country has been successful due to a large dose of capitalism. What better way to put capital in the hands of successful entrepreneurs than to leave it in their hands? Why "filter" such capital through the U. S. income tax system and then through the largest and most complicated budget process in the world to stimulate investment? What better way to encourage savings than to minimize and target capital gains taxation? For example, a graduated capital gains tax, say at 0 percent for the first $1 million then phased up to 50 percent of the top income tax rate would encourage investment by the vast majority of our

"small" businesses in America. By changing and targeting our capital gains tax policy to make locked-up capital available to stimulate wealth creation, I am convinced that we make that belief an economic reality.

The following are my recommendations for targeting our capital gains tax policy:

(1) Target a reduction in the Capital Gains Tax to those individuals or companies that invest, either equity including stock purchase or debt in companies that are headquartered in economically depressed areas or areas designated as enterprise zones. The reduction in capital gains rate could vary according to the length of time the investment is in place and according to the amount of investment. The theory behind this proposal is that companies headquartered in economically disadvantaged areas could be made more attractive to investors due to the change in capital gains tax that will yield a higher return possibility despite the higher risk profile of these businesses, if that were indeed the case because of the location or the type of business. Start-up businesses or minority firms in these areas with limited access to capital could attract more venture capital. As capital moves into these companies, they would be able to create more jobs, increase economic opportunities and social stabilization as they choose to remain in these neighborhoods, primarily inner cities, to take advantage of this new tax policy.

(2) Target a reduction in capital gains to individuals or corporations that invest over $25,000 in small or start-up businesses. For example, when BET went public, I personally sold $6 million in stock and paid about $2 million in capital gains tax since I had no basis in the stock. During that same period of increased visibility, I was asked to invest various amounts in a number of start-up companies that didn't qualify for bank loans. If I had been able to reduce my capital gains tax, by say 50 percent, provided I invested the difference in the form of debt or equity in those businesses, I believe I could have made a difference to up-and-coming entrepreneurs seeking $75 or $150 thousand to help launch their businesses. The capital gains tax on my return, if any, on those investments should be nominal.

(3) Target a capital gains tax reduction to anyone that provides a down payment in the form of second trust financing for first-time homebuyers. The interest paid on the down payment would not be taxed, however, any gain to the investor as a result of the property's appreciation at the time of sale would be taxed at a nominal capital gains rate. Under this proposal, I believe many young black Americans who can afford to pay a sizable mortgage but have no accumulated savings for a down payment could gain access to initial financing for their first home. I am convinced that high-net worth individuals would take advantage of this targeted tax policy to help their family and friends acquire a home particularly as the program became institutionalized by the participation of banks and mutual funds. This is tax policy and social policy at its best.

My purpose in proposing these three ideas is to argue for an enlightened tax policy that can stimulate wealth creation while encouraging wealth redistribution with limited government and bureaucratic intervention.

I believe that as a minority businessman and an entrepreneur, I can use my wealth to stimulate the economy in my community, create new opportunities for individuals left out of the system far better than any government hand-out or subsidy. In short, let the people who make the money have a direct voice in how their money is to be spent.

In conclusion, a restructuring in the capital gains tax need not be a tax gift to the wealthy or a stimulant to further wealth concentration among the few. It can be and should be a clear statement to all Americans that honorable efforts at wealth generation should be rewarded and that appropriate tax incentives for savings and wealth accumulation will continue to make our economic system the envy of the world. A tax policy that encourages wealth generation and distributes widely the economic results of that behavior deserves full consideration by The House Ways and Means Committee and the Congress.

Chairman ARCHER. Thank you, Mr. Johnson.

Our next witness is James Mann, chairman and chief executive officer of SunGard Data Systems, Wayne, Pa.

Mr. Mann you may proceed.

STATEMENT OF JAMES L. MANN, CHAIRMAN, PRESIDENT, AND CHIEF EXECUTIVE OFFICER, SUNGARD DATA SYSTEMS INC., WAYNE, PA.

Mr. MANN. Thank you, Mr. Chairman and members of the committee. My name is James Mann. I am chairman and chief executive officer of SunGard Data Systems, Wayne, Pa. I am honored that you have asked me here to testify today.

In a recent issue of Fortune magazine, I was quoted on the merits of reducing the capital gains tax rate. And I said, "It is good for the economy, good for my business, and good for me."

Let me explain what I meant. Prior to 1983, SunGard was a division of Sun Oil Co. At that time, it had annual sales of $30 million and was losing money. Sun decided that SunGard was a wasteful diversion of its corporate energies and put it up for sale. Sun found no corporate buyers. So in January 1983, Sun sold the company to an investment group of venture capital firms. I joined SunGard then as president and chief operating officer and received a small equity position.

Today, 12 years later, SunGard is among the top 25 information services organizations in the United States. We are the world leader in the field of investment management software. Last year our sales reached $440 million, 15 times greater than before the venture investment. We employ 2,400 men and women, a sixfold increase since 1983. Our average compensation per employee exceeds $50,000.

We are a $40 million positive contributor to the Nation's current account. We wouldn't exist but for the tax differential on capital gains that existed in 1983.

In 1983, SunGard wasn't an auspicious place to invest any money. SunGard's growth prospects are very difficult to discern. Without venture capital investors, the parent company, Sun, would have simply closed the business and laid off its employees.

Now, even with interested venture capital investors, SunGard wouldn't have been an attractive investment had there not been an abundance of venture capital funds available. A more limited quantity of available investment funds would have compelled venture investors to seek opportunities with higher intrinsic growth potential and lower risk. It was the abundance of venture capital that allowed a surplus for the capital infusion that fueled our subsequent growth.

It is my belief that in 1983 had tax on capital gains been higher, SunGard as an independent, high-wage company would never have seen the light of day.

Now, I don't think SunGard's story is unique. We all know how important entrepreneurial growth firms have been to the American economy in the creation of jobs, national wealth, and long-term growth. But that future role is far from assured. Our current Tax Code falls hard on savings and investment, which are the keys to growth.

Little wonder that our savings and investment rate is very low compared to the rest of the world. Eliminating or significantly reducing the tax on capital gains is the best immediate way I know of to begin to address our savings and investment predicament and to release resources to cultivate a new generation of entrepreneurial firms.

Many critics of lowering the capital gains tax rate worry that such a reform wouldn't be fair. My response is that fairness is ultimately a function of individual responsibility and opportunity which is in turn a function of economic growth.

I know the phrase, "a rising tide lifts all boats," sounds hackneyed, still I have yet a better way of framing the fairness issue. If our economy doesn't sustain growth, if it didn't create high-paying jobs through the initiative of entrepreneurs, fairness is a goal forever beyond our reach.

Members of both political parties know this. A capital gains tax rate reduction is a prominent part of the Contract With America and the 1992 Democratic Party platform asserted that an expanding entrepreneurial economy is the most important family policy, urban policy, labor policy, and minority policy America can have.

I agree and, as an entrepreneur who has enjoyed some success, I can tell this committee that a lower tax rate on capital gains is a great way to begin to realize that bipartisan vision of a growing entrepreneurial American economy that is productive, creates good jobs, and maintains and improves our standard of living.

Thank you.

[The prepared statement follows:]

TESTIMONY OF JAMES L. MANN
CHAIRMAN AND CHIEF EXECUTIVE OFFICER
SUNGARD DATA SYSTEMS INCORPORATED
BEFORE THE COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
JANUARY 25, 1995

Mr. Chairman and members of the Committee, my name is Jim Mann. I am Chairman and Chief Executive Officer of SunGard Data Systems, headquartered in Wayne, Pennsylvania. I am a member of the American Business Conference, an association of growth companies. I also serve as Chairman of the Information Technology Association of America, a trade association representing five thousand companies in the information technology industry.

I congratulate you for holding this hearing and I am pleased and honored that you have asked me to testify here today.

In a recent issue of FORTUNE magazine, I was quoted on the subject of capital gains taxation and, specifically, on the merits of reducing the tax rate on capital gains. In regard to reducing the capital gains tax, I said, "It's good for the economy, good for my business, and good for me." In my remarks, I would like to explain to you what I mean.

Let me begin by telling you about my company.

Prior to 1983, SunGard was a division of the Sun Oil Company. At that time, it had annual sales of about $30 million, it employed about 400 people, and it was losing money. Sun decided that SunGard was a wasteful diversion of corporate resources and energies and put it up for sale.

Sun found no corporate buyers. So, In January 1983, Sun sold SunGard to an investment group of venture capital firms. I joined SunGard as President and Chief Operating Officer and was granted a small equity position in the company.

Today, twelve years later, SunGard is among the top 25 information services organizations in the United States. We are a world leader in the field of investment management software and services.

Last year, our revenues reached $440 million (fifteen times greater than before the venture investment) with an operating income of about $70 million. We employ 2,400 men and women (a sixfold increase over 1983 employment levels) with an average compensation per employee of over $50,000.

SunGard has offices in principal cities in this country and in the world's major financial centers including London, Tokyo, Paris, Frankfurt, Stockholm, and Sydney. Approximately $40 million of our revenue comes from overseas sources making us a positive contributor to the nation's current account.

SunGard could not have done what it has done without talented and creative employees. But even with the right men and women, we would have never gotten off the ground without the then-existing tax differential on capital gains.

Keep in mind that in 1983, SunGard was not a likely place to put your money. Our growth prospects were difficult to discern. No company facing quarter-to-quarter performance pressures wanted to buy an underperforming division. Without venture capital investors, the parent company, Sun, would have simply closed the business.

Even with interested venture capital investors, SunGard would not have been an attractive investment had there not been an abundance of venture capital investment funds available. A more limited quantity of available investment funds would have steered venture investors to opportunities with higher intrinsic growth potential and lower risk. The abundance of venture capital at that time allowed patient investors to find SunGard and provide it with the capital infusion that fueled our subsequent growth.

That is why I can say that SunGard owes its existence to the comparatively favorable taxation of capital gains that prevailed in 1983 and made our company a desirable investment. It's impossible to prove a negative, but it is my belief that in 1983, had the tax on capital gains been higher, SunGard as an independent, high-wage company would never have seen the light of day.

There's nothing unique about the SunGard story; we all know how important entrepreneurial growth firms have been for the American economy in the creation of jobs, national wealth, and long-term growth. And we also know the crucial role that the entrepreneurial sector must play in the future.

But that future role is far from assured. Our current tax code falls hard on saving and investment which are the keys to growth. No wonder that our saving and investment rate is very low compared to the rest of the world. Eliminating or significantly reducing the tax on capital gains is the best immediate way I know of to begin to address our saving and investment predicament and thereby release resources to cultivate a new generation of entrepreneurial firms.

I of course know that many critics of lowering the capital gains tax rate worry that such a reform would not be fair. My response is that in the United States fairness is ultimately a function of individual opportunity which is, in turn, a function of economic growth. I suppose the phrase "a rising tide lifts all boats" is a bit of a bromide. Still, I have yet to find a better way of framing the fairness issue. If this economy does not enjoy sustained growth, if it does not create high-paying jobs through the initiative of entrepreneurs, fairness will be a goal forever beyond our reach.

To their credit, I believe members of both political parties know this. Obviously, reduction of the tax rate on capital gains is part of the Contract with America.

But it is also important to note that the 1992 Democratic Party platform asserts that an "expanding, entrepreneurial economy...is the most important family policy, urban policy, labor policy, minority policy and foreign policy America can have."

I agree, and as an entrepreneur who has enjoyed some success, I can tell this Committee that lowering the tax rate on capital gains is a good way to begin to realize the bipartisan vision of a growing, entrepreneurial American economy that is productive, creates good jobs, and maintains and improves our standard of living.

Thank you.

Chairman ARCHER. Thank you, Mr. Mann.

I am particularly pleased to welcome to the committee today a gentleman from my own home community of Houston, Tex., Mr. Hoak, who is the chairman of the Heritage Media Corp. We are delighted to have you here with us and to have a little hometown flavor from Texas, so you may proceed.

STATEMENT OF JAMES M. HOAK, CHAIRMAN, HERITAGE MEDIA CORP., AND VICE CHAIRMAN, AMERICAN BUSINESS CONFERENCE, HOUSTON, TEX.

Mr. HOAK. Thank you, Mr. Chairman. My name is Jim Hoak, and I am the chairman of Heritage Media Corp. I am also a vice chairman of the American Business Conference, a coalition of midsize growth companies. I would first like to thank you, Mr. Chairman, for holding this hearing and for the opportunity to testify before the committee.

I am speaking to you today as an entrepreneur who has started several companies over the last 25 years. I founded Heritage Communications in 1971 in Des Moines, Iowa with no employees and $1 million of risk capital. We sold Heritage Communications in 1987 for $1.6 billion. At that time, we had nearly 5,000 employees and were one of the largest companies in Iowa.

In 1987, I founded Heritage Media Corp. in Texas with equity of $5 million. All our equity is worth nearly $500 million and we have over 2,000 full-time employees and 15,000 part-time employees. During this same period of time, I have been part of the founding of several other firms, most of which have been substantial job and capital creators.

I can tell you without qualification that the driving financial incentive for creating these companies has been capital gains, and the tax on these capital gains has been very important in balancing the immediate risks of these ventures versus the longer term potential rewards.

I am currently starting another new company, an investment banking/merchant banking firm to support and encourage the development of entrepreneurial companies in Texas.

Let me tell you what you think about when you start a business. Your first thought is you have to be crazy, and all of your friends and family in relatively risk-free jobs tell you so. You then have to convince yourself that you really have got the answer and can't fail, despite the clear evidence that most new firms do fail. Is it worth it? You bet. Is it automatic? Far from it.

But it is important enough that enough Americans make this decision and take this risk in a way that ensures the continued growth of our economy and its ability to create jobs. Lowering the tax on the gains from long-term investments does change the arithmetic of decisions entrepreneurs make.

The current capital gains tax structure stagnates capital and hinders business growth. I have experienced several situations where a seller of a business avoids the high current capital gains rates by retaining his company and changing his strategy for milking the business rather than growing it. And I have seen many examples where the high rates make the cost of new growth capital too expensive for the entrepreneur to obtain.

I would like to also comment favorably upon the proposal for indexing capital gains. By itself, capital gains indexation might not be enough to stimulate investment, but it can and should be done, and I wish it had been done in 1978 when Chairman Archer first proposed it.

One of the strengths of the American society has been the fluidity between classes and income levels which is why I hate to hear a lot of the talk about which class benefits and all. Most Americans believe that they can improve themselves and their family's economic position.

The preferential capital gains tax is not a benefit only for the rich. It also benefits those people who seek the American dream. It benefits those people who are willing to take a risk for a reward. It benefits those people who create jobs and thereby benefit many others while they benefit themselves.

In the final analysis, I think that the debate about the capital gains tax is not a debate about the short term. The debate is about the future of our economic system. It is about the next generation of entrepreneurs.

I have been one of the fortunate people. I have created several companies over the last 25 years. I have definitely benefited myself and a capital gains differential has been kind to me, but I know that in pursuing my dreams, I have helped many others realize their dreams as well.

This is the context in which I view the current debate over capital gains: Simply put, do we want young Americans to have opportunities to become successful entrepreneurs and create new jobs? If so, we must provide them with sufficient financial incentive to undertake the risk and efforts starting a company demands.

Most of our trading partners, competitors have a more favorable treatment of capital gains than do we. We owe the next generation of Americans no less, an economic environment in which initiative can flourish. I don't believe that young Americans today are much different than their counterparts such as me of three decades ago. Many still dream of starting their own business or expanding existing ones.

Our obligation is to nurture their ambitions beyond the taxing stage. One necessary action is the congressional enactment of a meaningful capital gains differential. It worked for me and the many other entrepreneurs of my generation and it can work again.

Thank you very much.

[The prepared statement follows:]

TESTIMONY OF JAMES M. HOAK
CHAIRMAN, HERITAGE MEDIA CORPORATION
BEFORE THE COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
JANUARY 25, 1995

My name is Jim Hoak. I'm chairman of Heritage Media Corporation with headquarters in Dallas, Texas. I am a Vice Chairman of the American Business Conference, a coalition of mid-size growth companies. I would first like to thank you, Mr. Chairman, for holding this hearing and for the opportunity to testify before this Committee.

I am speaking to you today as an entrepreneur who has started several companies over the last twenty-five years. I founded Heritage Communications in 1971 in Des Moines, Iowa with no employees and $1 million of risk capital. We sold Heritage Communications in 1987 for $1.6 billion. At that time we had nearly 5,000 employees and were one of the largest companies in Iowa. In 1987, I founded Heritage Media Corporation in Dallas with equity of $5 million. Today our equity is worth nearly $500 million and we have over 2,000 full-time employees and 15,000 part-time employees. During this same period of time, I have been part of the founding of several other firms, most of which have been substantial job and capital creators.

I can tell you without qualification that the driving financial incentive for creating these companies has been capital gains, and the tax on these capital gains has been very important in balancing the immediate risks of these ventures versus the longer-term potential rewards. I am currently starting another new company -- an investment banking/merchant banking firm to support and encourage the development of entrepreneurial companies in North Texas.

Let me tell you what you think about when you start a business. Your first thought is that you have to be crazy, and all of your friends and family in relatively risk-free jobs tell you so. You then have to convince yourself that you really have got the answer and can't fail, despite the clear evidence that most new firms do fail. You find yourself betting everything on your venture, and usually come close to losing everything. There were times in both of my successful start-ups when we were within days of going under.

Is it worth it -- you bet! Is it automatic -- far from it!

But it is important that enough Americans make this decision and take this risk so as to ensure the continued growth of our economy and its ability to create jobs. Lowering the tax on the gains from long-term investments does change the arithmetic of the decisions entrepreneurs make.

Obviously, I believe that a capital gains differential is crucial to the economic future of companies like mine and to our economy. I believe that the 50% capital gains deduction which has been proposed would be very beneficial.

I have experienced several situations where a seller of a business avoids the high, current capital gains rates by retaining his company, and changing his strategy to milking the business rather than growing it. And I have seen many examples where the high rates make the cost of new growth capital too expensive for the entrepreneur to obtain.

I know that the Committee is seeking a package that will be deficit neutral, and I can tell you from a businessman's perspective that the induced growth, and incentives to save and invest, resulting from a capital gains tax cut will stimulate revenues over time and can lead to revenue neutrality. As Congressman Jim Jones said a couple of years ago, "We can enact a tax cut on capital gains that does not cut government revenues but does spur economic growth. We can do it, because we did it before -- in 1978."

I would like to also comment favorably upon the proposal for indexing capital gains. By itself, capital gains indexation might not be enough to stimulate investment. But it can and should be done, and I wish it had been done in 1978 when Chairman Archer first proposed it.

Indexation of capital gains is absolutely fair when compared with the rest of our tax structure. Harvard professor Martin Feldstein gives an example. An investor who bought a stock in 1973 for $10,000 and held it for 20 years while it earned 7.4% a year would have its value grow to $42,019. If he sold it, the 28% capital gains tax bill on the nominal $32,019 profit would be $8,965. But adjusting for inflation, the investor has actually realized only a $9,474 gain. In short, the capital gains tax consumes all but $509 of the investor's real profits -- a 95% tax! Is there any question as to why investment capital in our country is stunted, and long term, patient investing is scorned.

One of the strengths of American society has been the fluidity between classes and income levels. Unlike Great Britain with its stratified class system, most Americans believe that they can improve themselves and their families' economic position. The wealthy in this country have no guarantee that they will be so in the future. However, without incentives to invest, human nature says to the upper income levels to take the easy course -- do nothing and stagnate capital. This is a prescription for a declining economic system. On the flip-side, most of the people currently at the lower income levels feel they have the potential to achieve some wealth, and many do so over time. Certainly, the data show that movement among income groups is very strong in this country.

The preferential capital gains tax is not a benefit only for the rich. It also benefits those people who have the American Dream. It benefits those people who are willing to take a risk for a reward. It benefits those people who create jobs and thereby benefits many others while they benefit themselves.

In the final analysis, I think that the debate about the capital gains tax is not a debate about the short-term. It is not about income redistribution in the next few years. It is not even about the current budget. The debate is about the future of our economic system. It is about the next generation of entrepreneurs.

I have been one of the fortunate people. I have created several companies over the last twenty-five years. I have definitely benefited myself and a capital gains differential has been kind to me. But I know that in pursuing my dreams, I have helped many others realize their dreams as well.

This is the context in which I view the current debate over capital gains. Simply put, do we want young Americans to have opportunities to become successful entrepreneurs and create new jobs? If so, we must provide them with sufficient financial incentive to undertake the risk and effort starting a company demands.

Throughout most of this century, such financial incentives have been available. Most of our trading partners/competitors have more favorable treatment of capital gains than do we. We owe the next generation of Americans no less: an economic environment in which initiative can flourish.

Where are the entrepreneurs today who will build the job-creating companies for the next twenty to thirty years? What are they thinking about when they face the tough decision to leave their comfortable jobs and take on the risks and uncertainty of a new venture?

I don't believe that young Americans today are much different than their counterparts such as me of three decades ago. Many still dream of starting their own business or expanding existing ones. Our obligation is to nurture their ambitions beyond the talking stage. One necessary action is the Congressional enactment of a meaningful capital gains differential. It worked for me and the many other entrepreneurs of my generation. It can work again.

Chairman ARCHER. Thank you, Mr. Hoak.

Our next witness is Dr. Hatsopoulos, chairman of the board and president of Thermo Electron Corp. in Waltham, Mass.

Welcome. You may proceed, Doctor.

STATEMENT OF GEORGE N. HATSOPOULOS, PH.D., CHAIRMAN OF THE BOARD AND PRESIDENT, THERMO ELECTRON CORP., AND COCHAIRMAN, AMERICAN BUSINESS CONFERENCE, WALTHAM, MASS.

Mr. HATSOPOULOS. Mr. Chairman, I would like to thank you and your committee for inviting me. If you may recall, 2 or 3 years ago, you and I each gave a paper at a conference sponsored by the Council of Capital Formation, and I am delighted to be here in front of this committee to testify on capital gains, which I really believe has a great impact on the future of both my company and the future of the United States.

I would like to take these things in this order. First, about our company. Our company is one of the few companies that did not suffer from our past recession. In fact, throughout the recession we witnessed in the early nineties, we continued to grow in employment and sales. We never downsized anything. And our profits have been going up. In fact, this year we are completing a 10th year of record employment, sales, and earnings.

I would like to tell you how we managed to accomplish that. Ten years ago, the company adopted a very unusual strategy which has been written up in many magazines, in the Wall Street Journal and other journals. That strategy is the creation of new technologically oriented enterprises as being an important element of conducting our business. Not only do we try to grow our businesses and make them prosper, but also part of our assignment is creating new businesses. In fact, once we create a new business and reach a certain stage, we sell a minority interest to the public and retain majority control.

Actually, the parent does not sell any part of its holdings, we let the subsidiary dilute the parent somewhat by raising their own capital in the capital markets.

Currently, we have 10 subsidiaries that are publicly traded. We have never sold one share of them. They sold shares to the market to raise capital for their own growth. This has been essentially the secret of continuing to grow through bad or good economic times.

We have made a study internally to see how much of our technologies, what fraction of our technologies, have we commercialized in the last 10 years. We arrived at the conclusion that only about half of what we could have done in that time did we actually commercialize. If we had done all of them, we would now have over 20 publicly traded companies instead of 10.

The reason for the difference is very simple. In order to commercialize businesses, you need to invest at high risk. Once the business gets going, the risk declines, but initially the risk is very high and in order to attract capital which involves a high risk, you have to pay a premium.

If we had the capital gains tax treatment that exists currently in both Germany and Japan, we estimate that over the last 10

years we would have been able to commercialize a little more than twice as many businesses as we actually did.

Mr. Chairman, I would now like to turn to some macroeconomic issues because I have been a student of that field. In fact, the day that you presented your paper, I presented a paper on macroeconomic elements of the capital gains.

This country has created an enormous number of jobs over the last 20 years—in the tens of millions. In fact, there is no other country that even comes close to the ability of this country to create jobs. The problem we have had, however, is that we have created jobs that are not as high in value as those created in the past. As a result, our wages on average have stagnated.

This is exactly the issue that I tried to study in my spare time as an amateur economist. My conclusion is that we lost high value-added jobs to Germany and primarily to Japan because they have the ability to commercialize technology by taking more risks than we can. The source of that ability to take more risks is their tax system. If a Japanese person invests in government securities that are safe, they pay a tax of 50 percent.

If, on the other hand, they invest in a company that is growing, as many Japanese companies are, and there is an appreciation of their stock—generally they are not seeking dividends, but appreciation of the stock—the capital gains tax is more like 5 percent. Actually, in Germany it is zero. Hence, there are great incentives to make risky investments in new ventures.

The future prosperity and standard of living of the American people depends on our ability to create new industries. Industries that were prominent in the past have often declined because too many countries can now perform these jobs. Therefore, since we have an open world trade, there is no way that we can compete in such industries unless we pay our people low wages.

The only way we can pay our people high wages is to go into businesses where we have an advantage and that advantage is only created by taking risks. In order to take risks—to have capital available for risks—we need to equalize the burden by lowering our cost of capital. I am not talking only about venture capital, I am talking about corporations such as ours, or even General Electric, to avail themselves of capital so that they can take high risk and create new enterprises.

[The prepared statement follows:]

TESTIMONY OF GEORGE N. HATSOPOULOS
THEROMO ELECTRON CORPORATION

My name is George N. Hatsopoulos. I am President and Chairman of the Board of Thermo Electron Corporation and also Co-Chairman of the American Business Conference.

I would like to thank the Committee for holding this timely hearing on the important topic of capital gains taxation because it not only affects our businesses but, more significantly, the economic future of our country. I personally appreciate the opportunity to appear and to speak before you today on this subject.

Over the years, I have written frequently on topics in macroeconomics. I have concerned myself with issues relating to changing patterns in American savings and consumption, the cost and patience of capital, and the fiscal and budgetary roots of the decline in our long-term rate of economic growth.

I could easily demonstrate theoretically why Congress should reduce the tax on capital gains on equity investments. But the debate over capital gains will not turn on theory. A tax cut on capital gains will happen only if a sufficient number of legislators understand in real-world terms why entrepreneurs like me support a differential tax. So I would first like to frame my views from the perspective of our company, Thermo Electron.

In 1994, we completed our tenth year of record employment, sales, and profits. What set us aside from other companies is the fact that this record performance persisted throughout the recession of 1991 and 1992.

We attribute our success to the commercialization of new technologies based on ideas generated by our ongoing work in energy, the environment, and biotechnology. We identify major needs that surface in the economy and ask ourselves if we can address those needs through the appropriate application of one or another of our technologies.

If so, we create a new public subsidiary to put our ideas into action. Thermo Electron typically holds a controlling stake in the new venture and provides it with technical, managerial, and financial expertise.

Thus far, we have created twelve subsidiaries that are world leaders in businesses as diverse as the manufacture of environmental monitoring and analytical instruments, artificial hearts, cogeneration and alternative-fuel power plants, soil-remediation equipment, recycling equipment, and systems to detect explosives, drugs, and carcinogens. By spinning out our most promising new ideas into public subsidiaries, we have been able to preserve entrepreneurial discipline even as Thermo Electron itself has grown to the 309th spot in the *Fortune 500* list.

However, we have not done as well as we might have. Changes in tax policy, beginning in 1986, have made it impossible for Thermo Electron to fully commercialize all the technologies it possesses. These tax changes have effectively made the taxation of income from equity investments double that of the taxation of returns from debt-financed instruments.

Before 1986, interest income was taxed as ordinary income while capital gains were subject to a differential tax. Thus, before 1986, interest income was subject to a marginal rate of about 50 percent for the top income brackets while capital gains were taxed at 20 percent.

Tax reform in 1986 changed that. It eliminated the capital gains differential and lowered the personal tax rates. The result: capital gains and interest income were taxed at the same rate---28 percent.

It is true that the Budget Reconciliation Act of 1993 created a differential in a perverse way by raising personal tax rates on income other than capital gains. However, the benefit created by the differential created was almost totally offset by the harm resulting from increased marginal tax rates.

Consider these developments from a corporate point of view. When a corporation issues debt, it can write off its interest payments. On the other hand, equity is taxed twice: first on corporate income, then either on dividend income or, for those companies that retain their earnings to grow, on capital gains. By taxing capital gains at the investor level, we have, at the corporate level, raised the cost of equity relative to the cost of debt. Investors demand a higher price for their equity investments because equity income is taxed twice and capital gains receive no significant tax relief.

At Thermo Electron, we have no choice but to rely on equity to finance the commercialization of our technologies. We cannot underwrite ideas with debt---there is no collateral to balance the risk.

If, by some sort of magic, Thermo Electron were operating under the capital gains taxes that prevailed in this country in 1979, we would have generated twice the number of ventures. And finally, if Thermo Electron operated with the capital gains treatment currently afforded to investors in our Japanese and German competitors, we could have enacted three times the number of new ventures.

The fact is, Thermo Electron possesses more commercially promising ideas than we can finance under the prevailing tax code. My friends in Europe know this. They often tell me that the United States is second to none in entrepreneurial and technical expertise. They wonder why our government discourages that expertise.

I have never found a good answer to their question.

Let me now turn to macroeconomics issues. In the last 20 years, this country created an enormous number of new jobs. No other country even comes close to us in this respect. The problem we have is that over this period, the jobs we have created are lower value-added jobs while the number of high value-added jobs has declined. Many of the high-paying jobs we lost were in manufacturing. But we should not think that the only way to redress the situation is to recover the manufacturing jobs we used to have. That is not possible in the internationally competitive world we live in because there are too many people around the world that have learned how to perform these jobs. And many of these people are paid less than our people. On the other hand, to recapture such jobs by setting up trade barriers will deprive our consumers of lower priced products to the detriment of our national standard of living.

There is only one way to create high-paying jobs: we must create new high value-added industries. Our more advanced competitors, Japan and Germany, know that and focus on it. The United States can do even better because the entrepreneurial and technological talent that exist in this country is unparalleled.

I strongly believe that what the country needs to regain its preeminence in high-paying jobs are two things: first, an adequate amount of national saving; and second, a strong financial incentive for business to undertake new ventures in spite of risks.

Currently, U.S. national savings has fallen to less than two (2) percent of Gross Domestic Product (GDP) compared with more than eight (8) percent in the 1960s. In the long run, our current level of saving is not sufficient to maintain the standard of living of the American people, let alone increase it. Many have the impression that the sole culprit for the dramatic decline in national saving is the federal "disaving", i.e., the budget deficit. This is not so. The federal deficit accounts for only 40 percent of the decline. The remaining 60 percent is almost evenly split between the decline in personal saving and the decline in corporate saving.

It is clear to almost everyone that a direct way to increase national saving is to reduce the budget deficit. What is not so clear is how to increase private saving. Nevertheless, economics must play an important role. Under the present tax code, income used for consumption is taxed once. Income saved and invested in a noncorporate asset is also taxed on inflationary gains. Finally, income saved and invested in corporate assets is subject not only to inflationary gains, but also to corporate taxes. Such a triple taxation affects both personal willingness to save, and corporate willingness to save and invest in new businesses.

Japanese corporations reinvest earnings at twice the rate of U.S. companies because, by virtue of the prevailing capital gains differential, their stock value appreciation is taxed at a lower rate. This practice provides incentive to these corporations to undertake the commercialization of many new products, some of which are invented in the United States.

The ultimate way to redress the disincentives in our tax system to save and to create new industries is to drastically restructure the U.S. tax code and to provide total deferral of taxes until an asset is withdrawn from the national saving pool and consumed. This is the treatment that would prevail under the Nunn-Domenici tax reform or the flat tax proposal of Congressman Armey. The implementation of such a fundamental reform, however, will take several years, not only because of the needed public debate, but also because of economic necessities.

It is not prudent for us to wait for this to happen. Proposals under current examination by this Committee can and should be viewed as a necessary and consistent first step towards the achievement of broader tax reform. The capital gains initiative proposed by Chairman Archer provides an excellent case-in-point. It eliminates the tax on unreal gains resulting from inflation. More importantly, it encourages the creation of new businesses both by persons and by corporations. Thermo Electron and all of the members of the American Business Conference strongly support Mr. Archer's initiative.

Chairman ARCHER. Doctor, thank you very, very much and perhaps you can explore and develop your excellent ideas as we go into the inquiry part in a few minutes.

For the introduction of our last witness, I would recognize my colleague, Charlie Rangel.

Mr. RANGEL. Mr. Chairman, thank you for allowing me to introduce Michael Schler, who is the former chair of the tax section of the New York State Bar Association.

This committee has had a reputation of being the welfare committee for accountants, CPAs, and lawyers. And your testimony is going to be interesting because you are asking us to seek popular solutions that people may want as related to capital gains taxes and to avoid complexities that could increase fees, but also increase problems. So I thank you, Mr. Chairman.

Chairman ARCHER. Mr. Schler, I would point out that these lights in the center of the witness table will be green, yellow, and red. And when the light turns red it means your 5 minutes is up. We hope that you can keep your oral presentation within that 5-minute limit, and you may proceed.

STATEMENT OF MICHAEL L. SCHLER, FORMER CHAIR, TAX SECTION, NEW YORK STATE BAR ASSOCIATION

Mr. SCHLER. Thank you, Mr. Chairman and Congressman Rangel. My name is Michael Schler. I am here on behalf of the tax section of the New York State Bar Association. I was the chair of the tax section until my term expired yesterday, and I continue to be a member of our executive committee.

The tax section is dedicated to furthering the public interest in a fair and equitable tax system and to the development of sound tax policy. I am also a tax partner in the New York law firm of Cravath, Swaine & Moore and have practiced tax law for over 20 years.

We are very grateful for the opportunity to present our views today. I should say we take no position on the 50 percent capital gains deduction. That raises policy issues beyond our particular expertise as tax lawyers. However, with all due respect, we strongly oppose three provisions of H.R. 9: Capital gains indexing, indexing depreciation deductions, and the imposition of new procedural requirements for the issuance of tax regulations. I would like to briefly summarize our views which are expressed in much more detail as an attachment to my statement.

I should also add that we are a completely nonpartisan group. Our executive committee has members of all political persuasions and, as far as I know, the views I am expressing are essentially unanimous among all our members.

First on capital gains indexing. We recognize the theoretical correctness of indexing capital gains to take account of inflation. However, we believe there are two fundamental problems with indexing. The first is complexity. The indexing provisions of the bill on their face add only a few simple paragraphs to the code. However, we believe that in the real world indexing will vastly increase the complexity of the tax system for everyone, including individuals, businesses of all sizes, and the IRS. Activities that are relatively simple today will involve massive calculations under indexing: Buy-

ing and improving a home, buying and selling stock or an interest in a mutual fund or investing in an IRA.

Also, if a State chooses not to allow indexing for revenue reasons, and it will certainly be costly to the States, everyone in that State will be required to keep two sets of books, one taking into account indexing and the other not taking into account indexing. Individual taxpayers are likely to be dumfounded at the prospects of two sets of books.

The other major problem we have with indexing is that we believe it will inevitably result in the return of the tax shelter days of the eighties. Every experienced tax lawyer who reads the indexing provisions of the bill immediately dreams up a half dozen ways to beat the system and create a tax shelter that eliminates tax on unrelated income.

Some of the most obvious opportunities arise from the fact that assets are indexed while liabilities are not. As a result, totally artificial tax deductions can be created with little or no out-of-pocket cost by borrowing and using the proceeds to buy an indexed asset.

Also, there would be many ways besides borrowing to create a tax shelter out of indexing. Just keep in mind the world of financial products is extraordinarily creative and very motivated to develop tax-favored investments.

I should emphasize that when you set up a system where taxpayers can get back exactly the amount of cash they put up and get a capital loss, or get back more than they put up and not be taxed, you are really opening up the floodgates for creative tax planning.

In yesterday's article in the New York Times there were some people quoted as saying that the passive loss rules that were passed in 1986 would prevent a lot of tax shelter abuses from arising as a result of indexing. I don't think that is correct because the passive loss rules don't deal with investment activity. They only deal with real estate and other business activity, so I think any tax shelter opportunities that would exist would mostly still exist despite the passive loss rules.

I would like to turn now briefly to indexing depreciation deductions under the neutral cost recovery provision of the bill. We understand that the effect of that provision is that, on a present value basis, there would be no tax on a reasonable rate of return from the use of equipment. That is another way of saying that qualified equipment is treated like a municipal bond, although the equipment has a much higher tax-free yield.

Also, if you borrow money to buy a municipal bond, the interest is not tax deductible. If you borrow money to buy equipment, the profit is tax exempt and the interest is deductible. As a result, we force an enormous boon in tax shelters. Assistant Secretary Samuels talked in his testimony about deducting the cost of equipment. He was opposed to the whole provision, but I think even he was much too kind to it when he said that the immediate deduction was like a consumption tax. With a consumption tax, you can deduct the cost of your equipment, but if you borrow to buy equipment, you cannot deduct—you do not get a net deduction, which you do under this bill.

Finally, H.R. 9 imposes new procedural requirements before a Federal agency can issue regulations. We oppose those requirements because we believe taxpayers need more regulations rather than fewer. H.R. 9 also requires tax regulations to be easily readable, written in a reasonably simple and understandable manner, not contain double negatives, confusing cross references and so on.

I don't think there is anyone anywhere who thinks the Internal Revenue Code meets those requirements, and we think the bill is an example of Congress imposing rules on other people and exempting itself from the same rules. It is completely unreasonable to expect that tax regulations can be made simple as long as the code is almost incomprehensible.

Thank you very much.

[The prepared statement and an attachment follow. Additional attachments are being retained in the committee files.]

HEARINGS ON H.R. 9 BEFORE THE HOUSE WAYS AND MEANS COMMITTEE JANUARY 25, 1995

STATEMENT BY MICHAEL L. SCHLER ON BEHALF OF THE TAX SECTION OF THE NEW YORK STATE BAR ASSOCIATION

My name is Michael Schler. I am here on behalf of the Tax Section of the New York State Bar Association. I was the Chair of the Tax Section until my term expired yesterday, and I continue to be a member of our Executive Committee. The Tax Section is dedicated to furthering the public interest in a fair and equitable tax system and to the development of sound tax policy. I am a tax partner at the New York law firm of Cravath, Swaine & Moore and have practiced tax law for over 20 years. I am accompanied by Harold Handler, a tax partner at the firm of Simpson Thacher & Bartlett. He has practiced tax law even longer and is primarily responsible for our work on indexing.

We are very grateful for the opportunity to present our views today. We strongly oppose three provisions of H.R. 9: capital gains indexing, indexing depreciation deductions, and the imposition of new procedural requirements for the issuance of tax regulations. I would like to briefly summarize our reasons.

First, capital gains indexing. We recognize the theoretical correctness of indexing capital gains to take account of inflation. However, we believe there are two fundamental problems with indexing.

The first problem is complexity. The indexing provisions of H.R. 9 on their face add only a few simple paragraphs to the Internal Revenue Code. However, we believe that in the real world indexing will vastly increase the complexity of the tax system for everyone. This includes individuals, businesses of all sizes, and the IRS. Activities that are relatively simple today will involve massive calculations under indexing--buying and improving a home, selling the family car (yes, the car is an indexed asset), buying and selling stock or an interest in a mutual fund, investing in an IRA. Also, if a state chooses not to allow indexing for revenue reasons, everyone in that state will be required to keep two sets of books. Individual taxpayers are likely to be dumbfounded at this prospect.

The other major problem we have with indexing is that it will inevitably result in the return of the tax shelter days of the 1980's. Every experienced tax lawyer who reads the indexing provisions of H.R. 9 immediately dreams up a half dozen ways to "beat the system" and create a tax shelter that eliminates tax on unrelated income. Some of the most obvious opportunities arise from the fact that assets are indexed while liabilities are not. As a result, totally artificial tax deductions can be created with little or no out-of-pocket investment, by borrowing and using the proceeds to buy an indexed asset. Also, there would be many ways besides borrowing to create a tax shelter out of indexing. Just keep in mind that the world of financial products is extraordinarily creative, and very motivated to develop tax favored investments.

I would like to turn briefly now to indexing depreciation deductions. We understand that the effect of this provision is that, on a present value basis, there will be no tax on a reasonable rate of return from the use of equipment. This is another way of saying that qualified equipment is treated like a municipal bond, although the equipment has a much higher tax-free yield. Also, if you borrow money to buy a municipal bond, the interest is not tax deductible. If you borrow money to buy equipment, the profit will be tax-exempt and the interest will be deductible. As a result, we foresee an enormous boom in tax shelters.

Finally, H.R. 9 imposes new procedural requirements before a federal agency can issue regulations. We strongly oppose the application of these requirements to tax regulations. The requirements are so burdensome that the issuance of regulations may come to a grinding halt. Taxpayers need tax regulations to be able to plan their affairs. The biggest complaint among taxpayers is there are too few regulations, not that there are too many.

H.R. 9 would also require that tax regulations be "easily readable", "written in a reasonably simple and understandable manner", and not contain any "double negatives, confusing cross references, convoluted phrasing" and so on. I do not believe there is anyone anywhere who thinks that the Internal Revenue Code itself meets any one of these requirements. H.R. 9 is an example of Congress imposing rules on other people and exempting itself from the same rules. It is completely unreasonable to expect that tax regulations can be made simple as long as the Code is almost incomprehensible.

That completes my prepared statement. I would be happy to answer any questions.

HEARINGS ON H.R. 9 BEFORE THE HOUSE WAYS AND MEANS COMMITTEE JANUARY 25, 1995

SUPPLEMENTAL STATEMENT BY MICHAEL L. SCHLER ON BEHALF OF THE TAX SECTION OF THE NEW YORK STATE BAR ASSOCIATION

FEBRUARY 7, 1995

This statement supplements my statement at the January 25, 1995 hearing concerning capital gains indexing. It responds to the statement and testimony by Dr. Norman Ture, who was a later witness on the same day. Dr. Ture asserts that indexing assets but not liabilities provides the theoretically correct results, and calls "without merit" the earlier testimony by Assistant Secretary Samuels that indexing assets but not liabilities leads to tax arbitrage and tax shelter opportunities. This assertion by Dr. Ture is in effect an assertion that our prior statement is also incorrect.

For the reasons stated below, we believe that Mr. Samuels' testimony is correct and that Dr. Ture is not. Moreover, Dr. Ture's error appears to be a simple mathematical error. We do not believe this issue is an abstract economic or philosophical issue upon which there can be differences of opinion, any more than there can be any differences as to the sum of 2 plus 2.

We begin, as does Dr. Ture, with the example given by Mr. Samuels. Taxpayer T purchases land in year 1 for $100,000, giving a $20,000 cash down payment and borrowing $80,000. The land is sold several years later (assume in year 5), after there has been 30% inflation, for $130,000. Thus, the entire $30,000 of nominal profit represents an inflationary increase in the value of the property. T takes the $130,000 sale proceeds, pays off the $80,000 debt, and is left with $50,000.

Mr. Samuels points out that T started with $20,000, and to make T whole for 30% inflation it would take an additional 30% of $20,000, or $6,000, of nominal profit for a total cash proceeds (after debt repayment) of $26,000. That is, $26,000 in year 5 has the same value that $20,000 had in year 1. To the extent T receives more than $26,000 of cash in year 5, the extra cash is real profit that should be subject to tax. However, even though T receives $50,000 in cash, with basis indexation T has no tax liability on the sale because the tax basis of the asset has grown to $130,000. Thus, $24,000 of real economic profit has escaped tax.

Dr. Ture's written response to Mr. Samuels' example asserts the following:

> Notice, however, that in terms of constant purchasing-power dollars, the $50,000 in cash [T] has left over after paying off the mortgage indebtedness is only $20,000, exactly the amount of [T's] original cash investment. If [T] were subject to tax on the $24,000 of gain allocated by Samuels to the mortgage component of the investment, as Samuels suggests, [T] would net only $17,280. The tax would subject [T] to a net loss of $2,720 on the original investment. In fact, the arbitraging that Samuels asserts would result from indexing the basis of the asset but not the debt protects [T] from having to pay tax on a zero gain. The Treasury's complaint is without merit. (emphasis added)

The problem with Dr. Ture's analysis is the simple mathematical error in the first sentence. After 30% inflation, $20,000 will grow to $26,000, or alternatively $38,461 will grow to $50,000. In no event will 30% inflation turn $20,000 into $50,000. We believe it is indisputable that T has a true economic profit of $24,000 and should pay tax accordingly. We note that this profit is in year 5 dollars, which matches the fact that the tax on the profit would also be paid in year 5 dollars.

We would point out that the $24,000 of real economic profit that has escaped tax arises from the fact that the entire $100,000 tax basis of the asset is indexed for inflation, but no portion of the $80,000 liability is indexed. There are at least two ways of reaching the theoretically correct economic and tax results.

First, indexing could be limited to T's net investment of $20,000. This would result in an increased tax basis in the property of 30% of $20,000, or $6,000. The total tax basis would be $100,000 plus $6,000, or $106,000, and a sale for $130,000 would give rise to the economically correct taxable gain of $24,000.

Alternatively, the entire $100,000 investment as well as the $80,000 liability could be indexed. Under this approach, T would have no gain on the property (because the total sale proceeds of $130,000 in year 5 dollars has the same value as $100,000 in year 1 dollars). However, T would have an economic profit on repayment of the debt, because the year 5 dollars used by T to repay the $80,000 debt are worth less than the year 1 dollars originally borrowed by T. Given 30% inflation, the $80,000 year 1 dollars have the same value as $104,000 year 5 dollars (130% of $80,000 being $104,000). Since T is only required to repay $80,000 in year 5 dollars, T has an economic profit of $24,000 in year 5 dollars and should pay tax accordingly.

Chairman ARCHER. Mr. Schler, I can associate myself with the very last sentence since I do my own tax return, believe me. We have got a virtually arcane and impossible Tax Code in this country.

I appreciate the input of all of you. I would like to ask a question and direct it to each of you, if you would reply in turn. Assume that we are going to have a capital gains tax provision, we already have one in the current law where it is different than ordinary income and we have a 1-year holding period.

Is the 1-year holding period the optimum holding period or would you suggest a different holding period? You may start, Doctor. And then we will work to your right.

Mr. HATSOPOULOS. I believe that an ideal scheme would be to have a tax rate that does depend on a holding period and it escalates as the holding goes up. The problem with that is complexity. But there is a problem with the United States right now because a lot of corporations forgo especially risky long-term investments because their stockholders are pushing them to report earnings, and if you have a capital gains schedule where the longer you hold the lower the tax you can have the investors focus in on what the company would do, not in the next quarter, but what it would do 5 years from now. The only offsetting disadvantage of that is complexity.

Chairman ARCHER. Well, I understand that there are some who believe that we should have a sliding scale tax based on the length of the holding period, and perhaps that ought to enter into the discussion today, but, as you pointed out, it is complex.

In addition, we have had witnesses testify over the years that it creates cliffs and it affects the actual decisionmaking as to the timing for the sale of an asset and although I can understand there are advantages, there are disadvantages, but if you had to pick a holding period without a sliding scale, and have that in the law, should it be 1 year, 2 years, 3 years, 4 years, 5 years in order to qualify for a capital gains?

Mr. HATSOPOULOS. I would say 2 years, Mr. Chairman.

Chairman ARCHER. Two years.

Mr. Mann.

Mr. MANN. My focus is on venture capital because that is how SunGard was started and I believe a 1-year holding period is appropriate because no venture investment tends to mature before that.

However, I have seen some mature within 2 years, so I think that would be a bit long, and I think the sliding scale adds complexity which is undesirable—1 year would be my opinion.

Chairman ARCHER. Mr. Hoak.

Mr. HOAK. I would say that the 1 year is fine. I think that the 2 years does get a bit long, but I think that would be OK as well. I do think on the sliding scale, I think a lot of that can be taken care of through the indexation with all due respect to our last speaker.

I think that can be handled from a complexity standpoint and I think that there needs to be for long-term investment for the 20-year investment in my company, for example, that there needs to

be indexation for that. I think for the typical capital gains, 1 or 2 years.

Chairman ARCHER. Mr. Johnson.

Mr. ROBERT JOHNSON. I would argue for a 1- to 2-year kind of holding period. I would also suggest that there might be other things that you might do. For example, what was critical to BET's success was not only having the investment like TCI and Time Warner, but having the chief executive in the case of TCI serving on the board. That added a bona fide kind of commitment of that company to BET's growth and development.

To the extent that you can incent companies not only to invest but to take some active role in management, at least from a board oversight level, could also contribute to a likelihood of companies succeeding from capital investment.

Chairman ARCHER. Thank you.

Mr. Schler.

Mr. SCHLER. I think a sliding scale makes things more complicated, but I have no particular view as a tax lawyer on what the right period would be.

Chairman ARCHER. So you are not of an opinion relative as to whether it ought to be 1, 2, 3, 4 or 5 years.

Mr. SCHLER. That is correct.

Chairman ARCHER. OK. Thank you very much.

Mr. Rangel.

Mr. RANGEL. Thank you, Mr. Chairman. Mr. Schler, I had no idea what it was like to lose the majority here until I saw all of our staff gone. So I am going to hope that you and I can get together with the New York Bar Association so that I can get the benefit of your legal research in trying to perfect the Tax Code, and Mr. Hatsopoulos, I don't think anyone challenges your testimony. We know that we are going to have to change our way of doing business if we are going to enter this global economy. We know that things that we have been doing well, other people know how to do it just as well at a lower price.

What I don't understand and I expect Mr. Johnson to respond to this, too, that even if we were successful in providing the tax incentives for people to take more risks, accumulate the savings to make these investments so that America can continue to be in the leadership, what are we doing to prepare our work force to be partners with management in moving forward to meet these challenges? And I am not just talking about inner city.

Mr. Johnson is in a very high-tech business. It changes every day. And I know that we are doing enough research and development in the private sector, but we have universities doing pure research that could be converted so that our schooling system instead of just talking about degrees, can pump up the type of men and women that could assist in meeting these challenges.

Do we ever hear economists or people like you, Doctor, talking about this marriage between investment and intellectual abilities?

Mr. HATSOPOULOS. Mr. Rangel, I couldn't agree with you more. The issue of training people and bringing our work force up to snuff is the other side of the equation. On the other hand, let me say that currently even though we are nowhere satisfactorily training people for the jobs of tomorrow, currently we do have people

that are trained, and they cannot find the high wage and high value-added jobs that they could find 5 years ago.

Mr. RANGEL. Well let me say this, Doctor, that with all of this targeting that Mr. Johnson is talking about, it is hard for me to believe, Mr. Johnson, that no matter what incentives you give people to invest in certain targeted areas, that if that community is not prepared to meet the intellectual challenges of the labor market that is necessary, no incentive is going to cause them to put their money there, no matter what returns are there.

Mr. ROBERT JOHNSON. Mr. Rangel, you are absolutely correct that capital flow is where the best return is going to be regardless, and you could do artificial things to increase the return and I think a capital gains tax lower for investments in high risk areas, can help the return and therefore make that area more attractive to capital.

Mr. RANGEL. What I am saying, Mr. Johnson, is to lower the risk in those areas so that they are not looking at a high risk area. I mean, if you listen to Treasury and listen to our government talk today as to why we have to guarantee a $40 billion loan to Mexico, it is exciting. We have to do this. Because these people have to learn higher technology in order to produce better products to increase their health, their environment, and their ability to perform so they can become consumers and continue to be one of the major trading partners of the United States, to increase our exports and therefore our revenues so that we can continue to be a leader.

Now, why can't they do that with communities in the United States?

Mr. ROBERT JOHNSON. I think, Mr. Rangel, you are absolutely right. Our company just built a $20 million corporate headquarters in Northeast Washington, D.C., one of the most difficult neighborhoods in the District to say the least. And we believe that if we had more capital investment in Black Entertainment Television in the high-tech world of programming, we can train and employ people to work in this technology.

And with the upcoming information superhighway that is going to demand a great deal of trained workers, you could see more opportunities flowing to people in this area as well as higher skills and higher paying jobs. I think the Tax Code, if used to target companies that engage in training for higher skilled jobs, can stimulate capital flow and jobs.

Mr. RANGEL. I have been fortunate to have a substantial part of my congressional district be designated as an empowerment zone where we hope to be able to bring a marriage between the business and the schools so we are not talking just about diplomas and degrees but we are talking about job opportunities.

I hope that you would share your thoughts with us as we now find a half a dozen cities that will try to see whether government can do a better job in meeting the needs of the private sector. So I will be sending you a message on that.

Mr. ROBERT JOHNSON. I would be delighted.

Mr. RANGEL. Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Bunning.

Mr. BUNNING. Thank you. I would like to follow up with the panel on some of things that Mr. Rangel has talked about.

Les Samuels, the tax policy person for the Treasury, Assistant Secretary for Tax Policy, criticized the provisions of the Contract as not being sufficiently targeted.

I would like to ask the panel, in general, who do you think should be making the investment decisions for targeting where you invest? The Federal Government or the individual corporations or individuals who are making the investments? In other words, if we are not—if we are not sufficiently targeted, in the Contract, who should be making that decision?

Mr. ROBERT JOHNSON. I take the position that the entrepreneur, the person who has put him or herself at risk in raising capital and turning that into a business should make that decision. There is no doubt about it.

When I was starting BET, on any given day, I had my home and everything I owned mortgaged to the future of this business. And I didn't know from day to day back in the eighties when interest rates were around 14 and 15 percent and cable was in its infancy whether or not this thing would succeed or not. Well, fortunately it did.

I think coming through that crucible, I think I can sit back and look at business ideas, look at entrepreneurs, see if they have within themselves the instinct and the gut to go the distance in a very tough kind of an enterprise, that of startup businesses. Clearly I think I can do that better than any government bureaucrat or any government policy. I have done it with my business. We are doing it with other businesses.

Mr. HOAK. Mr. Bunning, I agree with that and I would add one thing more. One problem with the very specifically targeted provisions is that there is not enough faith in the business community that it will stay targeted. That is a problem with a lot of things that have been put in the past, if it is a 5-year window or whatever, and business doesn't feel it can count on the Tax Code remaining stable for 5 years and, therefore, when they are very specifically targeted, it may not produce much because we can't rely necessarily on staying there. So, therefore, I encourage you to have it be broad as it now is.

Mr. BUNNING. Thank you.

Mr. Mann.

Mr. MANN. Yes. It seems to me that most everyone can agree that investors and businessmen probably will make wiser choices on the investment of funds. Therefore, the thing that will cause those funds to be spread throughout the economy is a greater abundance of investment funds which would be provided by the differential and lower rate of capital gains taxation.

As I said in my opening remarks, SunGard was not a promising looking investment when the investment was made. But there was an abundance of investment funds and consequently there was some left over for us.

Mr. SCHLER. I would like to point out that the indexing provisions target specific kinds of assets. Only stock and tangible assets are indexed, intangible are not. That itself could create economic inefficiencies. The neutral cost recovery deduction itself gives much better tax benefits to tangible assets with a depreciable life of 10

years or less, so that is not really a neutral system in terms of different kinds of investments that taxpayers could make.

Mr. BUNNING. Quickly, can you tell me what steps we should take to increase the savings rate in this country? Quick.

Mr. HOAK. It is hard to be quick about it.

Mr. BUNNING. I know it is hard to answer quickly but I only have 5 minutes.

Mr. HATSOPOULOS. Cut the Federal deficit. Every dollar you cut from the Federal deficit increases national saving by one dollar.

Mr. BUNNING. We have every intention of doing that.

Mr. ROBERT JOHNSON. I think you put a consumption tax in place rather than taxes on income.

Mr. BUNNING. OK. Anyone else?

Mr. MANN. Consumption tax.

Mr. SCHLER. I am just a tax lawyer not an economist.

Mr. BUNNING. OK. Thank you.

Mr. HOUGHTON [presiding]. Thank you.

Now Mr. Ramstad.

Mr. RAMSTAD. Thank you, Mr. Chairman.

I want to thank all the witnesses for being here today. I want to tell you, Mr. Hoak, that you gave one of the most brilliant, poignant and articulate defenses of cutting capital gains that I have ever heard when you said that capital gains are about the next generation of entrepreneurs and that fulfilling my dreams enables many others to fulfill theirs as well.

It reminded me of a recent experience when I first ran for Congress. I was actually in the least affluent part of my district, talking about a number of subjects to a high school group. Afterward, one of the students came up to me and said he wanted to help on the campaign. And I asked him why, what was it I said that attracted him to the campaign. And he said, "I like what you said about capital gains."

I was a little bit surprised, coming from a 17-year-old high school student. And I asked him, "Do you have any capital gains?" And he said, "No, not now, Mr. Ramstad, but some day I hope to." And that is the kind of inspiration, that is the kind of incentive that we have to return to the Tax Code, and to our mindset nationally.

I would like to ask one question of Mr. Schler. I was struck by a couple of remarks you made. I am sure you agree with virtually everyone that fairness should properly be an element of the code. Do you really think it is fair for individuals who have saved and invested aftertax income in capital assets to pay taxes on the inflationary gain of that asset over the years?

Mr. SCHLER. Well, as I said, as a theoretical matter, we believe they should not. But, historically the reason for a reduced overall rate on capital gains, like the 50-percent deduction, has been that you are entitled to a lower rate because part of the gain is inflationary and so, to some extent, there is an overlap in the benefits you are getting if you reduce the rate and also index for inflation.

Mr. RAMSTAD. Well, I know we could go back and forth on this. I hope the will of the committee is somewhat different.

Let me ask you another question. Did I hear you say there are too few IRS regulations, not too many?

Mr. SCHLER. That is correct. Every taxpayer group that I know of thinks there should be more IRS regulations and they should come out quicker. The biggest problem is uncertainty in having this very complicated Tax Code.

Mr. RAMSTAD. Excuse me for interrupting. Who said that?

Mr. SCHLER. We have TEI, the Tax Executives Institute, and the American Bar Association. As far as I know every taxpayer group has asked for more regulations rather than fewer. There was also a GAO report in the last few weeks that did a survey of taxpayers and came to the same conclusion.

The problem is that Congress enacts these very complicated statutes and generally delegates all the hard areas to the IRS to solve by regulation, and then taxpayers are faced with this enormous uncertainty. They just don't know how to do their transactions because they don't know what the tax rules are, and they beg the IRS to put out rules.

It doesn't matter so much how they come out, just so people know what the rules are. The burden of uncertainty is really a drag on the economy and I believe pretty much all taxpayer groups believe the same way.

Mr. RAMSTAD. Let me ask the entrepreneurs, any of the entrepreneurs on the panel to respond to that.

Mr. HATSOPOULOS. Obviously the tax rules are so complex that in fact corporations spend a lot of resources in dealing with the Tax Code. There is no question about it. Those resources could be better spent developing products or selling those products.

Mr. RAMSTAD. I see the yellow light coming on. Let me ask the four, with all respect, the four entrepreneurs to Mr. Schler's left, certainly not ideologically speaking, but if there is any of you who agree that IRS regulations are too few in number.

Mr. ROBERT JOHNSON. Let me try to point out what I think Mr. Schler is saying. For example, we deliver our programming signal by a satellite transponder. The transponder is located 22,000 miles in the sky above the equator. Now, where is it taxed? Is it taxed in the jurisdiction where the company is headquartered? Is it taxed in all of the areas where we deliver the signal? Where do we pay the—how do we handle that asset?

It is when you don't have rules—I think what he is saying—that he would rather—best of all worlds from an entrepreneurial standpoint would have probably been no tax, but since you are not going to get to that world, the best would be, from any business point, certainty is always better than uncertainty. And I think what he is saying out of frustration, we want certainty since we can't have a flat no tax base.

Mr. RAMSTAD. Don't give up on that yet. I see my time is up.

Thank you, Mr. Chairman.

Mr. HOUGHTON. Mr. Stark.

Mr. STARK. Thank you, Mr. Chairman.

I find the testimony interesting. I guess I might have been an entrepreneur many years ago, but I can't remember, it was so long ago. But I want to test your memory a little bit. Mr. Johnson, BET was organized when?

Mr. ROBERT JOHNSON. 1980. January 25, 1980.

Mr. STARK. 1980. OK. And Mr. Hoak, you had a major transaction sometime around 1987. You sold a company in Iowa?

Mr. HOAK. Yes. Started in 1971, 1970, and sold in 1987.

Mr. STARK. So you started in 1970. Nineteen-seventy-one was when you first dipped into the entrepreneurial waters?

Mr. HOAK. That is correct.

Mr. STARK. And Mr. Mann, when did you emerge on the scene as an entrepreneur.

Mr. MANN. Well, I emerged more than once. This time in 1983, when SunGard was founded by the investment group.

Mr. STARK. But you had been an entrepreneur before that.

Mr. MANN. Yes, that is correct.

Mr. STARK. When was your first startup?

Mr. MANN. It is very embarrassing to make me admit this in a public forum, but it was 1966 or 1967.

Mr. STARK. OK. Now I guess I am going to ask you what the marginal capital gains rate was in 1968, let's say?

Mr. MANN. I don't remember what it was in 1968. I remember what it was, however, in 1983. It was 20 percent.

Mr. HOAK. I remember——

Mr. STARK. I will tell you it was 26.9 percent. Mr. Hoak, do you remember?

Mr. HOAK. I do remember. I have to admit I went back and checked it before this hearing, but the interesting thing then was——

Mr. STARK. What was the rate?

Mr. HOAK Thirty percent.

Mr. STARK. You were a little high. Maybe only 28.

Mr. HOAK. But there was a 40 percent differential at that time.

Mr. STARK. Mr. Johnson, do you remember what yours was?

Mr. ROBERT JOHNSON. No, I didn't focus on that.

Mr. STARK. It was about 28 percent.

My point is, and I didn't remember either, that I started in 1961 when it was higher than any of you guys can imagine. With the California marginal rate added in it was probably 47 percent. You guys couldn't pay that much tax if you paid it twice now.

Now, what I am suggesting is that for an entrepreneur and somebody who is going to start up a business and get going, the last thing you think about is what you are going to pay 5 or 1 or 10 years in the future in capital gains.

Gentlemen, the point is, when you got an idea or a chance to get off on your own, you do it. Mr. Johnson, I know that you had an opportunity that was created by a whole confluence of happenstances and you would have grabbed that chance, I am sure, if the capital gains rate had been 60 percent, because it was a great business that was just waiting to get started. I don't know as much about how all of you did.

So while one of the problems that we have is if we are going to drop it under Mr. Archer's proposal to 18 percent, sure that is 10 percent less than you might pay on the margin today, that is going to cost the government at some point in time some money. There is a debate as to how much it will be and I am just wondering if it is going to really stop people. I always think that entrepreneurs are born, not made; and I have a hunch that we are going to see

entrepreneurs continue regardless of what we do with the capital gains tax.

I don't mean to pinch you into a corner on this, but are there other areas, and I have a hunch there are efforts in terms of regulation, having nothing to do with the Tax Code, that would keep you from going into a business more than future taxes.

Go ahead, Mr. Johnson, I am sorry.

Mr. ROBERT JOHNSON. Let me respond to that. I stated clearly in my testimony that the furthest thing from my mind and the furthest thing from the investors' minds was what was going to be the return on the equity. It was really this was a great idea and it was an exciting thing to do.

But having said that, when you get to the point where you do have a return and you look back on what you have accomplished, why shouldn't you have the full benefit and fruits of that hard work?

Mr. STARK. I am with you. When I sold my business and came to Congress, I told you I paid 47.5 percent, and if Mr. Archer will make this tax retroactive to 1973, I will be right there with him.

Mr. ROBERT JOHNSON. I paid 28 percent in Federal and 10 percent in the District of Columbia, so I am at 38 percent, so I understand that. The point I am making, though, is with the difference I would have under Mr. Archer's proposal, I believe that instead of being 1 BET, there might be 2 or 3 or 4 or 5 other kinds of companies employing 450 people like I do, because I think I can better deploy the dollars than the $2 million I sent to the D.C. government, and to the Federal Government. I don't know what they did with it, but I do know that there are a lot of guys out there right now looking to me to put $200,000 or $300,000 in their business.

Mr. STARK. If the Chair will indulge me for a final comment, and I understand exactly what you are saying, but I think you would find as we look at the availability of venture capital, particularly from the venture capital funds and there have been lean years and there have been some years when there has been $5 of venture capital for every decent startup available. And I don't think that has had any relationship to the capital gains tax. That has a relation as to whether the major pension funds have been intrigued by diversifying into capital gains. Though when they haven't, I think that in this case you have to make sure that you will get a bigger pool of venture capital by cutting the capital gains tax, and I am not sure that the panel has made that or that we have the economic information to make it.

Thank you, Mr. Chairman.

Mr. HOUGHTON. Thank you.

Mr. Zimmer.

Mr. ZIMMER. Thank you, Mr. Chairman.

I just would like to respond to Mr. Stark. He may be one of those venture capitalists or those entrepreneurs, rather, who was born rather than made, but in my experience as an attorney working on venture capital matters with a large corporation which could have invested its money in any number of activities, the amount of the return on a capital investment that you get to keep has a lot to do with how you invest your money. And I think it is just a matter of rationality.

I want to point out that much of what I know about tax law and tax shelters I learned at Mr. Schler's law firm. I was an associate at Cravath, Swaine & Moore, and I have a great respect for the capabilities of its tax department. I spent a lot of time doing tax shelter work, leverage leasing of every asset known to man and some that I didn't know existed until I worked on the papers.

But I do disagree with your conclusions as to the desirability of indexation. You have told Mr. Ramstad, Mr. Schler, that in the abstract, it is not fair to impose a tax on a gain that reflects solely the impact of inflation.

Let me ask you whether you think it is appropriate, it is a legitimate feature of the Tax Code to deduct the cost of interest borrowed to purchase an asset.

Mr. SCHLER. Well, if the interest is paid on a loan to purchase an investment asset, yes, because that goes into your calculation of your net income. If the interest is for a personal asset, it is not deductible now unless it is mortgage interest and I think it probably should not be.

Let me just add one other thing. The entire Tax Code is really a tradeoff between what is theoretically accurate and what is administrable. And if we want to be theoretically accurate, every time somebody buys some foreign currency travelers checks and goes to Europe and cashes them, they are going to have gain or loss because the currency rates have changed in the meantime.

You just can't administer a system that is accurate to every last penny. You have to have some overall simplifications in order to have an administrable system. And the more you get into things like indexing, even though we all admit it is theoretically accurate, the more unadministrable the whole code just becomes.

Mr. ZIMMER. Well, you just conceded that at least interest incurred for investment is a legitimate tax deduction and, previously, you conceded that it is not fair to tax a gain that is solely the result of inflation, but you are attacking the combination of those two factors as some kind of unjust enrichment of the investor, an unjustified tax shelter.

How do you explain that?

Mr. SCHLER. Let me give you an example. Let's say you use $100 to buy an asset and sell it for $110, and that is because of 10 percent inflation. Since you end up with exactly the same value of cash that you started with since $110, after 2 years, say, is worth exactly the same as the $100 that you started with, as a theoretical matter, I would agree you should not be taxed on that gain because you end up with the same net worth you started with.

On the other hand, if you borrow $100 to buy an asset, you haven't laid out any money at all. Assume you sell the asset after the same 2 years for $110 and use the $110 to pay off your loan, $100 of principal and $10 of interest. You start with no cash and you end with no cash, and you get to index the basis of the asset for inflation. In this transaction, there was absolutely no out-of-pocket to you at the beginning and no cash at the end. Nevertheless, you get—you would get a higher tax basis in the asset.

If there is 10 percent inflation in that period, you would have a tax basis of $110, you would have no gain when you sold the asset. You also get a $10 interest deduction, and so you end up with a

net tax benefit which would shelter other unrelated investment income that you have. I don't know of any theoretical justification for a tax benefit from a transaction that you broke even on.

Mr. ZIMMER. I would like to pursue that further but the yellow light is on. I have one quick question.

Do you believe it would enhance the simplicity of the Tax Code to reduce the capital gains rate to zero?

Mr. SCHLER. It would enhance it even more to eliminate the income tax altogether.

Mr. ZIMMER. Could you answer my question.

Mr. SCHLER. But the answer to your question, I suppose, no, it would not because you would have all the same distinctions people used to have to make on distinguishing capital gains from ordinary income.

Mr. ZIMMER. We already do, don't we, because of the differential?

Mr. SCHLER. The greater the difference in rates, the more pressure there is and the more tax shelters. Also, the further you reduce the rate, the bigger the tax shelter you get from the interest deduction from the borrowing to buy the asset that gives rise to the reduced tax on the sale. So the lower the capital gains rate, the more you are going to allow taxpayers to keep a lot of interest deductions, allowing people to shelter more and more other income on one of these leveraged transactions.

Mr. ZIMMER. Thank you.

Mr. HOUGHTON. Mr. Johnson will inquire.

Mr. JOHNSON OF TEXAS. No questions, Mr. Chairman.

Mr. HOUGHTON. Ms. Dunn.

Ms. DUNN. No questions.

Mr. HOUGHTON. Mr. Collins.

Mr. COLLINS. No questions.

Mr. HOUGHTON. Mr. Portman, do you have any?

Mr. PORTMAN. Thank you, Mr. Chairman.

Just briefly, I don't want to lose this opportunity to talk to people who in the real world are entrepreneurs, and I am sorry my former entrepreneur colleague has left because I really wanted to give you a chance, the four of you, to respond to his question which took practically his entire time. So if you could think back to the point he was making with regard to what is the incentive to invest in a startup enterprise, I would appreciate your response to that.

Also, I would like you to be thinking about a question that I have. If you had a choice between indexing and a reduction of, say, 50 percent in the capital gains rate on the one hand and then a third option which would be reducing individual rates overall and perhaps corporate rates, how would you gauge those?

First, respond to Mr. Stark's statement.

Mr. HOAK. Responding to Mr. Stark's statement first, I think that he is wrong in his conclusion. I think it is possible or it is likely that entrepreneurs on average would still begin businesses, but we are dealing at the margin and I think that it is the extra investments, as Bob talked about, that can create a larger savings and larger capital formation group in this country.

Also, he is looking only at the entrepreneur. He is forgetting that the outside capital sources, and I can say absolutely that in the late seventies when the capital gains rate went down, capital was

much easier to attract to my company. Therefore, we had a tremendous growth spurt because of that. So the outside investors, as was indicated over here, do absolutely look at the aftertax return and maybe the entrepreneur plows forward because of a dream in some cases but not all.

As far as your choice, if I can just quickly, I would take the cut in the capital gains rate and the indexation. Even though I would dearly love to see also a reduction in the individual rates, I think it is important for capital formation in this country that we have a large differential. And the reduction in 1984 bringing everything down to 28 percent, while attractive in some ways, I think did hurt capital formation in the country.

Mr. PORTMAN. Thank you.

Mr. Mann.

Mr. MANN. Yes. I think there will always be entrepreneurs, but common sense kind of tells me that there will be more, the more incentive there is for entrepreneurship. And also, Congressman Stark's analysis didn't take into account that sometimes an entrepreneur is unable to start a business with his own money. He needs outside sources of money which sometimes comes from friends, relatives.

But in today's complex world, it comes in large part from professional venture investors, and professional venture investors are certainly motivated by the advantage that the tax reduction on capital gains gives to a venture investment compared to the other forms of investment that they could make. And in that case, I think, also, it makes sense that the more venture funds available to entrepreneurs, the more they are going to invest and the greater the rewards for venture investments, the more funds will be available.

Mr. PORTMAN. Dr. Hatsopoulos.

Mr. HATSOPOULOS. Well, I am a little disturbed with the course this discussion is taking for the following reason. People in America feel that the main source for new business creation, which is very important to maintain our high standard of living, is new startups.

Now, there is no question it is an important source, but virtually none of the businesses that start with technology in Japan and by which Japan competes with this country, were new startups. They were businesses started within major corporations.

The problem in America is that there is a tremendous ability of U.S. corporations to start new businesses, to go in new directions the way Yamaha does, the way Sony does, the way many of the other Japanese companies do. Few of them do. Why? Has anybody asked the question why all the enormous resources and capital that exists in U.S. companies don't go into creating new businesses?

Why do we have to sell them to the Japanese? I have studied this issue for 10 years. The answer is that there is tremendous pressure for American companies to produce results now.

In our company we have invested in a major enterprise that took us 26 years, that is an artificial heart, we just came out with it. I don't think there is another major corporation that would ever come close to this because the investment in R&D and intangible investments, which is what that takes, are not capitalized, they are expensed. And, therefore, nobody notices it, the stockholders don't

notice it. This is a major problem we have and nobody talks about it.

Mr. PORTMAN. Dr. Hatsopoulos, you had made the point previously that the capital gains differential will assist in a longer term investment strategy by businesses. Is that your view?

Mr. HATSOPOULOS. Let me give you—if I may.

Mr. PORTMAN. Mr. Johnson.

Mr. ROBERT JOHNSON. I didn't get to the earlier question.

Mr. HOUGHTON. Can you make it quickly.

Mr. HATSOPOULOS. I would like to point out that the Japanese corporations pay less than a half of their earnings—the fraction of earnings that we pay in America. These are nationally available data. The reason is that their investors don't want dividends. They want their companies to reinvest their earnings to get growth so that the leverage that you get in Japan is in a completely different fashion than what we have been discussing right here and that is a major source of growth that is completely dismissed in this country.

Mr. PORTMAN. Mr. Johnson.

Mr. ROBERT JOHNSON. To Congressman Stark's point, I think the one thing he forgot is that capital doesn't flow to every segment of this society on an equal basis, and the biggest problem for minority startups and entrepreneurs is lack of available capital, access to capital. So you need the kinds of incentives, the kinds of targets that I talked about to get capital to flow.

An inducement you can give by reducing the amount of capital gains on whatever investment you might make in these businesses is going to be helpful to encourage the flow of capital.

Mr. HOUGHTON. Thank you very much, Mr. Johnson.

Mr. English.

Mr. ENGLISH. Thank you, Mr. Chairman.

Mr. Schler, I enjoyed your testimony. It was a powerful green-eyeshade sort of a presentation which, as a former municipal internal auditor, appealed to me on kind of a primal level.

Mr. SCHLER. I will take what I can get.

Mr. ENGLISH. I was curious, though, yesterday we heard testimony from a number of people representing small business organizations to whom I posed the question: Was the question of tax complexity a serious argument for them and for their membership against indexing capital gains? And these are generally people who would prefer to do their own tax returns, who don't like accountants, who hate lawyers.

And I wonder, in view of the fact that they strongly feel that capital gains should still be indexed, even if it makes the business of filling out a tax return more complicated, is the loss of tax simplicity really more important than the incentive effect and the unlocking effect of a capital gains cut and indexing capital gains?

Mr. SCHLER. Well, I cannot speak to the incentive or unlocking effects because that is really an economic question rather than a technical tax question.

Mr. ENGLISH. Sure.

Mr. SCHLER. But I really do think that indexing will be more complicated than people may realize in theory. It only takes up a few pages of the bill and people might think that indexing—any-

thing you can add in 2 pages to the code can't add too much to the tax return, but it is really not true.

If somebody buys an interest in a mutual fund and holds it for 10 years, there are going to be 40 calculations for indexing. If you buy stock, and invest in a dividend reinvestment plan, every time there is a dividend that gets reinvested, you get a new holding period.

Every time you make a gift, the recipient of the gift today has to know the tax basis, the original cost, of the property that was gifted. Under indexing they are going to have to know what the original purchase date was to the calendar quarter. And it is a really—it is a very all-pervasive kind of change in the rules that people are used to. I am really not sure people would support indexing if they sat down and realized on a line-by-line basis on the tax return just what it is going to do.

Mr. ENGLISH. OK. I guess the point being, that the ultimate users of the tax system, the taxpayers, if they are supportive of slightly more tax complexity under these circumstances, maybe that ought to be the overriding concern. But let me follow up, you made a similar argument against the neutral cost recovery system in that it would add to the complexity.

At the same time, we have heard testimony, again on previous panels, that investment in plant and equipment is a critical catalyst to economic growth and development particularly with small, internationally competitive manufacturing firms that make up a good bit of the employment base in places like my district and that perhaps this sort of investment, specifically in equipment, is the biggest factor in economic growth and development right now in our economy.

I wonder if you find the Nickles system troublesome from a complexity standpoint. Can you suggest some tax incentives for capital investment that would be acceptable from your standpoint. I noticed in your testimony you didn't really get into that.

Mr. SCHLER. As I said before, we are tax lawyers and we really have not studied alternatives. I do think that system is very complicated because it is an elective system and because it has lower depreciation in the early years than people are entitled to today. You get all the benefits in the later years.

If you are going to sell your equipment within a few years, you are better off not being under the new system as you get faster depreciation under the current rules. So every time you buy a piece of equipment, you have to make an election as to which system you want to be under. To do that, you have to figure out how long you think you are going to hold the equipment. And if you are wrong, you end up worse off than if you had made the other election. I think that itself is going to add vast complexity into the system.

Mr. ENGLISH. I understand that. I guess my concern is, the current tax law is biased against that sort of capital investment. I think we need, accordingly, to change that law and hopefully do it with some conformance with the general concerns and principles you have raised.

I don't have a lot of time left, but I would like to throw to the panel, generally, we have heard a lot of criticism of the capital gains tax cut. We have heard from the standpoint of the equity. We

have heard from a number of people in yesterday's panels about the king for a day effect, a lot of the middle-class taxpayers are a one time only payer of capital gains.

But I wonder if there isn't a substantial middle-class stake in a capital gains tax in terms of the growth and opportunities that arise. And, you know, I would be happy to have Dr. Hatsopoulos respond.

My time has expired, but respond briefly.

Mr. HATSOPOULOS. Mr. English, your question was whether there is a middle-class——

Mr. ENGLISH. Whether working families, whether American workers don't have a stake in the economic growth and opportunity that is going to arise from the unlocking of this and reinvestment of this capital.

Mr. HATSOPOULOS. They probably are going to have a direct—not only indirect, but direct benefit. First of all, a lot of people that are making between, say, $45,000 and $90,000 have stock options. These people do. All of our employees have a stock purchase plan. They all avail themselves of that stock purchase plan. The stock they buy, they have to hold for 1 year. And they do that.

Eighty-five percent of our employees are in our stock purchase plan, and some of them earn less than $45,000. Maybe $30,000. Some of the assistants—my Secretary—are participating. I know. My secretary has consistently. So I think that there are a lot of individuals that would be very supportive of a lower capital gains tax.

Let me tell you, in my own company——

Chairman ARCHER [presiding]. The gentleman's time has expired.

Mr. ENGLISH. Thank you, Mr. Chairman.

Chairman ARCHER. I believe that all of the panelists have been questioned at this point. Gentlemen, you have made a great contribution by coming and giving us your testimony and responding to questions. We are very grateful to you. We wish you Godspeed.

We are prepared to hear the testimony of our next panel. I want to welcome each of you to the committee. As I mentioned to the previous panels, the rules of the committee are that we would like for you to limit your oral testimony to the committee to 5 minutes or less. The red light will come on at the time 5 minutes is up. You will be permitted to submit your entire written statement into the record without objection.

Our first witness this morning is James Morgan, president-elect of the National Venture Capital Association. We are pleased to have you and you may proceed.

STATEMENT OF JAMES F. MORGAN, PRESIDENT-ELECT, NATIONAL VENTURE CAPITAL ASSOCIATION, AND PRESIDENT, MORGAN, HOLLAND VENTURES, INC., BOSTON, MASS.

Mr. MORGAN. Thank you, Mr. Chairman. It is a great pleasure to be with you this morning, although I have to confess that is a tough panel to follow. You have had some very interesting testimony. I have been reflecting, it is 28 years almost to the day that my favorite professor asked me to join him in the venture capital with a company called American Research and Development, and

when Fortune magazine did a cover story on what General Derorio did, they called it a dream factory. And much of what you have been dealing with this morning, much of the testimony you have heard, has that dreamlike aspect to it. Venture capitalist entrepreneurs teaming together to build great corporations are really nothing more than the fulfilling of the American dream, the dream that Americans have to create wealth for their families, for risk takers, so that the family can take its role as the major social body in this country, take care of its elderly, educate its children.

I might also point out that a great deal of wealth that is created in this process goes into philanthropy. And as we have all been watching the unfolding events in Washington the last few months, we recognize that the role of private philanthropy is going to become more and more important as the government just can't take care of these social programs where I am from in Boston, the major universities, hospitals, inner-city education programs, inner-city parochial schools, museums, the arts.

These are very, very heavily supported by the successful entrepreneurial activities that take place in the high-tech regions in Boston. The entrepreneurs don't seek subsidies or handouts from the government, really just a chance to build these dreams into realities and to build net worth to build wealth.

In the materials that have been distributed, you will have a great deal of information, statistical information regarding the role of patient capital. We have distributed to you the Fifth Annual Venture Capital Economic Impact Study which documents the jobs creation, the tax base growth, exports. Basically it tells the story of the gazelles of the American economic scene, the companies that move quickly. They spot and seize opportunities and as a result create the jobs, the tax base, exports, quality of life.

It also documents that in recent years, and I see no reason why this trend shouldn't continue, maybe even accelerate, there is an increasing level of capital needed to launch the truly major corporations that are going to be the international competitive companies of tomorrow. It just simply takes more money.

You have got to get to market faster. You have got to build a local company faster. Product life cycles are shortened so the slow growth scenario that was very much a part of building a venture-backed company when I joined the industry 28 years ago just doesn't work today. If you follow a flow growth path, chances are that somebody will knock you off before you have a chance to build an interesting company.

There has been a decline in sources in a relative manner of capital for building companies. We look at the buildup of capital in this country, take for example the equity mutual funds. They have grown at a staggering rate so that now they are four times as large as they were 10 years ago or so, whereas venture capital has remained relatively constant in absolute dollars, a fairly small pool of capital but with the mutual funds and other sectors of capital markets growing very rapidly.

So the suggestion that venture capital is alive, well, and healthy is not statistically accurate because the percentage of capital being allocated by our capital markets has fully been declining. There are

a smaller number of companies that have been supported and corporations are far less active.

Very importantly, and not too widely mentioned so far today, is the role of the individual, angel investor as we call them. Very many of the companies that we start get their initial launching from angel investors. The written testimony of the National Venture Capital Association, as I mentioned, provided statistics. You will hear from some more entrepreneurs later on in the panel.

I would like to make one comment about the motivation of founders. There was some suggestion that founders don't examine the possible payoff from the fruits of their hard work. I have been involved with entrepreneurs all my life and I would reject that point. First of all, I think, by the way, today's generation of company founders are far more sophisticated.

Those spreadsheets and analytical techniques are available now that really weren't available 20 or 30 years ago. Sure, an entrepreneur will not be deterred, but it is just not fair if he realizes at the end of the day that a great portion of his winnings for which he risked so much are going to be taxed away. There is a breaking of a social contract there and it also takes place with employees who benefit from stock options.

Those stock options as options are not useful. The stock doesn't buy a house. They eventually have to sell that holding and it is on the sale that it finally dawns on them that the tax man is there taking a great deal of the bite out of their profit, this profit that they risked and worked hard for, and I think that is a little bit behind some of the concerns that you see in the country now about what is happening in Washington.

I think that the vitality of the growth sector has never been more critical, and what we as a National Venture Capital Association are recommending is sweeping tax changes to relocate the allocation of capital back to those who are closest to the opportunities and problems of society. I think that is really at the core of the opportunities of society which, as I understand it, both parties are attempting to build. And I appreciate the chance to comment.

[The prepared statement and attachment follow:]

TESTIMONY OF JAMES F. MORGAN
NATIONAL VENTURE CAPITAL ASSOCIATION

The National Venture Capital Association (NVCA) is an association of nearly 200 professional venture capital organizations located throughout the United States. It was organized in 1973 to foster a broader understanding of the importance of venture capital to the vitality of the U.S. economy. Its affiliate, the American Entrepreneurs for Economic Growth,is composed of nearly 8,000 emerging growth companies which employ over one million Americans.

Mr. Chairman, the NVCA appreciates the opportunity to present its views on the U.S. economy and proposals " to encourage Americans to increase savings and investment". In light of the current adverse investment climate for growing businesses, particularly for high technology companies, we are convinced that enactment of a significant reduction in the tax on capital gains could go further to promote economic opportunity and growth, international competitiveness, as well as increase savings and investment, than any other single legislative change.

As active participants in the entrepreneurial process for over 25 years, NVCA hopes to shed light on what is happening to our country's emerging companies as they struggle to develop new technologies and products that enhance our ability to compete in the world marketplace.

Our interest in this matter is intense because the venture capital industry has been at the forefront of creating and growing some of the most successful businesses in America today: Apple Computer, Genentech, Sun Microsystems, Federal Express, Intel, Silicon Graphics, America OnLine, and Thermo Electron are just a few of our past successes. Venture capitalists continue to fund new technologies in critical fields such as medical device, communications, environmental, biopharmeceutical, and software. In fact, in 1994 INC. magazine's list of its fastest growing public companies contained 56 venture-backed companies...this at a time when venture capital funding still has not reached the heights it did in the 1980's.

These important successes sometimes overwhelm the critical importance of many of our growing companies to the welfare of this society. Companies in which venture capitalists now are helping to grow include those that will give hope to people across virtually the entire spectrum of diseases and afflictions. Other companies are attempting to control hospital costs through medical innovations as well as through new software and communications applications. This private sector response to issues the government and the American public want solved can only move forward if investors are given sufficient motivation to provide funding to these businesses for a long period of time.

PATIENT LONG-TERM EQUITY CAPITAL, i.e. VENTURE CAPITAL IS ESSENTIAL FOR RAPIDLY GROWING COMPANIES

Patient, long-term equity capital is the lifeblood of America's entrepreneurs and their young growth companies. In such diverse areas as biotechnology, computer sciences and environmental sciences, these rapidly growing companies are creating new industries, developing new technologies and producing new products. They are the engines which drive America's economic growth, and represent in the starkest manner American workers' ticket to economic opportunity. However, they also have voracious appetites for patient, long-term equity capital - i.e. venture capital.

The National Venture Capital Association recently conducted its fifth study on the economic impact of venture capital on the U.S economy. This research demonstrates strongly that young, venture-backed companies generate a significant stream of benefits for America's economy which will be expanded upon infra. However, this research also shows that the jobs, technical advancements, exports, and asset growth created by venture-backed companies comes with a mounting price tag. U.S. venture-backed companies founded between 1981 and 1985 needed an average $7 million in venture capital during those first five years to sustain themselves and grow. This venture capital financing hurdle jumped to $10 million for growing companies founded between 1985 and 1989. Today, America's star emerging companies, founded between 1989 and 1993, need an average of $12 million in venture capital by the time they are 5 years old to survive and thrive.

PROFESSIONAL VENTURE CAPITAL AND INFORMAL INVESTORS ARE THE ONLY DOMESTIC SOURCE OF EARLY STAGE, PATIENT LONG-TERM CAPITAL FOR AMERICA'S EMERGING GROWTH COMPANIES

Traditional sources of debt capital are not available to these companies because they lack the track record or collateral to back up a loan. Young growth companies absolutely require equity and their only significant sources for equity capital are individual and corporate venture capital investors and professional venture capitalists.

Unfortunately, there has been a decline in institutional venture capital financing. The peak year for fund raising by the industry was $4.2 billion in 1987; in 1991 only $1.3 billion was raised for pure venture capital financing. 1992 and 1993 saw increased activity of $2.5 billion. 1994 figures, now being compiled, initially show activity for the year in the low $3 billion range which is encouraging, but still falls well below the figures of the mid 1980s.

By comparison, while the venture capital industry has been treading water, money continues to flow into the mutual fund industry. In 1987 while institutional venture investors raised $4.2 billion, equity, bond and income funds had net sales of $74 billion. In 1993 the numbers were $2.5 billion and $280 billion respectively.

Venture capital's situation also can be seen in the number of small emerging companies that were financed with professional venture capital since the ramifications of the 1986 and 1993 acts were felt. The peak in the number of companies attracting investment again occurred in 1987 when professional venture investors funded 1,737 new and growing companies. That number has declined virtually every year since, so that in 1993 just under 1,000 such businesses were funded. Think of the jobs that could have been created had not this decline taken place.

Finally, corporations, one of the taxpaying entities which fund venture capitalists, have decreased their investment in institutional venture capital. New money invested in institutional funds by corporations dropped to $200 million in 1993, (excluding direct investments by corporations in emerging growth businesses).

In addition to the decline of institutional investing, there has been a withdrawal of the individual or "informal" investor from the long-term, high risk marketplace who, as a result of the 1986 and 1993 tax changes, has moved to a shorter-term, more risk-averse profile. These "informal" investors are the mothers and fathers, the aunts and uncles, and the doctors and office workers, as well as already successful businessmen who typically provide over 90 percent of start-up capital in small companies.

This is of profound importance. Professional venture capital firms, such as those represented by the NVCA, provide a critical, albeit small, portion of the total capital invested in young companies each year. The fact is that the vast majority of the new and growing firms in this country are not appropriate investments for professional venture capitalists, or they need less capital than professional venture capitalists typically invest. The entrepreneurs who found most companies must seek their capital directly and informally from individual investors.

A 1988 Small Business Administration study found that informal investment "appears to be the largest source of external equity capital for small businesses. Nine out of ten investments are devoted to small, mostly start-up stage firms with fewer than 20 employees."

These figures are important because opponents of a lower capital gains tax often contend that untaxed institutions, predominately pension funds, play a major role in supplying venture capital firms with the capital to invest in emerging companies. However, as demonstrated it is the informal investor who puts a major [redacted] share of dollars into our country's vital small growth companies and nearly all of these informal investments come from taxpaying investors.

This point was made just last month when INC. magazine showcased America's 500 fastest growing private companies. These companies, which now employ over 47,000 and average 6 years in age, received all or a portion of their start-up capital from the following sources:

personal savings (71%); other family members (27%); friends (12%); other informal venture investors (13%); formal venture investors (13%) and other employees or a partner (19%).

In sum, we need the individual investor because they often are the investors in seed and start-up companies which as they begin to germinate become attractive to institutional investors who generally invest larger sums. Individual investors also provide liquidity in public securities markets, buying equities in growth oriented, small cap companies on their own and through company stock purchase plans and stock option plans, discussed infra. Institutional venture capitalists and individual investors are thus dependent upon one another and this relationship is very sensitive to the vagaries of the tax law.

RECENT TAX POLICY HAS NOT ENCOURAGED YOUNG GROWTH COMPANIES TO REACH THEIR POTENTIAL

To be sure, small and emerging businesses always will have problems raising capital as investing in them entails a high degree of risk. However, government can make the problem less onerous and in the process help the Nation.

Unfortunately, recent tax policy has made capital more expensive for young and emerging growth companies. In short, tax changes enacted in 1986 and 1993 hurt America's small business community because they rewarded short-term profits over stable, long-term investment. This in turn has led to a higher cost of patient, long-term capital and an erosion in America's technological and innovative leadership, thus reducing our ability to compete internationally.

The increase in the cost of capital is especially burdensome to young growth companies because: 1) they rely heavily on equity finance rather than debt, 2) they need patient rather than short-term capital, and 3) they typically reward their investors with long-term capital gains, while mature companies reward their investors with dividends or interest.

While the Omnibus Budget Reconciliation Act of 1993 and the 1986 Tax Reform Act included some provisions which stimulated the U.S. economy, they unfortunately had a negative affect on small and young emerging high-growth companies because they penalized long-term investors. Recent attempts at "tax reform" have penalized these visionary investors by raising the long-term capital gains rate while simultaneously providing a boon for short-term investors. Our tax policy, in effect, is channeling funds away from long-term investments which are crucial to our economic vitality. In taxing capital gains as ordinary income, Congress in 1986 sent a clear signal to individuals and corporations that there was nothing special about long-term investments. As a result, patient investment in productive job-creating enterprises has been sacrificed for short-term gains.

This situation was not helped by the perverse legislative development which occurred in 1993. When Congress voted for the Clinton budget package it in affect created something we believe is worthwhile: a tax rate differential between capital gains and ordinary income. However, this differential was created by raising ordinary tax rates, not lowering capital gains rates. If we want Americans to save and invest we have to allow them to keep some money to do just that. This won't occur by raising ordinary tax rates thereby creating an artificial differential which many Americans do not have the resources to take advantage of.

In addition, while the "targeted capital gains" provision in the budget package was well intentioned and supported by NVCA, we viewed it then and now as a first step in the process to produce a meaningful, broad-based capital gains reduction.

In short, the decline in professional venture financing, in combination with the rapid withdrawal of the individual and corporate investor from the small company marketplace, has created an environment where small companies have virtually lost one of their principal avenues for raising new capital. This lack of private venture capital in the U.S. is forcing some of America's capital intensive young growth companies to look for capital overseas.

Based on these circumstances, any change made in tax policy must stimulate investment in young, growing businesses if you wish to spur the economy, create new jobs, produce goods for export and increase consumer confidence. The best way to stimulate the needed investment is to create a meaningful differential in the tax system between ordinary and capital gains rates which will make it attractive to individuals and corporations to once again give up liquidity and security in exchange for long-term appreciation.

PUBLIC POLICY WHICH ENCOURAGES LONG-TERM INVESTMENT IN GROWTH COMPANIES WILL BENEFIT THE ENTIRE NATION

The National Venture Capital Association recently conducted its fifth study on the economic impact of venture capital on the U.S. economy. The results demonstrate the importance of venture-backed companies which typically are technology-oriented. Despite their youth, the 500 companies in the survey grow jobs incredibly quickly: in year one of existence they averaged 16 employees while those who are now six years old average 218 employees. The average annual job growth rate of these survey companies is an astounding 25% versus a net loss of 3% in Fortune 500 companies between 1989-1993. In sum, venture-backed companies aggressively grow jobs for America's workforce.

Despite these impressive statistics, employees of emerging growth companies take a major gamble working in this sector of the economy and should be rewarded for doing so. Today millions of working men and women in rapidly growing enterprises receive stock options and participate in stock purchase plans. Venture capitalists have learned that employees who are treated fairly and have an actual stake in the operation and potential profitability of a company can produce incredible results. When these results occur, and they by no means certain, we believe that employees should not be penalized by being taxed at the identical rate of ordinary income and at a rate not indexed for inflation. It simply is not fair and runs counter to America's entrepreneurial spirit.

NVCA's latest research also indicates that venture-backed companies create a greater percentage of skilled jobs, and do so more cost effectively. For example, engineers, scientists and managers composed 59% of all the jobs produced by our survey companies, while they compose less than 15% of the United States labor force.

Our research also found that venture-backed companies invest more in plant, property and equipment as well as research and development than Fortune 500 companies. While Fortune 500 companies spent on average 7% of their equity on research and development between 1989-93, venture-backed survey companies spent 23% or more than three times as much. A copy of the NVCA survey is attached for your review.

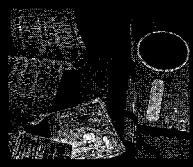
Providing entrepreneurial companies with long-term, low-cost capital through a capital gains reduction also will sow the seeds for future growth. NVCA's research found that benefits to the economy from venture-backed companies multiply quickly. The term "international start-up" powerfully describes the competitive nature of these young companies. Already, these companies averaging only 4.5 years in age have generated $4 million each in export sales from 1989 to 1993. Between the time the average survey company was one year old, it grew export sales an average of 171 percent each year.

This research, conducted by Coopers & Lybrand and the research firm VentureOne, demonstrates strongly that young, venture-backed companies generate a significant stream of benefits for America's economy. However, the jobs, technical advancements, exports, and asset growth created by venture-backed companies need to be nurtured. America needs a more hospitable environment for investment, particularly early-stage investment in small emerging growth companies. We need to bring the individual and corporate investor back into this market. In doing so America's entrepreneurs will become convinced that long-term capital will be available to begin and expand their operations. NVCA believes strongly that an immediate reduction in the existing capital gains rate will produce this message and move our Nation's economy foreword.

Coopers & Lybrand

Coopers & Lybrand L.L.P.

VENTUREONE



Fifth Annual Economic Impact of Venture Capital Study

National Venture Capital Association

About the Survey

The foundation of America's economic strength has been driven by entrepreneurs with vision and drive. These visionaries use their technical and managerial skills, supported by critical financing, to build new industries, create new companies and jobs, add wealth to America's workforce, and keep the United States strong and competitive.

This report, the *Fifth Annual Economic Impact of Venture Capital Study*, focuses on the venture capital link between an entrepreneur's vision and the resulting effect on America's economy.

Over 1,800 questionnaires were sent to young, venture capital-backed companies. They were asked about their financial activities over the past five years. We received 495 responses (almost 28 percent) from these emerging businesses.

Because the financial data provided by these survey companies is generally not publicly available, this report delivers valuable insight on the impact young venture-backed companies have on our economy. The data was analyzed using means, or averages. In many cases, the results are compared to the economic impact of the Industrial Fortune 500 companies. This comparison helps benchmark the effect these young companies have on job creation, research and development, long-term capital investment and other critical areas of our economy.

A project of this caliber is only possible with a dedicated and qualified team of players:

- The National Venture Capital Association (NVCA) sponsored the study, providing overall guidance and support.
- VentureOne undertook the task of surveying the 1,800 venture-backed companies and building the database of responses.
- Coopers & Lybrand L.L.P., using VentureOne's database, analyzed the numbers and developed this report.

For a description of the NVCA, Coopers & Lybrand L.L.P., and VentureOne Corporation, or to find out how to order more copies of this report, please turn to page 12. An explanation and definition of venture capital can be found on page 11.

Executive Summary

The economic impact of venture capital-backed companies is measured annually by Coopers & Lybrand L.L.P. and Venture One Corporation for the National Venture Capital Association. Almost [illegible] companies provided to the [illegible] survey. The findings [illegible] generalize [illegible]

Venture-Backed Companies Are Engines of Quality Job Creation

The [illegible] companies [illegible] hard from [illegible] generate an average [illegible] U.S. jobs per company. For the first five years of a venture-backed company's life, it gives its workforce nearly [illegible] annually.

Professional Venture Capital Helps Companies Create Breakthrough Technologies and Products, Enhancing U.S. Competitiveness

[illegible] Venture [illegible] companies [illegible] industry [illegible] companies [illegible] of capital in [illegible] development [illegible] an average of $8.7 million per company between 1989 and 1993. In the same time, the capital [illegible] companies in their years of [illegible] research [illegible] development [illegible] 70 percent [illegible]

Rapidly Growing Venture-Backed Companies Boost U.S. Competitiveness

Today's venture-backed companies aggressively grow export sales. From 1989 to 1993, the average young survey company generated $8 million in exports. During the [illegible] years of these companies' [illegible] export sales [illegible]

Venture Capital Cash Requirements Intensify Over Time

Today's entrepreneurs face greater financing challenges than yesterday's visionaries to generate this significant economic benefit stream. The average amount of venture capital required by start-up companies during their first five years of life has risen considerably since the early 1980s. Companies founded between 1981 and 1987 needed an average of $7 million [illegible] capital during th[illegible]

Coopers & Lybrand L.L.P. [illegible] that were founded and raised venture capital between 1985 and 1[illegible] saw this financing [illegible] to $10 million. Most recent [illegible] venture-backed companies [illegible] between 1989 and 1993 [illegible] increase in [illegible] during these [illegible] and thrive.

[illegible] provide [illegible] equity to [illegible] venture capitalists who [illegible] outside the company's [illegible] *chart XVII on page [illegible]*

As more companies secure venture capital financing, the positive impact [illegible] our economy continues to [illegible]

Chart I

Venture-Backed Companies Stimulate Our Economy

	Economic Benefits Generated Between 1989 and 1993	Growth Rates During a Company's First Five Years
Job Creation	[illegible] jobs per company	[illegible] annually
Investment in Research & Development	$8.7 million per company	[illegible] annually
Export Sales	[illegible] per year	[illegible] annually

Coopers & Lybrand L.L.P.

Participant Profile

For the truest image of the impact that venture capital investments have on our economy, this study only looks at young, emerging companies that have few other financing alternatives. Almost half of the study's participants are less than four years old *(Chart II)*.

Nearly 80 percent of these new companies are private *(Chart III)*. They depend on private equity to help fund research and development, pay workers, invest in capital equipment, and expand their markets.

Their most significant source of equity is professional venture capital. Venture capitalists contribute more than critical financing. These seasoned investors lend experience and business savvy to the company, guiding the young venture along.

Chart II
These Companies Are Young
Survey Companies' Age

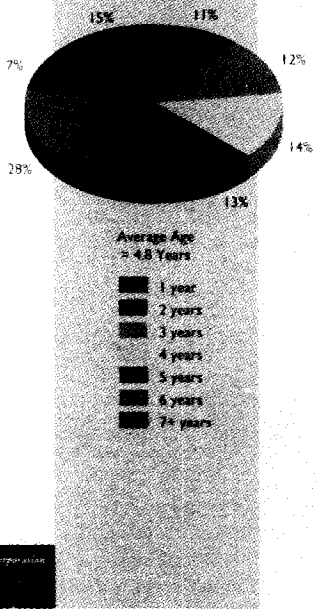


Chart III
They Are Mostly Private ...for Now
Survey Companies' Ownership Status

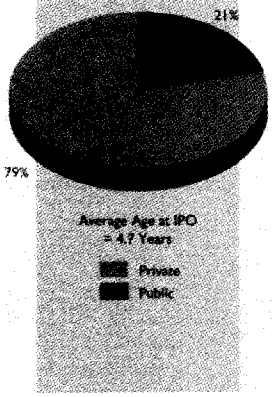
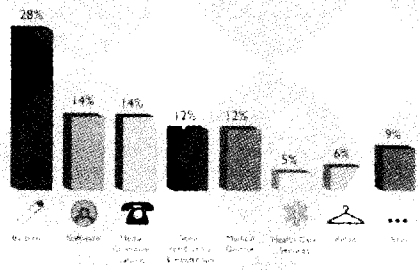


Chart IV

They Focus on Growth Industries

Percentage of Survey Companies by Industry



Coopers & Lybrand L.L.P.

Venture-Backed Companies Are Engines of Job Creation

Job growth is at the heart of economic strength. With the support of venture capital to develop technologies and products and expand operations, these young survey companies work hard to provide jobs for America's workforce. On average, the venture-backed companies in our analysis generated 152 U.S. jobs per company from 1989 to 1993.

America's economic strength is also grounded by the strong foundation of a technically skilled workforce — the kind fostered by venture-backed companies.

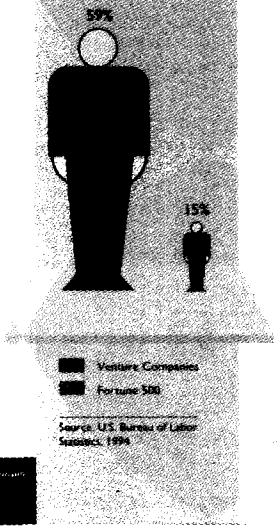
The percentage of highly skilled engineers, scientists, and managers generated by young survey companies is almost four times greater than the percentage of skilled jobs created in the economy as a whole (*Chart V*). As these venture-backed survey companies expand operations, the percentage of production and other positions should also increase.

As venture-backed companies mature, their workforce grows dramatically. In the first five years of a survey company's life, the average number of jobs grew nearly 98 percent annually. They typically begin with a small, dedicated workforce concentrating on research and development. As they grow, operations expand and they add to their manufacturing, sales, marketing and other staffs. By the time the average survey company is six years old, it employs over 200 people (*Chart VI*).

Chart V

Venture-Backed Companies Create a Greater Percentage of Skilled Jobs

Percentage of Engineers, Scientists and Managers in Labor Force

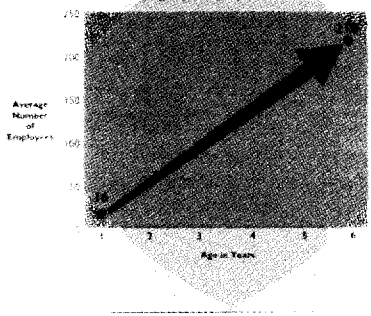


Source: U.S. Bureau of Labor Statistics, 1994

Chart VI

Survey Companies Grow Jobs Quickly

Average Number of Employees by Age of Company



Venture-Backed Companies Create Breakthrough Technologies and Products

Venture-backed companies create jobs at a faster clip than Fortune 500 companies. From 1989 to 1993, the venture-backed [illegible] companies added to grow jobs at average of 25 percent each year. This dynamic growth helps offset the three percent average annual job loss experienced by Fortune 500 companies during the same time period (*Chart VII*).

[illegible] global technological leadership depends in part on U.S. companies' ability to create breakthrough products and [illegible] the marketplace. Venture-backed companies strengthen America's technical advantage through their focus on developing new technologies and processes. From the time the average company was one year old until it was five years old, investment in R&D accelerated nearly 70 percent each year.

With limited access to debt financing, their growing companies depend on investment equity from venture capitals to reduce their R&D losses. Once capitalized, our survey companies immediately put their money to work by investing one and a third times as much of their equity in R&D as Fortune 500 companies (*Chart VIII*).

Chart VII

Venture-Backed Companies Aggressively Grow Jobs for America's Workforce

Average Annual Job Growth Rate 1989 - 1993

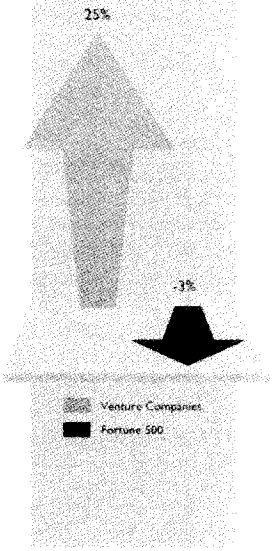
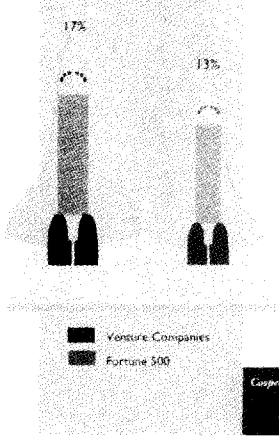


Chart VIII

Investment Equity Fuels the R&D Engine

Average R&D/Equity 1989 - 1993



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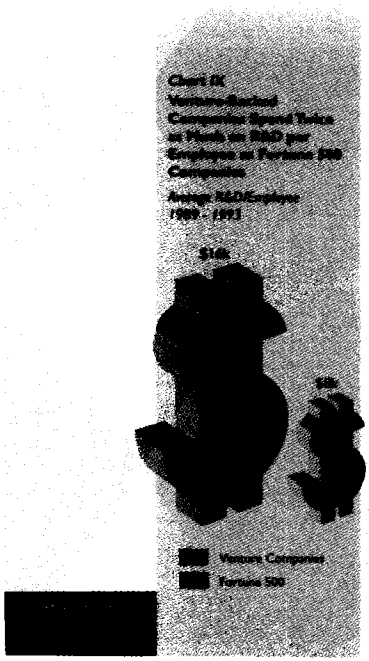
The average survey company also invested twice as much in R&D per employee as the Fortune 500 companies *(Chart IX)*. Over the past five years, venture-backed survey companies increased their annual investment in R&D four times faster than Fortune 500 companies *(Chart X)*.

These emerging companies, through their obvious commitment to research and product development, will expand America's technical prowess into the next century. As more venture capital is invested in these promising companies, greater product and service development breakthroughs can be realized.



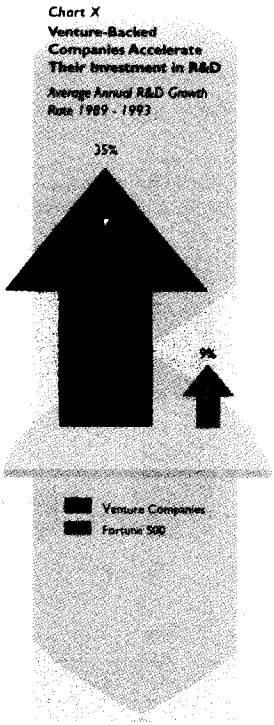
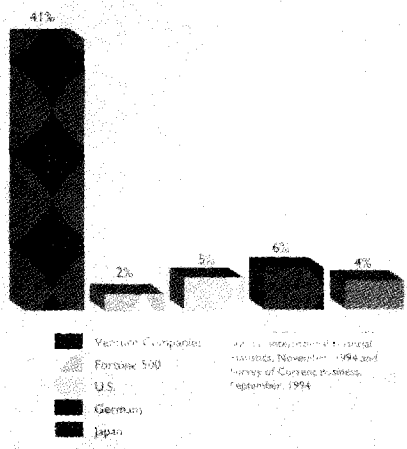


Chart XI

Venture-Backed Companies Boost U.S. Competitiveness

Compound Average Sales as GDP Growth Rate 1989 - 1993



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Already, these companies, again averaging only 4.8 years in age, have generated $4 million each in export sales from 1989 to 1993. Between the time the average survey company was one year old until it was five years old, export sales more than tripled each year. As a percentage of revenue, export sales have become an increasingly important component for venture-backed companies over the past five years, helping to improve America's balance of payments.

In 1989, exports comprised only four percent of total revenues of the average survey company. By 1993, sales from global markets made up 11 percent of total revenues for these aggressively growing companies. *(Chart XII)*

Venture-backed companies also soar in productivity, sharpening America's competitive edge. From 1989 to 1993, the average survey company grew sales per employee 12.4 percent each year, more than twice the productivity growth rate for Fortune 500 companies during the same time period *(Chart XIII)*.

Chart XII

Venture-Backed Companies Work Hard to Improve our Balance of Payments

Average Exports as a Percentage of Revenue 1989 - 1993

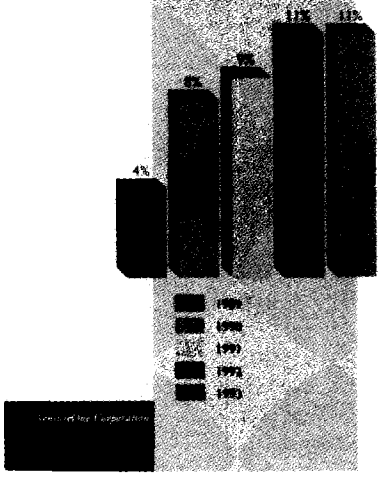
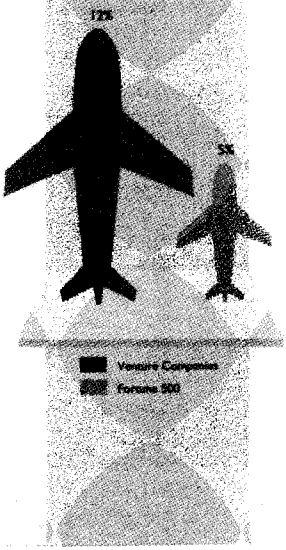


Chart XIII

Venture-Backed Companies Soar in Productivity

Average Annual Sales per Employee Growth Rate 1989 - 1993



Survey Companies Invest in the Future

Venture-Backed Companies Spend Their Hard-Won Equity on Critical Resources

Chart XIV

Venture-Backed Companies Invest in Capital Equipment at Three Times the Rate as Fortune 500 Companies

Average PPE/Revenues
1989 - 1993

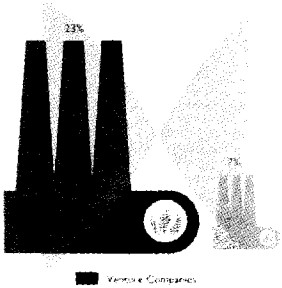


Chart XV

Venture-Backed Companies Finance Critical Resources with Hard-Won Equity

Average Equity/Assets
1989 - 1993

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Cash Requirements Intensify Over Time

The economic benefits stream created by venture-backed companies comes at an increasing cost. U.S. venture-backed companies founded between 1981 and 1985 needed an average of $7 million in venture capital during those first five years to sustain themselves and grow. This venture capital financing hurdle jumped to $10 million for growing companies founded between 1985 and 1989 (today, America's emerging companies founded between 1989 and 1993, need an average of $12 million in venture capital by the time they are five years old to survive and thrive *(Chart XVII)*.

Venture-backed companies have less other financing vehicles to underwrite their growth. Professional venture capitalists provide, on average, 69 percent of each survey company's total equity *(See Chart XVIII on page 11)*. Venture capital financiers invest alongside the companies' founders while contributing their expertise and industry knowledge to help companies avoid start-up growth pains and move them toward becoming tomorrow's leading industrial and service companies.

As more young companies find the venture capital they need to create jobs, generate exports, build advanced products and services, and invest in capital equipment they will continue to forge a positive impact on a strengthened U.S. economy.

Chart XVI
Venture-Backed Companies Need an Increasing Amount of Equity to Support Resource Growth
Average Annual Equity/Asset Growth Rate 1989 - 1993

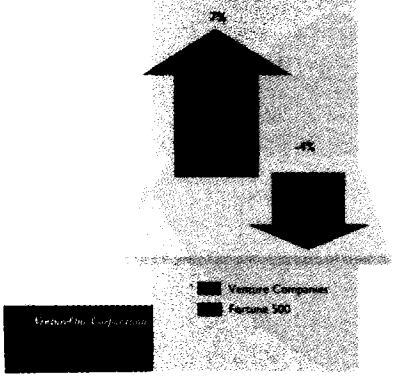
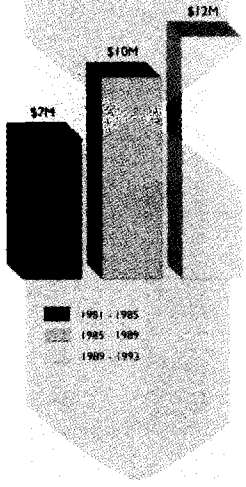


Chart XVII
The Magnitude of Start-Up Financing Required by Survey Participants Grows
Average Venture Capital Invested per Company



What is Venture Capital?

[illegible]

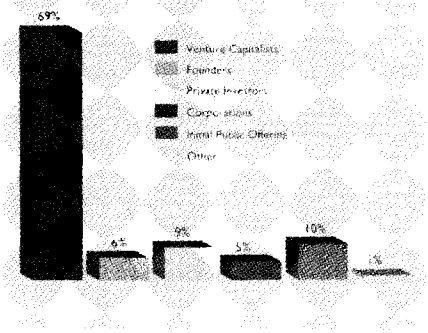
- [illegible]
- [illegible]
- [illegible]
- [illegible]
- [illegible]
- [illegible]

[illegible]

Chart XVIII

These Companies Depend on Venture Capital

Sources of Equity 1989 - 1993



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[illegible]

About the Participating Organizations

The National Venture Capital Association (NVCA)

The NVCA is an association of 200 professional venture capital organizations with over $30 billion of capital under management. Venture capital firms organized the association in 1973 to foster a [illegible] of the importance of venture capital in [illegible] of the U.S. economy.

The American Entrepreneurs for Economic Growth (AEEG)

The NVCA also represents over 5,000 emerging growth companies through the American Entrepreneurs for Economic Growth. The AEEG is the nation's largest entrepreneurial network, representing over one million jobs in the United States.

Coopers & Lybrand L.L.P.

Coopers & Lybrand L.L.P. is one of the world's leading international professional services firms to entrepreneurs and venture capitalists. Coopers & Lybrand's National High Tech and Venture Capital Groups provide accounting, auditing, tax and consulting services to emerging and mature technology companies.

VentureOne Corporation

VentureOne is a leading provider of investment research to venture capital professionals. Venture One's clients license the Venture Data System, a comprehensive database tracking the business [illegible] and financing plans of over 5,000 venture financed companies in the U.S. Venture One's influential clients [illegible] managing over $15 billion [illegible] capitalists, [illegible] and business development professionals.

For details on the survey or any of these organizations, contact:

National Venture Capital Association:
703-351-5269

American Entrepreneurs of Economic Growth:
703-351-5246

Coopers & Lybrand L.L.P.
[illegible]

Venture One Corporation:
415-357-2100

To order additional complimentary copies of this survey, please call either the NVCA or Coopers & Lybrand L.L.P.

Chairman ARCHER. Thank you, Mr. Morgan.

Our next witness is Christopher Brody who is the chairman of the tax committee of the National Venture Capital Association.

STATEMENT OF CHRISTOPHER W. BRODY, CHAIRMAN, COMMITTEE ON TAXES AND INCENTIVES, NATIONAL VENTURE CAPITAL ASSOCIATION; AND PARTNER, WARBURG, PINCUS & CO., NEW YORK, N.Y.

Mr. BRODY. Thank you, Mr. Chairman and members of the committee. I am also partner——

Chairman ARCHER. Mr. Brody, if you will indulge me suspending for a moment. I would like to recognize my colleague, Charlie Rangel, to make an introduction and I apologize for overlooking him.

Mr. RANGEL. Both Amo Houghton and I thank you, Mr. Chairman, for an opportunity to acknowledge the contribution that Mr. Brody and his National Venture Capital Association has made in creating jobs and how necessary it is that we continue to reward those who take the risk.

We also are concerned with a piece of legislation that both Mr. Houghton and other members of this panel are supporting that would remove some of the impediments of the capital gains incentives we have provided as relates to the tax treatment of section 212 and partnership investment expenses, and Mr. Houghton joins me in welcoming you to this panel.

Mr. BRODY. Thank you very much. We are very appreciative of all of your support.

Chairman ARCHER. Mr. Brody, you may proceed.

Mr. BRODY. Thank you.

I am a partner of Warburg, Pincus & Co. and I have been a full-time venture capitalist for more than 25 years, during which time our firm has provided long-term equity capital to over 200 businesses.

We are often asked, "What is venture capital?" I believe it is the process of providing both long-term, patient, risk equity capital with substantial human resources of the venture capitalist working on an ongoing basis with portfolio companies to help them achieve their goals.

Venture capital includes the following three characteristics. One, we provide equity capital as long-term investors in partnership with management. Second, we are actively involved not only in assembling and organizing the capital in partnership form and in making investments in portfolio companies, but we work extremely close with these companies on an ongoing basis sometimes serving as chairman of the board or chairman of the management company of these companies. Our commitment is very time-intensive.

Third, we are not investment bankers, we do not take transaction fees, and we are only successful economically if our portfolio companies are successful.

What I would like to do this morning is to describe a specific investment. It happens to be one which was very successful because most investments do not work out this well either for the investors or for the management employees, when they do, the opportunity to be able to retain on an aftertax basis the benefit of such success is extremely important and the willingness to take some risks is

significantly enhanced by the capital gains rates structure in this country.

In mid-1989, our firm was approached by a husband and wife entrepreneur team who had written a software code which enabled the users of the product to prepare their own tax returns on PCs. The husband had originally written the product to help himself. His friends said it was better than anything else on the market. His wife quit her job as a schoolteacher, literally moved the car out of the garage and used the garage as a shipping bay as they started this company. The name of company is ChipSoft and the product, TurboTax, is the leading product today in the preparation of tax returns on PCs.

When we met these people, ChipSoft was essentially a tax software product. It was not a company. It had outgrown the capability of its founders who were stressed out and wished to retire, had no business plan or strategies, no business infrastructure, and operational problems which were so severe that on my second visit to the company the computer which kept track of all operations and shipping crashed three times in one morning.

The commitment that we made to the founders was that we would buy a majority stake in the company. The founders retained 18 percent and another eventually nearly 20 percent was set aside for management and all employees. We committed to share responsibility for management of the company unless a professional CEO had been recruited.

We realized that in the long run, the culture of the company had to be changed. The people inside the company were already stretched and they would have to be motivated to work incredible hours for which cash compensation was not adequate. That was the reason why we decided that every employee in the company—there were 60 full time at the time, today there are 1,200 as I will explain—receives stock options. Those options, together with additional shares which were subsequently issued to attract and recruit additional people to the company, have a value today of $80 million.

During the 6-month period, before we made our investment, three of us from our firm—one of my other partners, myself and an associate—conducted a market research survey of the industry, drafted a strategic plan for the company, designed a new organization chart, laid out a recruiting plan, and negotiated the structure of the investment.

You may think that this was a lot of work but the pressure really started the day after we invested because it was not only their company, it was also ours. We set out immediately to recruit a top CEO. That took 6 months before we found the right person. In the meantime—and we worked with him to recruit six individuals to the tax management of the company, most of whom came from higher paying safer jobs in large corporations, recruited a world class board of directors, helped the company make acquisitions with its common shares to acquire other products which it was going to need to grow, and ultimately helped the company negotiate with underwriters for an IPO.

By mid-1993, it was clear that the marketplace was consolidating and that the functions that we performed would be integrated with

other functions. We had had a comarketing agreement for years with a compatible product which was a personal finance product managing a checkbook with a PC. And in the end of 1993, that company, which was called Intuit, whose product is Quicken, is the leading product in its marketplace, was merged with ChipSoft and we had a company doing over $200 million in sales with substantial growth potential.

Today the combined companies, both of which were total startups in the eighties, are operating a $350 million annual sales rate employing 1,200 full-time employees in operations located on the west coast, Midwest, Southwest, and Southern parts of the United States, serve 4 million home users as well as thousands of small businesses and are now starting to generate significant revenues from international exports.

They are also becoming a significant Federal, State, and local taxpayer. We believe the company has also dramatically enhanced the productivity of its customers.

This has obviously been a very successful experience for the founders, entrepreneurs, the professional management who left more secure positions in exchange for an opportunity to grow a business and get a capital gains, employees who had stock options, a board of directors who did not receive a penny in cash but got stock in return for a significant commitment to help the company. And of course it has been very successful for the investors.

The original informal backers, the angels who loaned these people some money their first day, the venture capitalists and our limited partners and the shareholders who acquired their interest in the IPO and subsequent trading market, without all of whom this, could not have happened as it did. What we all have in common in varying degrees is that we all took risks because we were motivated by the potential for capital gains, and because we were successful we were rewarded.

One final caveat I would like to leave in closing, a 50 percent or some other dramatic reduction in capital gains rates would have a very salutary effect on the venture capital entrepreneurial process. In the past, there has been a suggestion and at one point in the tax law this has been coupled with making this a preference item if it was an exclusion for AMT purposes. Our calculations indicate that would result in no change.

I would urge the committee in their deliberations on capital gains, that they look at capital gains net, that is, after all AMT applications, both preference items for exclusions and, as Congressman Rangel referred to, the inability of venture capital firms today to deduct their expenses against the capital gains that they generate if they are successful.

I want to thank you very much for giving our industry an opportunity to testify at the hearings today and obviously would be very happy to answer any questions that you wish.

[The prepared statement and attachment follow:]

TESTIMONY OF CHRISTOPHER W. BRODY,
ON BEHALF OF THE NATIONAL VENTURE CAPITAL ASSOCIATION,
BEFORE THE COMMITTEE ON WAYS AND MEANS
U. S. HOUSE OF REPRESENTATIVES

Wednesday, January 25, 1995

Hon. Chairman and Members of the Committee:

Good morning, my name is Christopher Brody and I very much appreciate the opportunity to testify this morning before the Ways and Means Committee with respect to legislation to significantly reduce capital gains taxes.

I am a member of the Board of Directors of the National Venture Capital Association and Chairman of its Committee on Taxes and Incentives. I am a partner of Warburg, Pincus and Company, and have been a full-time venture capitalist for more than twenty-five years, during which period our firm has provided long term equity capital to over two hundred businesses. Our firm has over one hundred employees dedicated to venture capital; over fifty of the employees are professionals, twenty-eight of whom are highly experienced partners in the firm.

We are often asked, "What is venture capital?" In its simplest definition, I believe that it is the process of providing both long term, patient, risk equity capital, with the substantial human resources of the venture capitalist working on an on-going basis with portfolio companies to help them achieve their goals. Venture capital portfolio companies are generally privately held at the outset, although, in many instances, the companies to which we provide equity capital can be publicly traded.

Venture capital includes the following characteristics:

- We provide equity capital as long-term investors, in partnership with management, infriendly transactions.

- We are actively involved, not only in assembling and organizing the capital in partnership form, and in making investments in portfolio companies, but in making a substantial commitment in human resources. We work closely with the management team, generally at the level of the board of directors and, while usually not involved with management on a day-to-day basis, are extremely active in reviewing strategy, key personnel decisions with respect to the senior management (personnel assessment, recruiting, and compensation), and key financing decisions, as well as identifying other important missing resources and helping obtain them. Sometimes we may serve as Chairman of the Board or Chairman of the Management Committee of our companies. The venture capitalist's commitment is always time intensive, whether the investment is successful or not.

- We are not investment bankers, we do not take transaction fees, and we are only successful economically if our portfolio companies are successful. Generally our capital is raised in partnership form, provided by limited partners, in a partnership which will make twenty to fifty investments over a four to six year period, providing diversification of risk as a result of being done in a portfolio fashion. The investments, when made, may be held as long as ten to twelve years (but more generally five to ten years).

The venture capital process in the United States is the envy of foreign countries, many of whose key ministers have often approached us to explain this "great success of venture capital in the United States". The basis of our response is that the development and success of venture capital in the United States had been based upon four elements, which are:

1. The availability of risk funds to go into the industry, both formal firms and informal ("the angels" alluded to in earlier testimony);

2. The development of highly experienced professionals (i.e., venture capitalists) dedicated to the management of commingled funds (primarily in partnership form);

3. The ability of these portfolio companies to raise capital, not only from venture capitalists, but subsequently from public markets to further finance growth, and ultimately enable investors to exit profitably;

4. And last, but certainly not least, the development of the entrepreneur with extremely strong incentives for management and employees to build these portfolio companies

Success and low capital gains rates reinforce each of these elements.

These four elements have developed dramatically over the last two to three decades as venture capital has developed in the United States. What is particularly potent about these four elements is that the incentives for each can be most forcibly stimulated by lower tax rates on capital gains than the tax rates on ordinary income such as interest or dividends. The reason for this is that from the point of view of the investor of risk capital, there is no interest income (because this is equity not debt) and there are generally no dividends (because high growth companies need to retain their profits and re-invest them in their businesses in order to finance growth, and therefore cannot pay dividends), and from the point of view of entrepreneurs, they may very well have left a safer, higher paying job in taking the risk to build the company. But, if successful (and for every large success there are many failures), the reward for all involved will be capital gains.

These four elements reinforce each other, and success reinforces success. If you want to stimulate this important segment, you must do it with low long term capital gains rates and a significant differential to ordinary income tax rates -- capital is highly elastic and there is lots of competition for places for it to go.

What I would like to do this morning is to describe a specific investment; it happens to be a transaction which, at least to date, has been very successful. Because most investments do not work out this well, either for the investors or for the management and employees, when they do, the opportunity to be able to retain (on an after-tax basis) the benefits of such success is extremely important, and the willingness to take such risks is significantly enhanced by the capital gains rate structure in this country.

Anatomy of a Successful Investment

In mid-1989, our firm was approached by a husband and wife entrepreneur team who had written software code which would enable users of the product to prepare their tax returns on PC's. The husband had initially written the product in order to prepare his own tax return (he had been a programmer at a large company), and had made it available to friends who advised him that it was better than anything else on the market. His wife quit her job as a school teacher and literally started the shipping department for the company by opening their garage door and recruiting friends to help wrap and package the product for shipping during the peak portion of the tax season. The name of the product was Turbo Tax, and the name of the company was ChipSoft.

At the time of our investment, ChipSoft was essentially a tax software product, rather than a company. While its product sales were growing rapidly, its product was based upon old technology, and ChipSoft had no management or business infrastructure, and had outgrown the capabilities of its founders, who were completely stressed out and wished to retire. When we arrived, the company had no marketing department, inadequate resources to rapidly update the product each year as tax regulations changed, no business plan or strategy and operational problems which were so severe, that I remember at one of our visits to the company, the

computer that kept track of all operations and shipping crashed three times in one morning.

The commitment that we made to the founders was that we would buy a majority stake in the company. The founders retained 18% of the company, and another, eventually nearly 20%, was set aside for management and employees. We also committed to share responsibility for management until we succeeded in recruiting a CEO, as well as to continue to guide the company going forward, so that it could transition from essentially being a very successful product with great potential, into becoming a professionally managed business with a top flight management team.

The company had been run as a sole proprietorship, by which I mean that other than the two founders, no one else owned any stock in the company. We realized that, in order to be successful in the long run, the culture of the company had to be changed, and people who were already stretched would have to be motivated to work incredible hours, for which incremental cash compensation was not available, nor adequate. Accordingly, we decided that every person who was in the employ of the company on the day we made our investment (some 60 full-time employees, many of whom had lower level jobs) would receive stock options in the new company. Today, those options, together with additional shares which were subsequently issued to attract and recruit additional people to the company, have an aggregate value of $80 million.

Between our first meeting with the founders and the date of our investment, we spent six months doing due diligence, helping the company and negotiating the transaction. During this six month period, before we had even made the investment, three of us from our firm (one of my partners, an associate, and myself) had already :

- Conducted a market research survey of the industry (which was at a very early stage);
- Drafted a strategic plan for the company;
- Recognized that because the company served two very different markets and, notwithstanding its excellent common core technology, therefore had to be divided into two divisions: one which served the professional tax preparer (a total potential market of some 200,000 tax preparers in the United States), and one which would serve the very rapidly growing market of people who had personal computers in their homes;
- Designed an organization chart for the future, and laid out a recruiting plan for the company; and,
- Negotiated and structured the investment.

While one might think that the six months that we worked on this transaction between the time we first met the founders, and closed on the investment, was intense, our work, and the pressure really started the day after we closed, because now, it was not just their company, but also ours.

While we immediately set out to recruit a top flight Chief Executive Officer, it was another six months before our firm had identified and recruited the individual, a man who had been President of a large industrial company. In the meantime, one of my partners ran the company with the founder. Because the company was already in the middle of the tax season, we paid a consulting firm to temporarily staff the marketing department, until we could recruit one.

Over the next three and one half years of our investment (early 1990 to mid-1993), working closely with the new CEO, we undertook the following changes:

- Recruited an additional six key individuals for the top management team, which included: division general managers for the two newly created divisions, a vice president of marketing, a vice president of finance, a vice president of operations, and in order to prepare to become a $100 million business, a chief operating officer, who was already COO of a large publishing company.

Two of the things that motivated these people, most of whom had left higher paying, safer jobs, with larger companies, was the challenge of participating in successfully building a rapidly growing smaller company, and secondly, the equity incentives through stock options, if they were successful.

- Recruited a world class Board of Directors for the Company, which included the former head of operations of a $10 billion computer company, as well as a man who had recently retired as president of Microsoft.

  Because the company could not afford significant directors' fees in cash and as an incentive for their heavy involvement as members of the Board of Directors, none of the directors received any cash compensation, but they did receive, or had the opportunity to purchase, stock in the company. These directors have been extremely and actively involved in helping the company.
- Helped the company use its common shares to make two acquisitions: one, a company, which, while floundering, had more technologically advanced MAC and Windows software products (which were then rewritten and upgraded by the ChipSoft for its customer base), as well as another, also floundering company, which had technology which would enable ChipSoft to offer electronic filing capability to its customers. While both of these acquired companies were in financial difficulty, ChipSoft could not have purchased them for cash because: (a) it could not pay the required purchase price in cash, (b) it wanted the founders of the acquired companies to be motivated on an on-going basis, and (c) because the sellers wanted stock in order to participate in the upside of the combined companies.

- In April, 1992, we identified and negotiated with underwriters for an initial public offering, which raised capital to finance the further growth of the business. The IPO was not an "exit for the investors", but served to raise capital to further grow the business.

- By mid 1993, it was clear that the marketplace and product offerings for personal finance products in the home would be consolidating, and that it was extremely important that a tax product could interface easily with other home finance products such as checkbook management. ChipSoft had a marketing partnership for many years with a company called Intuit, whose personal finance product, Quicken, was also a market leader in its category. (Turbo Tax was the market leader in the personal tax market.) It was clear that if these two companies combined, they would be able to offer a stronger, and better integrated product line to their customer base, as well as enjoy the benefit of more efficient operations, be able to offer better technical support for their customers, as well as having greater resources for future product development. Because of the large market values of both companies relative to their cash resources, as well as the unconditional requirement of both sides to get the full benefit of participation in the combined companies, the merger had to be done completely in common stock. Accordingly, at the end of 1993, ChipSoft and Intuit combined, creating a company which was doing over $200 million in sales and continued to have substantial growth potential.

The Intuit story is a somewhat similar, and also interesting story. At approximately the same time that the founders of ChipSoft were inventing a tax product (the mid 1980's), a young marketing consultant, and some colleagues, set out to design simple-to-use software which would enable the users to manage their personal finances, primarily oriented around the checkbook. By mid-1993, the company was doing approximately $100 million in revenues. Also, like ChipSoft, Intuit had been founded with "informal venture capital", or private savings from individuals, and later had benefited from the extensive involvement of two venture capitalists on its Board of Directors, and had also gone public through an initial public offering.

The Aftermath

Today, the combined companies, both of which were total start-ups in the 1980's, are operating at a $350 million annual sales rate, employ 1,200 full-time employees in operations located on the west coast, midwest, southwest, and southern part of the United States, serve some 4 million home users, as well as thousands of small businesses with their accounting software, and are now starting to generate significant revenues from international exports of their technology as well. This combined company is also going to be a very significant federal, state and local

taxpayer. We believe that the company has enhanced the productivity of its customers, both individuals preparing their tax returns and managing their other personal financial affairs, as well as the many small businesses which are using the product for taxes and accounting.

Although the amount of work (which can be measured in "man years") required before an investment is made is substantial, an even greater commitment of human resources by the venture capitalist is required after the investment is made. What has been described is a successful deal, but I think you can imagine that, when companies are not successful, or continue to experience significant problems on an on-going basis, the venture capitalist's commitment of time is also intensive, but not as gratifying.

The purpose in describing this story to you is to convey, by example, that when venture capital is successful, it creates jobs, it can develop new products and technology, it generates potentially large corporate taxpayers, it enhances international competitiveness, and it can improve the quality of life.

The Potential Effect of Capital Gains Tax Rates on the Process

This has obviously been a very successful experience for the founders/entrepreneurs, the professional management who left secure positions in larger companies, the employees who had stock options, the members of the Board who received stock rather than cash compensation for their time, and the founders and entrepreneurs of the companies who were merged into ChipSoft and Intuit. And, of course, this has also been a very successful investment for the investors: the original informal backers, the venture capitalists and their limited partners, and the shareholders who acquired their interests in the IPO and subsequent public trading market, without all of whom this could not have happened as it did.

What they all have in common is that, in varying degrees, they all took risks because they were motivated by potential capital gains, and because they were successful, were rewarded.

While I would like to reiterate for every big success, there are many failures, this type of story has happened in the United States in many industries. In the computer hardware industry, Apple Computer and Intel Semi-Conductor were both venture capital backed companies, and without the PC and the micro-processor chip, ChipSoft and Intuit would never have followed.

This type of success can happen many times again. And if you want to nurture and encourage this venture capital/entrepreneurial advantage which we have in the United States, please significantly reduce real capital gains tax rates - this is capital gains rates net of all potential adjustments such as AMT, preference items, etc. In doing so, you are focusing on the essential economic reward of the entrepreneur and investment risk taker.

One final caveat which I would like to leave in closing. A 50% or some other dramatic reduction in capital gains rates would have a significant and salutary effect on the venture capital/entrepreneurial process. In the past, this has, at one point, been coupled with making the exclusion a preference item for AMT purposes. We have submitted, as part of our written testimony, some calculations which show that if such a notion were to be implemented, it would essentially take away any benefit of a reduction in capital gains rates; please bear in mind that the entrepreneurs and investment risk takers hope they will be extremely successful, which, if they achieve success, will almost, by definition, mean that they will create large capital gains which will put them in the AMT. Any AMT adjustment which takes away the advantages of a long term capital gains tax rate reduction would eliminate the incentive which you are trying to achieve. I know this is not what has been intended.

Again, I want to thank you for giving our industry an opportunity to testify today at your hearings. We also appreciate the recent efforts of Congress in enacting lower capital gains rates for qualifying small businesses. Our message today is that a broader approach towards capital gains reduction would have an even greater, and more important, impact on the entire

venture capital/entrepreneurial process. And let me be clear, the tax treatment for an investor who invests in one of these companies after it has been successful and gone public is also important, because if the tax treatment is favorable, he or she can afford to pay a higher price and has a greater incentive to invest, which pulls along the entire valuation train, and provides greater incentives and opportunities, for those involved throughout the train, including at the beginning.

I hope we have been able to convey to you what we do, how we are involved with our companies, and how important your deliberations, and the outcome of your deliberations, can be on the venture capital/entrepreneurial process in this country. If any of you have any questions, I would be delighted to answer them now, or later if you wish. Again, thank you very much.

HOW AMT TREATMENT OF CAPITAL GAIN AND INVESTMENT EXPENSES IS VITAL TO OBTAINING BENEFIT OF CAPITAL GAINS REDUCTION

At present, individuals who live in high tax states and have substantial capital gain income in relation to ordinary income are generally taxed under the alternative minimum tax ("AMT") instead of the regular tax. This occurs even though the maximum AMT rate and the maximum capital gain rate are both 28 percent, because deductions for state and local taxes and for investment expenses (i.e., section 212 deductions above the 2% floor) incurred to produce the capital gain are denied for purposes of determining the AMT.

If Congress reduced the capital gains rate, but made the reduction a preference for AMT purposes, the benefit of the reduction would be eliminated for most taxpayers who incur significant capital gains. For example, if Congress were to enact a 50 percent capital gain exclusion, the effect of the exclusion would be to reduce the maximum capital gains rate under the regular tax to 19.8 percent (50% x 39.6). However, if the capital gains exclusion were made a preference for AMT purposes, individuals who have significant capital gain income will continue to be taxed at the 28 percent rate under the AMT -- receiving no benefit from the enactment of the 50 percent exclusion. This will be equally true for both small entrepreneurs, who receive a one-shot capital gain as the result of the sale of a business, and for venture capitalists.

Furthermore, as illustrated by the following examples, if making the exclusion an AMT preference is combined with the present law rule denying the deduction for investment expenses, venture capitalists who receive capital gain income will be taxed at rates well in excess of the top 39.6% rate on ordinary income. (These examples assume the investor has enough ordinary income to reach the 39.6% rate.)

Current law. If an investor has a $100,000 capital gain and a $30,000 investment expense (in excess of the 2% floor) incurred to produce the gain, the investor will be taxed on his $70,000 net gain under the regular tax and (assuming the maximum 28% rate applies), will pay $19,600 of tax. However, under the AMT, the investor is taxed at the 28% rate on the $100,000 gross gain, and must therefore pay $28,000 of tax. This translates to a 40 percent tax on the net gain earned from the investment.

50% Capital Gains Exclusion as Preference. If Congress were to enact a 50% capital gains exclusion, but make it a preference for AMT purposes, investors with significant capital gains would inevitably be subject to tax under the AMT and would thus receive no benefit from the reduction in capital gain rates. For example, a taxpayer with a $100,000 capital gain would receive a $50,000 deduction for regular tax purposes. However, the $50,000 would be added back to income for AMT purposes, making the investor taxable on the entire $100,000 gross capital gain at the 28% top AMT rate -- essentially no change from current law. This consequence would be exacerbated if Congress retains the current law treatment denying the deduction of investment expenses for AMT purposes, because -- as shown above -- the investor will be taxed on gross, rather than net, capital gains -- causing investors to bear taxes substantially in excess of 28% on their net capital gains and defeating Congress' objective in lowering the maximum regular tax capital gains rate to 19.8 percent.

Chairman ARCHER. Thank you, Mr. Brody.

Our next witness is Amaury Piedra of NeoCAD in Boulder, Colo. We welcome you and you may proceed.

STATEMENT OF AMAURY PIEDRA, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NEOCAD, INC., BOULDER, COLO.

Mr. PIEDRA. Thank you, Mr. Chairman, and members of this distinguished committee. Good morning. Thank you for the opportunity to appear before you today.

I am Amaury Piedra, president and chief executive officer of NeoCAD of Boulder, Colo. I am appearing before you this morning in that capacity. NeoCAD develops and markets design automation software directed at a certain class of semiconductor electronic components. These components are programmed in the field by the hardware design engineers who are implementing digital functions in computers, telecommunications equipment, instrumentation, in fact, across the whole spectrum of electronic systems.

Founded in November 1990, we already have 60 employees and about 40 percent of our revenue comes from outside the United States. NeoCAD truly is one of the Nation's high technology startups which will lead American business into the 21st century.

All NeoCAD employees have stock options, there are no exceptions. From the receptionists and the shipping clerk all the way to the chief executive officer. This gives everyone a sense of ownership and interest in the future of the company. It creates a healthy long-term view inside the enterprise. We expect to continue to grow employment at 10 to 15 percent per year over the foreseeable future and to go public in the next 18 months.

Mr. Chairman, I am here to talk about the capital gains tax provisions in the proposed Job Creation and Wage Enhancement Act, a reduction. A significant reduction in the capital gains tax will stimulate the formation and investment of long-term risk capital which will result in many benefit streams.

A significant reduction in the capital gains tax will shift money tied in passive investments to new job creating ones.

I have submitted a written statement to the committee explaining the many reasons why I am a strong supporter of the capital gains tax cut and indexation for inflation. NeoCAD was founded with venture capital from Hill & Carmen Ventures, a venture firm founded in Boulder and Institutional Venture Partners of Menlo Park, Calif., one of the deans of venture capital partnerships. During the past 4 years, 60 jobs have been created, 60 high-paying jobs averaging over $56,000 a year, jobs which did not exist 4 years ago.

NeoCAD is just one small example in many of risk capital availability helping to create jobs.

Not every potential venture is as fortunate as NeoCAD and gets financed particularly by top flight investors.

That is why I am here today. As an entrepreneur, I have also seen the ugly side of a startup business, when money is not available to grow. Just before joining my present company, I was president and chief executive of Seattle Silicon Corp. in Bellevue, Wash.

Seattle Silicon was in the business of selling custom chips and automation software for chip design. It was an excellent technology but, because of insufficient patient risk capital, we had to sell the

design automation business to Ichi Electric of Japan. This was a devastating experience with lost jobs and lost technology. Now, because of lack of capital, a Japanese company owns a great technology which we should have been exploiting and exporting.

Investors have certain criteria which they follow in financing a new company. If the tax on the capital gains returns was lower, capital would be more patient and more available. Some of our brightest potential companies would not have to sell to foreign investors who have an eye on the startups' technologies and intellectual property portfolios.

There are no guarantees, but if the capital gains tax had been lower in 1991 when we sold Seattle Silicon, we may have gotten additional capital because capital is a lasting response to the supply and demand. The capital gains tax is a tax against those trying to achieve. Most of these are not rich but want to be. It is a tax against risk taking and entrepreneurship.

Mr. Chairman, long-term risk capital availability is essential to economic growth. The lack of it results in ideas not being turned into products and services, lost jobs and loss of competitiveness. The issue we discuss today is simple. If we want broader participation in the economy, and greater growth, we have to create more jobs. More employees means more employers. We want more employers. We need more risk capital. To make more risk capital available, we have to cut the tax on capital gains and index those gains for inflation.

Thank you very much for inviting me to share some of my thoughts on this most critical issue before the country.

[The prepared statement follows:]

TESTIMONY OF AMAURY PIEDRA
NeoCAD, INC.

Mr. Chairman and Members of this distinguished committee -- good morning. Thank you for the opportunity to appear before you today.

I am Amaury Piedra, President and Chief Executive Officer of NeoCAD of Boulder, Colorado. I am appearing before you this morning in that capacity. NeoCAD develops and markets design automation software directed at a certain class of semiconductor electronic components. These components are programmed in the field by the hardware design engineers who are implementing digital logic functions in computers, telecommunications equipment, instrumentation, in fact, across the whole spectrum of electronic systems.

Founded in November, 1990, we already have 60 employees and about 40% of our revenue comes from outside the United States. NeoCAD truly is one of the nation's high technology start-up companies which will lead American business into the 21st century.

All NeoCAD employees have stock options -- no exceptions. This gives everyone a sense of ownership and interest in the future of the company. It creates a healthy, long-term view in the enterprise.

We expect to continue to grow employment at 10% per year over the foreseeable future and to go public in the next 18 months.

Mr. Chairman, I am here to talk about the capital gains tax provisions in the proposed Job Creation and Wage Enhancement Act.

A reduction in the capital gains tax will stimulate the formation and investment of long-term risk capital which will result in many benefit streams. A significant reduction in the capital gains tax will shift money tied in passive investments to new job-creating ones.

So, Mr. Chairman, I am here to discuss how a capital gains tax cut and indexation for inflation will help create jobs, improve our competitiveness in the global market, grow the economy and improve our standard of living.

We all recognize the names: IBM, Boeing, Sears, General Motors. What these companies have in common is downsizing. Business conditions are such that the large American enterprises will continue to cut jobs. It seems that this will be the reality in the American job market in the foreseeable future. In the first half of 1993, a net 255,000 jobs were identified for elimination in the U.S., mostly by large U.S. companies.

Job creation will depend on the small, entrepreneurial emerging growth companies. These companies were the job creation engine in the last decade, creating about 17 million jobs during a time window when large U.S. enterprises eliminated about 4 million jobs. The near future augurs for more of the same.

The reasons for the corporate downsizing, layoffs and reorganizations are many, but one of the key ones is that, by any measure of efficiency and productivity such as innovation per R&D dollar, revenue per employee, overhead costs, new products per development dollar, dollars to create a job, time to market, etc., small entrepreneurial companies, "the gazelles" of American business, compare very favorably with the large enterprises.

A recent book by John Case (*From the Ground Up: The Resurgence of American Entrepreneurship) contains the following table.*

FORTUNE 500 EMPLOYMENT HISTORY

YEAR	EMPLOYMENT (MILLIONS)	% OF GNP
1954	8	37
1959	9	40
1969	15	46
1979	16	58
1989	12.5	42
1991	11.9	40

The table illustrates the emergence of the entrepreneurial growth companies as the dominant factor in GNP value, and this, at a time when small farm enterprises are on the retreat.

In spite of the evidence in favor of the entrepreneurial emerging-growth companies, our system of taxation continues to favor large companies with physical assets which can be used as collateral to obtain debt financing. The service of this debt is, of course, deductible as an expense of the enterprise in the income statement.

If small entrepreneurial companies are to create jobs, we must have capital available for these companies to emerge and grow. This capital must be in the form of equity, because these small enterprises do not have the hard assets required as collateral by the commercial lending institutions. The capital which goes into the creation and growth of these entrepreneurial companies must be in the form of long-term equity investments.

This type of investment represents uninsurable risk -- there is no collateral. Investments in the emerging growth companies are in people, ideas, innovation, potential future intellectual property and potential future products.

To make sure there is enough long-term risk capital to fuel the jobs engine, we must provide incentives to create that capital. A cut in the capital gains tax, creating a significant differential from regular income, will create an unprecedented investment climate and boom in investments in innovative enterprises which will create an explosion in new jobs. The benefits to the economy would be of historic proportions.

A 1993 study by Gary and Aldona Robbins of the Institute for Policy Innovation calculates that only indexing gains for inflation at that time would have created an additional 550,000 jobs, would add $511 billion to the GDP and increase capital formation by $1.8 trillion -- all by 1997.

Reductions in the capital gains tax have always resulted in increased tax revenues to government. The following table shows the irrefutable historical data:

Year	Capital Gains Tax Rate	Taxes Paid (in millions)	Capital Gains Income
1977	48%	$8.104	
1978	28%	9.104	
1979	28%	11.669	Tax Cut
1980	28%	12,459	
1981	28%	12,684	
1982	28%	12,900	Tax Cut
1983	20%	18,500	
1984	20%	21,800	
1985	20%	26,478	
1986	20%	49,700	
1987	28%	32,941	Tax Increase
1988	28%	38,963	
1989	28%	35,769	
1990	28%	27,829	
1991	28%	24,505 *	

* Estimate - American Council for Capital Formation
Source: U.S. Treasury Department

The data presents a clear-cut case for reducing the capital gains tax just from the standpoint of tax revenues. Coupled with the employment data, it makes for a powerful argument in support of such a tax cut. Every time the tax rate has gone down, investments have increased and so have capital gains realizations and taxes on those gains. In contrast, the capital gains tax rate was raised to 28% from 20% in 1986. 1986 taxes on capital gains were very high as people realized gains before the tax increase went into effect in 1987. So, 1986 was an unusual year, but, if we look at 1985, taxes from capital gains were higher than today.

There are $7 trillion or more in the U.S. of unrealized capital gains. Of that, $1 trillion is real and the balance of $6 trillion is from inflation gains. Private assets unencumbered by debt represent about $19 trillion today. The largest element of this money is homeowner's equity. By cutting the capital gains tax rate and indexing the gains for

inflation, an enormous amount of capital would be freed up from present passive investment and become available to fund new and growing companies. The freed up capital would reflow into new enterprises. These companies would create jobs and economic prosperity. With the potential to borrow against unencumbered assets and invest that money in new businesses with the promise of capital gains under reduced tax rates would result in an increase in capital gains tax revenues, a broader taxpayer base and increased productivity and competitiveness for U.S. businesses. The tax cut would create an investment boom which would push the economy to new levels undreamed of under the present tax structure and rates.

Mr. Chairman, the capital gains tax cut has been attacked by some as "trickle down economics" and a give-away to the rich. This is a dishonest representation.

Let's consider the first accusation -- "trickle down economics." First of all, there are no capital gains until an investment has been made and people have been hired. If the enterprise is successful -- and this is far from guaranteed -- then there is the possibility of capital gains realizations. The benefits have been realized by those employed before the investors can reap any benefits. So where is the "trickle down"?

The second characterization of the capital gains tax cut is that it is a give-away to the rich. There is no question the rich will benefit. However, so will many others. One of the many studies available on the subject we are discussing today showed that 70% of the tax returns reporting capital gains in 1990 were for taxpayers with incomes of less than $75,000. The exact same group which the most vocal political critics of the capital gains tax reduction say they want to help.

The majority of capital for new ventures comes informal investors rather than from professional venture capital. Institutional venture capital represents less than ten percent of money for new ventures. According to a study by the Small Business Administration, in 1988, informal investors supplied businesses with $55.6 billion of capital. This compared to $3.7 billion from institutional venture firms. Further, in the highly visible high technology arena, a 1990 survey by the American Electronics Association, the National Venture Capital Association and Coopers and Lybrand (a public accounting firm) indicates that 54 percent of all these firms got their original financing from founders, their families, friends or other individuals. Once these companies begin to grow, they become attractive to institutional investors who generally invest larger sums.

The capital gains tax is really a tax not on the rich, but on those who try to make a hard fought profit for themselves and their investors. It is a tax on entrepreneurship.

In addition to the distorted view of the capital gains tax cut given by its critics, there is a large element of unfairness in this tax. The main sources of capital gains are inflation

and retained earnings. Inflation gains are totally artificial -- on paper only, not in real terms. The taxation of these artificial gains is not taxing real income. This taxation should not happen.

Retained earnings have been taxed at the company level. Taxing the capital gain from this source twice is hardly conducive to encouraging re-investment.

The existing tax system has forced business owners, homeowners, workers and farmers to "lock in" their assets rather than pay high capital gains taxes on mostly artificial gains and retained earnings. This prevents the movement of capital from passive to active, job-creating investments. In addition, capital continues to be exported to countries such as Germany, Holland, the United Kingdom or Japan, where capital gains taxes are much lower than ours or non-existent.

A meaningful reduction in the tax on capital gains can do more to stimulate the economy than most of the single tax tweaks more frequently proposed.

A great opportunity is in front of us to reduce, or even better, eliminate the capital gains tax. For the good of the country, we must act against this opportunity-destroying, counterproductive tax.

A cut in the capital gains tax will encourage long-term investment in new ideas and growth enterprises as well as create employment. Long-term thinking is something which we have long admired in Japan and short-term thinking something for which we are self-critical. This proposed tax chaange will improve exports and make our technologies and products more competitive in the global market.

Just as important as cutting the capital gains tax is leaving the tax cut in place.

We must have a stable, long-term investment infrastructure to ensure ideas will become products and services and add value to the economy.

Most start-ups are high risk for the principals who leave jobs to start their companies. In addition, many entrepreneurial companies must attract experienced management to grow. These managers are usually in high-paying jobs and one of the few ways in which they are attracted to start-ups is through stock options and the potential of capital gains over the long term. It is more attractive to these people if they know the taxes on this type of gain are low and will remain that way.

If we are to have greater and broader participation in economic growth and improved standard of living and greater economic freedom, we have to have capital. We must create the environment for investors to put capital at risk -- long term.

Mr. Chairman, the issue which we discuss today is relatively simple.

If we want growth, we have to have more employees. If we want more employees, we need more employers. If we want more employers, we need more risk capital. To make more risk capital available -- new capital or reflowing from old, passive investment -- we have to cut the capital gains tax and index capital gains for inflation.

Thank you for inviting me to share some of my thoughts on this most critical issue for the economic well being of our nation.

Chairman ARCHER. Thank you, Mr. Piedra. And thank you also for complying precisely with the 5 minutes. The red light came on just as you finished, so I am grateful for that.

Our next witness is John Chapoton, who is a counsel for the Alliance for Business Investment. A gentleman who is not unknown to this committee, because you have sat out there in a different capacity before.

We are pleased to have you as a witness and you may proceed.

STATEMENT OF JOHN E. CHAPOTON, COUNSEL, ALLIANCE FOR BUSINESS INVESTMENT

Mr. CHAPOTON. Thank you, Mr. Chairman. It is a pleasure to be here. As you said, my name is John Chapoton. I am a partner with the law firm of Vinson & Elkins. I am appearing today to give you the views of the Alliance for Business Investment in support of the reduction of the Federal income tax on capital gains.

The Alliance for Business Investment is an association of money center commercial banking corporations actively engaged in the business of providing significant amounts of equity venture capital to small- and medium-sized emerging companies. The members of the Alliance provide this equity capital through subsidiary corporations, either subsidiaries of bank holding companies or SBICs, small business investment companies.

I will be very brief. The most important message I want to convey today is that corporations as well as individual pension funds and other tax-exempt institutions are vital sources of venture capital in the market today.

A December 1994 study by Asset Alternatives, Inc., which is a specialized information research firm located in Wellesley, Mass., has found that commercial banks now have more than $5 billion invested in venture capital and in recent years have provided between 6 and 13 percent per year of the total amount of new venture capital invested by all professional venture capital firms.

It is therefore essential that this committee, in providing incentives for growth in business productivity and the jobs that are created as a consequence, reduce taxes on capital gains from corporate investment in the same manner as investment by individuals. And the proposal before you, Mr. Chairman, does that. And we strongly support it.

I should add that, in this regard, the treatment is consistent with the traditional treatment of capital gains of individuals and corporations—or at least traditional before 1986, that is—both have been given a lower rate of tax.

The importance of the banking industry in the venture capital business is reflected in the success of the companies that begin their life in part or totally because of capital provided by banks. I list them in my statement. They are companies that you would know such as Federal Express, Compaq, James River Paper, Somerset Pharmaceuticals which developed the anti-Parkinson's drug L-Deprenyl, Celestial Seasonings, Gymboree, and many others.

The important message, again, is that corporations play the same important role as individuals in creating these and other growth-related industries and making job creation a reality.

I think the role of corporations is not as well understood in the venture capital area. Banks and other financial institutions do play an important role. These include insurance companies and industrial companies, particularly those involved in high technology industries or in the venture capital business. Most larger U.S. banks, over 50 banks in this country, have separate venture capital subsidiaries and the total value of their equity commitment is considerable.

In the last 10 years their venture capital investment has grown, some tenfold, as I mentioned, to $5 billion, a meaningful portion of total venture capital. And the contribution they make exceeds the size of their participation because they represent a substantial source of venture capital that provides a cushion when other sources of venture capital dry up.

For example, in the period 1987 to 1991, there was a substantial decline in the amount of new venture capital available in the market. It fell to only $1.4 billion when venture capital fell out of favor with pension funds and tax-exempt organizations which had been the traditional providers of capital to venture capital firms. But bank capital investment actually increased in that year and, indeed, in 1991 accounted for 13 percent of the total investment by venture capital.

I must mention there are bank regulatory restrictions on investments by bank subsidiaries in venture capital, but there is still a lot of room for growth. A very small portion of total bank assets is dedicated in this manner, but the results are very favorable and they do respond very actively, as most investors do, to increased rates of return on investment. And of course the way to do that is by lowering the capital gains rate.

I finally mention as a tax policy concern, Mr. Chairman, as you know, that investments through corporations are taxed very heavily in this area. This is certainly no exception. You really have three levels of tax on venture capital investments through corporations and this acts as a significant disincentive to venture capital investment by banks and by other corporations. A reduction in the rate of capital gains tax on the corporate venture capital side or on the general capital gains side and the venture capital side in particular certainly would be appropriate and certainly would remove a disincentive to an otherwise economically desirable activity.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF
JOHN E. CHAPOTON
ON BEHALF OF THE
ALLIANCE FOR BUSINESS INVESTMENT
BEFORE THE
HOUSE COMMITTEE ON WAYS AND MEANS

January 25, 1995

Mr. Chairman and Members of the Committee:

I am pleased to have the opportunity to present the views of the Alliance for Business Investment in support of the proposed legislation to reduce Federal taxes on capital gains contained in H.R. 9, the "Job Creation and Wage Enhancement Act of 1995." I am the Managing Partner of the Washington Office of Vinson and Elkins, L.L.P., a law firm based in Houston Texas, and I serve as counsel to the Alliance.

The Alliance is an association of money-center commercial banking corporations actively engaged in the business of providing venture capital to small and medium-sized emerging companies through wholly-owned venture capital subsidiaries. The members of the Alliance have made major commitments to support new businesses and products by making available needed equity venture capital. Banks are in a unique position to provide needed venture capital to emerging, growth-oriented companies.

The importance of the banking industry in the venture capital business is reflected in the success of the companies in which they have invested. Some of the better-known companies that began life in whole or part with bank venture capital include Federal Express, Compaq Computer, James River Paper, Ethan Allan Interiors, Office Depot, Nextel Communications, Morris Air (now part of Southwest Air), Thermoscan, Somerset Pharmaceuticals (developer of the anti-Parkinson's drug L-Deprenyl), Staples, Celestial Seasonings, and Gymboree, to name just a few.

The most important message I would like to convey today is that corporations, as well as individuals, are a vital source of venture capital. A new study of the venture capital market by Asset Alternatives, Inc. has found that commercial banks have more than $5 billion invested in venture capital and in recent years have provided between 6 and 13 percent of the total amount of new venture capital invested each year by all venture capital firms. It is therefore essential that this Committee, in providing incentives for further growth in new businesses and

products -- and the jobs that are created as a consequence -- reduce taxes on corporate investments in the same manner as on investments by individuals.

Needless to say, the Alliance strongly supports the current proposal, which does just that.

The Effect of Reducing Taxes on Capital Gains

I will not take the Committee's time reiterating the benefits to the economy of a reduction in Federal taxes on capital gains. Others, including a multitude of eminent economists, have catalogued these benefits over the years and in these hearings, and the positive effects of such changes are well known to the Committee. One of those positive effects is, of course, job creation. The Asset Alternatives study just referred to credits bank venture capital investments with the creation of 80,000 new jobs over the last ten years.

A reduction in the tax on earnings from savings -- in the manner provided in the legislation for capital gains -- will clearly increase the incentive to save, and therefore the amount saved and invested. An increase in savings and investment will in turn increase the rate of economic growth and foster job creation.

The Importance of Venture Capital

Venture capital is a particularly powerful force for economic growth. The National Venture Capital Association has testified about the importance of venture capital for emerging companies, and their job-creation potential. I would add that, according to a study prepared for the Small Business Administration, a new job is created for every $17,000 of venture capital invested. It is difficult to believe that there could be any more efficient use of savings for growth. We strongly support the proposed reduction in capital gains taxes; it would significantly increase the amount of available venture capital.

The risks involved in venture capital investments are substantial. The recipients of this type of capital are frequently companies with little or no operating history and virtually no sales; they may never have generated any earnings. All they have is an idea or a product, and a plan to exploit it. It should not be surprising that investments in a very large percentage of these companies result in losses, frequently total losses.

We are not talking now of what may be called "seed" money, the initial capital (usually less than $1 million) needed by an entrepreneur at the outset of the enterprise. That initial seed capital is usually too small an amount to attract the professional venture capital investors, although professionals occasionally become involved at the start-up level. Instead, we are talking about the next stage of investment where venture capital is needed to bring a new product or idea to market or to expand into new markets, and where substantial amounts of capital are generally needed. It is at these stages that corporate venture capital investors, along with other institutional investors and venture capitalists, provide the necessary wherewithal to give the new venture a meaningful chance.

We are also talking about cases in which bank venture capital companies help firms that have reached maximum potential with their current management or capital to expand and grow. They do this in a variety of ways, including the introduction of new capital and financing structures.

The Role of Banking Corporations in the Venture Capital Market

The role of individuals in providing venture capital, either directly or through professionally managed funds, is well known. Most of us are also familiar with the important role of pension funds and other tax-exempt institutional investors.

Less familiar, I believe, is the increasingly important role played by corporations. Bank affiliates and other financial institutions are actively engaged in the venture capital business. Many insurance and industrial companies, particularly those involved in high-technology industries, also in the venture capital business.

Most of the larger U.S. commercial banks have venture capital subsidiaries. These are nonbank corporations, which do not invest depositor funds, but instead obtain funding from the parent bank holding company. In fact, over 50 U.S. commercial banks operate venture capital subsidiaries today. And the total value of their investments in venture capital is considerable. In the last ten years, bank venture capital portfolios have increased ten-fold in value, to nearly $5 billion. This represents a very significant portion of total venture capital currently invested in the United States.

Moreover, the importance of banks in the venture capital market exceeds the mere size of their participation. Banks represent a stable source of venture capital that has provided a cushion during periods when other sources of capital have contracted. Independent venture capital firms must constantly go to the market to seek funds from individual and institutional venture capital investors. The venture capital subsidiaries of banks, in contrast, obtain funds from their parent banking companies, with their many and diversified sources of funds. This enables banks to be more consistent, long-term players and makes them less subject to the fluctuations in the availability of venture capital funds.

For example, the 1987 to 1991 period was marked by a substantial decline in the amount of new venture capital available to the market -- to only about $1.4 billion -- when venture capital investment fell out of favor with pension funds and other institutions that provide capital to independent venture capital firms. Bank venture capital investments, on the other hand, actually increased during this period. In 1991, in fact, venture capital provided by banks accounted for 13 percent of the annual total amount invested by capital venture firms.

Bank venture capital affiliates are in an unusually good position to diversify their portfolios and reduce the risk inherent in venture capital investments. Their portfolios are diversified across such industries as manufacturing, services, communications, health care,

technology, and retailing, with no industry accounting for more that a quarter of the total. Their portfolios are also diversified geographically, with investments in nearly every state and the District of Columbia. And bank portfolios include investments in a great number of companies, well over 1,300 currently, insulating them from the risk of concentration of their investment in only a relatively few businesses, which could experience losses that exceed the norm.

While the regulatory restrictions on equity investments by bank groups are significant,[1] there is considerable room for expansion of their participation in the venture capital market. Banks with venture capital subsidiaries currently invest, on average, only one-third of one percent of total bank group assets in this manner. Banks and other venture-capital investing corporations are not different from any other type of potential venture capital investor. They respond positively to increased rates of return on investment. Indeed, publicly-held companies are particularly sensitive to the rate of return earned on investment capital, as their financial statements are carefully scrutinized by shareholders and investment advisors. A reduction in the rate of tax on their capital gains would increase the rate of return on venture capital investments and obviously make these investments more attractive to bank management and bank stockholders.

Tax Policy Concerns

A reduction in the tax on capital gains is appropriate to compensate for the limitation under current law on the deduction for capital losses. Capital losses are currently deductible by corporations only to the extent of capital gains. If a corporation with recognized capital losses does not have any offsetting capital gains within the five-year carryover period, it loses the deduction for the losses entirely. The limitation may thus well result in excessive taxation over time, when gains are eventually recognized that cannot be offset by earlier losses, and it is thus questionable from an economic standpoint. While its administrative purpose in the tax law is understandable, so long as the limitation exists it creates a strong disincentive to making relatively risky investments. A reduction in the tax on capital gains is an appropriate mitigation of the effect of the limitation.

The venture capital investments of corporations are also heavily-taxed under current law. The return on venture capital invested by corporations is effectively taxed at three levels: (1) The earnings of the recipient of the capital are subject to the regular corporate income tax, (2) the gains earned by the investing corporation (in our case the bank's venture capital subsidiary) are subject to the corporate income tax, and finally (3) distributions of those gains to individual stockholders of the investing corporation or its parent (in our case the bank holding company) are once again taxed. This compounding of tax -- an effective direct tax rate of 57.75 percent on venture capital profits that are ultimately distributed to the investing corporation's stockholders -- acts as a significant disincentive to venture capital investments by banks and other

[1] In general, equity ownership in any one corporation is limited to 4.9 percent of the voting stock and 24.9 percent of total equity. The Small Business Investment Company program excepts banks from these limitations, but only with respect to investments in small corporations.

corporations. As we have seen, however, banks are in a particularly advantageous position economically to provide venture capital to the market. A reduction in the rate of capital gains tax on corporate venture capital investments is certainly appropriate and would remove a disincentive to an otherwise economically desirable investment activity.

* * * * *

In conclusion, the Alliance for Business Investment supports the reduction in tax on capital gains as proposed in the Job Creation and Wage Enhancement Act of 1995. We urge the Committee to bear in mind the contribution made by the investments of banks and other corporations, and in particular the important role they play in providing venture capital to the small and medium-sized growth-oriented companies that are at the heart of innovation, economic expansion, and job creation.

Chairman ARCHER. Thank you, Mr. Chapoton.

And our last witness is Dr. Jane Gravelle, Senior Specialist for Economic Policy with the Congressional Research Service.

Dr. Gravelle, you may proceed.

STATEMENT OF JANE G. GRAVELLE, PH.D., SENIOR SPECIALIST IN ECONOMIC POLICY, CONGRESSIONAL RESEARCH SERVICE, LIBRARY OF CONGRESS

Ms. GRAVELLE. Thank you, Mr. Chairman, members of the committee. I thank you for the opportunity to appear before you today to discuss the economic effects of capital gains tax cut proposals. My discussion is focused on proposals in the Contract With America. It addresses the revenue costs and some other issues.

Given our current concern for the size of the budget deficit, an important issue is the potential revenue loss from this capital gains tax cut which is currently estimated at around $60 billion over the next 5 years. If tax cuts increase the budget deficit and are not otherwise paid for, the effect will be to reduce the Nation's savings. The consequences for the budget deficit may be markedly different from those indicated by the current 5-year revenue estimates. There are two reasons I believe that this cost may be larger than suggested by current revenue estimates.

First, the revenue cost of the capital gains tax cut is dependent on the size of the realizations response which may be currently overestimated. Both the administration and the Joint Committee on Taxation include in their revenue estimates the expectation that individuals will respond to lower capital gains taxes by increasing realizations of capital gains. This effect lowers the static estimate in the budget window by more than 60 percent.

There have been extensive criticisms of the methodologies of statistical studies used to measure this response. In recent years, new evidence has been presented that suggests that this response may be smaller than that assumed in the past, especially after the first few years. In a study that I have prepared, the observation of historical ratios of realizations to accruals was used to calculate an upper limit of this response suggesting a much lower realizations response.

This research was recently corroborated by a new statistical study that controlled for certain problems that had occurred in the past. This problem was basically that a lot of these studies were probably picking up transitory responses rather than permanent responses to lower capital gains rates.

If these new lower measures of realizations response were used, the revenue cost would probably double. Second, the revenue loss associated with the proposal would likely be much larger beyond the 5-year budget window in part because of rapid growth of the loss due to indexation. This effect, even using the higher realizations response, could eventually more than double the estimates. Both effects taken together, the lower realizations response and the transition to indexing, could more than triple the revenue costs.

It is also important to note that we cannot necessarily depend on the capital gains tax cut to offset any deficit-induced effects on national savings by stimulating private savings. Economic theory does not assure that cutting taxes on capital income will increase

private savings because of offsetting income and substitution effects, and empirical evidence has not clearly supported such a response.

I would like to quickly summarize some other points made in my written testimony. First, that cutting capital gains taxes may improve the efficiency of economy in some ways but may increase other distortions. The overall effects are not clear.

Currently, capital gains taxes are increased above rates on ordinary income due to taxation of inflationary gains but are reduced to defer failure of tax gains and the current tax cap.

In terms of distribution across the income classes, capital gains tax benefits accrue mostly to higher income individuals. For example, previous data presented in 1990 for a 30-percent exclusion indicated that over half of the benefit would go to the top 1 percent of taxpayers and about three-quarters to the top 5 percent.

Finally, while there is no particular complexity in reintroducing an exclusion, inflation indexing is likely to lead to additional complexity as will the prospective nature of the change.

Thank you.

[The prepared statement follows:]

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Statement of Jane G. Gravelle
Senior Specialist in Economic Policy
Congressional Research Service

Before

The Committee on Ways and Means
United States House of Representatives

January 25, 1995

on

Capital Gains Tax Proposals

Mr. Chairman and Members of the Committee, I am Jane G. Gravelle, a Senior Specialist in Economic Policy in the Congressional Research Service of the Library of Congress. I would like to thank you for the opportunity to appear before you today to discuss capital gains tax cut proposals. My discussion is focused on the proposals in the House Republican Contract with America, but the analysis, of course, applies as well to similar Congressional proposals.

I would like first to discuss the effects of these proposals on the budget deficit, both in the short term and in the long run. Secondly, I would like to discuss the economic effects of these tax changes on economic efficiency, on both horizontal and vertical tax equity, and on the complexity of the tax system.

Given our current concern for the size of the budget deficit, an important issue is the potential revenue loss from this capital gains tax cut, currently estimated at around $60 billion over the next five years. If tax cuts increase the budget deficit and are not otherwise paid for, the effect will be to reduce the nation's savings. The consequences for the budget deficit may be markedly different from those indicated by the current five year revenue estimates.

There are two reasons to believe that this cost may be larger than suggested by current revenue estimates. First, the revenue cost of the capital gains tax cut is dependent on the size of the realizations response, which may be currently overestimated. Second, the revenue loss associated with the proposal will likely be much larger beyond the 5-year budget window, in part because of the rapid growth of the loss due to prospective indexation.

As you know, there has been considerable disagreement over the past few years over the revenue consequences of a capital gains tax cut. Both the Administration and the Joint Committee on Taxation (JCT) include in their revenue estimates certain behavioral responses. The most important of these responses, by far, is the expectation that individuals will respond to lower capital gains taxes by increasing realizations of capital gains. These increased realizations of capital gains will then produce additional taxable gains and additional revenue which will offset the static revenue loss. (The static revenue loss is the loss arising from the lower tax rate assuming there is no behavioral change.) If estimates used in the past by the Joint Committee on Taxation are retained, this projected increase in realizations will be substantial and will lower the static estimate in the budget window by more than sixty percent.

There has been a substantial body of empirical research on the realizations response, which has yielded a wide range of estimates. In particular, studies that estimated the relationships between realizations and tax rates across different taxpayers (micro-data studies) often yielded extremely large responses. This empirical research is, for a variety of reasons, very difficult to perform, and all of the studies have been subject to a variety of criticisms. In 1990, as you may recall, there was an extensive public debate about the magnitude of these empirical estimates and the merits of the alternative research methodologies employed -- an issue which was never fully resolved.[1]

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[1] These issues were discussed in a variety of different articles at that time. See, for example, Gerald E. Auten, Leonard E. Burman and William C. Randolph, Estimation and Interpretation of Capital Gains Realizations Behavior, National Tax Journal, September 1989,

In recent years, I believe that new evidence has been presented that suggests that this response may be smaller than that assumed in the past, especially after the first few years. First, because of the wide variation in estimates based on statistical analysis, I prepared an alternative method of assessing the likely size of the realizations response.[2] This analysis is based on a relatively simple observation -- in the long run, realizations cannot exceed accruals. That is, realizations would equal accruals over a long period of time (year after year) only if individuals sold all assets after holding them less than a year. Indeed, one would never expect that all gains would be constantly realized, even in the absence of taxes and other transaction costs. The observation of historical ratios of realizations to accruals can be used to measure the upper limit of the realizations response and to suggest a likely size of that response. This analysis suggested a lower, perhaps much lower, permanent realizations response than that measured in most statistical studies. Basically, this type of approach provides a "reality check" on statistical estimates.

This approach suggests that the very large realizations responses found in most microdata studies lead to implausible estimates of changes in realizations responses, and suggests that the results found in these studies probably reflect transitory rather than permanent realizations responses.

A recent statistical study, which used a new approach to control for transitory effects that had long plagued microdata statistical studies, also found much smaller realizations responses, results which are more plausible in light of these historical measures of realizations and accruals.[3] If the findings in these recent studies are correct, the revenue estimates could be twice as large as they would be based on prior year assumptions.[4]

Secondly, the prospective indexing feature of the capital gains tax cut proposal is a provision that costs little in the five year budget horizon because it applies only to newly purchased assets. (Indeed, it is possible that such a provision raises revenue initially, as it induces sales in order to qualify for inflation indexing.) The loss from indexing grows rapidly, however. Prospective indexing allows indexing for inflation only for assets purchased after a given date. After one year, therefore, the reduction in taxable gain would be one year's worth of inflation for assets sold after one year. In the second year, the reduction would be one year's inflation for assets sold after one year, plus two years of inflation for assets sold after two years, and so forth.

On a static basis, this provision might eventually increase the revenue cost as estimated in the budget window by about fifty percent after it takes full effect. If, however, the realizations response used in the past by the Joint Committee on Taxation is assumed to be correct, this provision could more than double the revenue loss because it would apply to a much expanded base. Both of these effects taken together -- a smaller realizations response than that used in the past and the transition to full indexing -- could more than triple the eventual cost of the proposed capital gains tax cuts.[5]

If the cost is much larger than budget projections, either the revision will decrease national savings through a higher budget deficit or require larger offsetting changes elsewhere to maintain budget deficit neutrality.

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pp. 353-374; Can a Capital Gains Tax Pay for Itself? by Jane G. Gravelle, Congressional Research Service Report 90-161, March 23, 1990; Gerald E. Auten and Joseph Cordes, Cutting Capital Gains Taxes, Journal of Economic Perspectives, Winter, 1991, pp. 181-192.

[2] See Limits to Capital Gains Feedback Effects, by Jane G. Gravelle, Congressional Research Service Report 91-250, March 15, 1991.

[3] Burman, Leonard E. and William C. Randolph, Measuring the Permanent Responses to Capital Gains Tax Cuts in Panel Data, American Economic Review, September, 1994, pp. 794-809. More recent surveys of the literature cover this more recent research; see George R. Zodrow, Economic Analyses of Capital Gains Taxation: Realizations, Revenues, Efficiency and Equity, In Tax Law Review, Vol. 48, No. 3, 1993, pp. 419-527; Jane G. Gravelle, The Economic Effects of Taxing Capital Income, Cambridge, MIT Press, 1994, p. 143-151.

[4] This calculation assumed a coefficient of 3.5 for prior revenue estimating assumptions and a coefficient of 1 for a revised estimate, using a semi-log estimating function and assuming the reduction in tax rates is 45 percent.

[5] This estimate assumes that inflation indexing is roughly equivalent to another fifty percent exclusion. See Jane G. Gravelle, Estimating Long Run Revenue Effects of Tax Law Changes, Eastern Economic Journal, Vol. 19, Fall, 1993 for a discussion of the time path of revenue losses from prospective indexing of capital gains.

It is also important to note that we cannot necessarily depend on the capital gains tax cut to offset deficit-induced effects on national savings by stimulating private savings. Economic theory does not assure that cutting taxes on capital income will increase private savings because of offsetting income and substitution effects. Although an increase in the rate of return will cause some greater preference for future consumption and the savings to accomplish it, an increase in the rate of return will also enable the attainment of a fixed or even higher level of future accumulations with less savings. Or, to make this point another way, if you were saving for a fixed target, an increase in the interest rate would reduce savings.

Because of this theoretical ambiguity, it is necessary to turn to empirical research to determine whether private savings will increase, and empirical evidence would be necessary in any case to determine the magnitude of any effect. While it is very difficult to perform this analysis, this body of research suggests that effects of higher rates of return on savings have small effects on savings behavior and, in some studies, negative effects.[6] That is, it is possible that cutting capital gains taxes will reduce savings.

I would also like to briefly discuss other issues that the committee might wish to consider regarding the proposed exclusion and inflation indexing. These issues include efficiency, equity, and simplicity.

Efficiency Issues

An argument for reducing the capital gains tax made by economists is based on the distortions that the tax produces, including the lock-in effect, and the contribution of capital gains taxation of corporate stock to distortions that disfavor corporate equity investments, and the general effect of reducing the taxation of capital. How significant these distortions are found to be depends, of course, on the magnitude of empirical measures of realizations responses and investment allocation (portfolio responses). The distortion arising from lock-in could be significant as a fraction of revenue. At the same time, the proposed tax reductions could magnify other distortions, such as the choice of dividend payout ratio and distortions of other taxes if they are used to replace the revenue. Notably, the reduction extends to noncorporate investments (primarily sale of real estate) as well. Some economists also are concerned about the possibility of low capital gains tax rates playing a role in tax sheltering and avoidance activities. Unfortunately, the role of lower capital gains taxes in increasing or decreasing economic efficiency remains unclear.

Inflation indexing is probably less likely to reduce the lock-in effect than an exclusion. The lock-in effect is most serious for those assets that have been held a substantial period of time, but these assets will receive a smaller exclusion from indexing than short lived assets. For example, if a corporate stock is appreciating at a three percent annual rate and there is a three percent inflation, indexing for an asset held one year will result in an exclusion of 49 percent of gain, while indexing for an asset held 20 years will result in an exclusion of 36 percent of the gain.[7]

Arguments are also sometimes made that the capital gains tax has an important influence on risk-taking, entrepreneurship, and the availability of venture capital, and hence productivity growth. While such a relationship may exist, there is little empirical evidence of a link between the capital gains tax rate and productivity growth. Also, much of formal venture capital offerings is not subject to capital gains taxation,[8] and the vast majority of capital gains accrue on real estate or sales of stock of long established corporations. As you know, a current tax benefit already exists for gains on new stock issues of small business corporations.

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[6] For a summary of this literature, see Jane G, Gravelle, The Economic Effects of Taxing Capital Income, Cambridge, Mass., MIT Press, 1994, p. 27.

[7] The value of an asset costing one dollar held for one year is 1.03 times 1.03 and the gain without indexing would be that amount, minus 1, or .0609. If the asset is indexed, the gains will be 1.0609 minus 1.03 (the latter number the basis increased by inflation), or .0309. The gain is reduced by 49 percent. For the asset held for twenty years, the gain is 1.03^{20} times 1.03^{20}, minus 1; the gain with indexing subtracts 1.03^{20} and the result is an exclusion of 36 percent.

[8] See James Poterba, Venture Capital and Capital Gains Taxation, in Tax Policy and the Economy, vol. 3, ed. Lawrence Summers, National Bureau of Economic Research, MIT Press, Cambridge, 1989.

Finally, there is no correct way to provide for an inflation adjustment for capital gain on the sale of depreciable property, when tax depreciation itself is not reflective of economic depreciation.

Equity Issues

An important argument for indexing capital gains is that gains include those arising solely from general price changes in the economy. These gains do not constitute real income and it may be argued that it is unfair to tax them. At the same time, capital gains income benefits from other aspects of the tax law, including the ability to defer taxation of income and the ability of avoid taxation entirely on assets held until death. Higher income individuals also benefit from the current 28 percent cap. In addition, the taxpayer has the advantage of control over the realization of gain, so that he can choose to realize offsetting losses.

Whether, on average, these benefits outweigh the penalties imposed by taxing inflationary gains depends on average holding periods and inflation rates. Currently, it is likely that the average effective tax rate on capital gains is lower than the statutory rate for corporate stock where such effective tax rates can be calculated. This effect varies across individuals and assets, depending on the holding period and the real appreciation rate. The combination of the fifty percent exclusion and inflation indexing will lead to effective tax rates well below the statutory rate.

Vertical distribution effects of the capital gains tax cut may also be of interest to the Committee. A capital gains tax cut will primarily benefit higher income individuals. When a thirty percent tax cut was proposed in 1990, the Treasury department estimated that 54 percent of the benefit would have gone to those with incomes over $200,000, a group constituting about one percent of the population.[9] About 74 percent would have gone to the top five percent earning over $100,000.

Simplicity

While, the addition of more tax preferences for capital gains is likely to induce greater efforts to convert ordinary income into capital gains, there is no inherent complication in actually computing capital gains with an exclusion. The proposal from prospective inflation indexing would, however, be more complicated. Unlike an exclusion, an inflation adjustment requires a separate adjustment for each vintage of assets. Also, since only assets purchased after a given effective date would be eligible for indexation, further complications would occur, since eligible assets would have to be purchased after a given date.

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[9] Classification was based on five year averages in order to mitigate the problem that individuals would appear in the higher group because of realization of a large gain in one year.

Chairman ARCHER. Thank you, Dr. Gravelle. You have opened the door for some interesting colloquy.

When you say capital gains are not taxed at death, is it not true that the capital gains included in the market value of every asset are taxed at the highest percentage rate of any tax in our system, 55 percent?

Ms. GRAVELLE. You are talking about estate tax?

Chairman ARCHER. Yes. Is it not true that the market value of the assets receive a 55 percent tax, including the capital gains, the appreciation during a lifetime?

Ms. GRAVELLE. That is right.

Chairman ARCHER. They are taxed in a big way at the time of death?

Ms. GRAVELLE. That is correct. Although there are a lot of exclusions, a lot of exclusions from the estate.

Chairman ARCHER. But when you talk about what I personally disagree with as to the distribution tables about who gets the benefit from capital gains, if in fact it is the top 1 percent, as you say, then they are the ones who are going to pay the estate taxes, big time.

Ms. GRAVELLE. Well, if they have Mr. Chapoton for a lawyer——

Chairman ARCHER. But in order to involve more of our panel in this discussion, Mr. Chapoton, do you have any disagreement with the analysis that Dr. Gravelle has just presented to the committee?

Mr. CHAPOTON. Well, I do have several points of disagreement. I think that she would agree that lowering the capital gains rate is positive for savings and investment and her fundamental point is that, in the process, you increase the deficit by a greater amount than you will offset it with the positive effect of a capital gains cut, and I think it is a valid point.

You know it, this committee understands it, that you do need to cut spending when you do this. The other, of course, question that she also raises is how much the capital gains cut will reduce revenues if at all. And that is a many, many factored question which has been discussed at length before this committee.

But I think that is really the significant question here. I think everybody would agree that lowering capital gains rates is positive for the economy and positive for savings and investment.

Chairman ARCHER. In the current environment you have the President, Newt Gingrich, Al Gore, and a majority of both the Senate and House of Representatives committed toward getting to a balanced budget. Irrespective of how they say it, they want to get there. It seems to me that the argument that if you don't tax capital gains that you are increasing the deficit, and therefore you are offsetting one type of savings with another, is not valid. It merely means that another area of consumption will be squeezed in order to get to that balanced budget.

So it seems to me, in the current environment, that is not a valid empirical argument. But let me test out something on all five of you because I have tried to approach things from a basic common sense standpoint. What are the sources of capital?

We all know we have to have capital to increase productivity in order to increase real earnings or standards of living. I think everybody would agree with that. You have to have savings that are in-

vested if you want to increase productivity. Now, where can that capital come from? Where do those savings come from?

Well, government can tax the production of people and instead of spending it on consumption-type items, which we do in this country today with the proceeds from our taxes, the government can build the factories, buy the tools, and provide the jobs. That is one source of capital. You are all nodding. That has been tried in the Soviet Union. It has been tried in Western Europe and they have all moved away from it because it doesn't work. So let's put that one off the table for the United States of America.

The second source of capital will depend on the savings of foreigners who have a higher savings rate and who are permitted to keep their savings when they have a capital transaction instead of having it taken away from them by government. Those foreigners then can come in and they can build the factories, and they can buy the tools, and they can provide the jobs so that we can increase our productivity.

Most Americans that I talk to don't much like that, but we have become dependent on more and more of that as a source of providing the tools of production in this country.

The disadvantage, besides that Americans don't like it, is that we then have a mortgage on our productivity for all time for dividends and interest that have to be taken overseas.

The third way of savings and capital investment is that Americans have to forgo consumption, and they have to provide the savings to increase productivity. And I am a firm believer that we have got to stop talking about the rich against the poor or the corporations against the individual. We must protect savings wherever we find them because savings are what we lack in this country.

If, in fact, higher income people are where the greatest savings are, then we should gladly be prepared to protect and encourage that because every worker's personal standard of living, family real earned income, can increase by our productivity. To me this is very, very basic.

Is there any one of you that disagrees with that?

Ms. GRAVELLE. I just would like to remind you that at least the point that I made in my testimony is that we can't be certain that cutting these taxes will increase savings—private savings. We can't be certain of that. Our theory tells us that we don't know for sure, and if we look at the evidence on this issue we don't find the evidence.

Chairman ARCHER. You are leading me to my next basic point. It seems to me that the nucleus of existing domestic savings in the United States is just as important as new savings that we can attract. Every one of those dollars of savings is available to be employed to increase productivity.

And I don't think you need to be in an ivory tower with a theory to understand that whenever you sell a business that has 10 machines and the government takes 2 of those machines and sells them and puts the money in the Treasury to be spent on consumption, that you have got less capital employed in the domestic marketplace. And that is precisely what happens with a capital gains tax. Every time you have a transaction, a part of capital savings that is already out there is vacuumed up by the giant vacuum

cleaner, brought into the Treasury and disbursed on consumption items for the most part.

Obviously, building roads and infrastructure is not a consumption item. Do you disagree with that? You can talk about theory but isn't that the practical reality of what exists?

Ms. GRAVELLE. Basically, what I am trying to say is that when we try to look for evidence on whether changing tax rates or changing the rates of return—any of these things that change the return to investors—we do not find that clear evidence that aggregate savings goes up. In the case where somebody is selling machines, the machines are still there. It depends on what people do with all of their savings when they are faced with a tax.

Chairman ARCHER. You are going back to half the equation which is incentive for new savings. I am also talking about existing capital savings.

Ms. GRAVELLE. Existing capital can't be destroyed. Physical capital is still there.

Chairman ARCHER. It is. If every time you have a transaction the government takes 20 percent of that, 28 percent if you have a zero basis, there is 20 to 28 percent less in the marketplace than there was before, and that is converted to consumption.

Ms. GRAVELLE. The point is that it is not clear that that is what happens.

Chairman ARCHER. But it has to be. You are talking about whether there is an incentive for new capital. And you can theorize on that. These gentlemen would disagree with you. But relative to existing capital it can't be a theory. It has to be a reality. You are converting capital savings to consumption. There is no way it could be otherwise.

I am wondering if you gentlemen would agree that the existing nucleus of capital savings can be just as important as new savings. And let me predicate that by saying, since you are venture capitalists, many of you, that someone has to save to put the venture capital in there. Cannot venture capital just as easily come out of the existing savings pool as well as from potentially some incentive for new savings?

Mr. PIEDRA. Mr. Chairman, if I may, I would like to address two of the issues.

One is the one you just mentioned, which indeed it is. If we can free up locked-in capital and move it to job creating capital investments, it would be a tremendous boon to the economy, no doubt about it.

But we are also ignoring a hard fact as to the results of capital gains tax reductions. And that is hard historical data, not future analysis, not theoretical analysis, but historical data indicates that every time we cut capital gains, tax investments go up and so do collections on realized capital gains. I think we are ignoring that hard fact, not hypotheses.

Chairman ARCHER. Let me say maybe some of the theoreticians are ignoring it. I am not.

Mr. BRODY. I am not an economist. I just go based on what I see in real life.

I describe an example of a company where the founders, the new management, the entrepreneurs as a group, made in excess of $100

million. They come to me, and they say we don't want to pay capital gains. If we sell our shares we don't participate in the upside of the company, and there is a big toll tax when we go home.

Many of these people are now experienced and very successful entrepreneurs, and if their capital was unlocked not only would you get their capital going to other situations, you would get their experience and talents helping other people, which would have a multiplier effect.

I agree if there were a reduction in the capital gains rate it would liberate capital and the productivity and multiplier effect. You would have a big impact stimulating productivity and new jobs going forward.

Mr. MORGAN. Mr. Chairman, again living through these things perhaps makes a bigger impact on you than looking at the numbers.

I have lived through the ups and downs of the capital gains rate in this country. When I started my company, my own firm in 1981, a third of the capital came from families, repositories of wealth, usually industrially successful families who were willing to take the risks, the illiquidity, and, frankly, a little bit of the vicarious enjoyment of participating in creating new ventures and taking the risks that are associated.

Come 1986, that source of capital just about dried up because these families may or may not have had good investment advisors, but they all had good tax advisors, and the tax advisors quickly pointed out to them that risk and illiquidity, along with a tax on the winnings, just didn't compute to being a sensible investment.

That also affects the angel investors, people that make a little bit of money. And in the Boston area they are called the breakfast club, and these successful entrepreneurs get around in the morning at breakfast and decide whether or not they are going to give a little bit of money to somebody else to start a company. But they do pay attention to the tax rates, and if the tax rates permit them to keep a good hunk of their winnings they will take those kinds of risks.

Chairman ARCHER. Thank you very much for that input. You are real people out there realizing the decisions that people make in a real world, and we are very grateful to have your input.

Mr. Collins will inquire.

Mr. COLLINS. Thank you, Mr. Chairman.

Mr. Chairman, I like your example of the vacuum cleaner. Ms. Gravelle, do you have a vacuum cleaner?

Ms. GRAVELLE. I sure do.

Mr. COLLINS. What happens when you turn it on?

Ms. GRAVELLE. Hopefully, it sucks up the dirt from my rug.

Mr. COLLINS. It also makes a loud noise. I despise the one that my wife has. But that sucking is heard by a lot of people who own assets that they would probably sell or would like to sell, but they feel locked in because they hear that noise.

A couple of years ago I was in a small TV rental shop in Georgia. The area was not much bigger than this area here—not this room. When I walked in, the lady immediately, knowing who I am, spoke to me about taxes. She said, you know, I have a small piece of property at the edge of town that I could have sold three times, but

I won't sell it because I don't want to turn over so much of my gain on it to the government. That was that sucking sound that she could hear.

How long have you been with Congressional Research?

Ms. GRAVELLE. Twenty-five years.

Mr. COLLINS. What did you do prior to that?

Ms. GRAVELLE. That is my only job except for going to Treasury and teaching and other things.

Mr. COLLINS. That was pretty evident by your comments.

Mr. Brody, you mentioned the alternative minimum tax. I would like you to go a little deeper with that because the alternative minimum tax is a thorn in my side, too.

Mr. BRODY. There are two potential issues as it relates to the capital gains rate that might ultimately deliver it and the stimulative impact it would have on venture capital.

At one time, when we had an exclusion against capital gains, the exclusion was a preference item for alternative minimum tax, which basically meant you got the exclusion from your capital gain which reduced the amount of capital gain you had. But then you took that exclusion you got and you put it back into your tax return and paid taxes on that as well.

Effectively, when you were done you did not achieve the capital gains rate that was originally advertised. And if you had a full exclusion, which is a full preference—AMT is 28 percent and capital gains rates are 28 percent today at the top bracket—you basically made zero change in reduction.

From the point of view of a venture capital firm, our business is very expense-intensive. We have 110 employees in our firm, over half of whom are professionals. We invest in 10 new companies a year and spend a great deal of time working with those companies, helping them achieve their objectives. Those expenses are not deductible if you are in the AMT. And the result is the expenses we incur to create the capital gains—just as a manufacturer creates expenses to incur revenue—are not deductible.

So if there is an advertised capital gains rate, if we look at what our capital gains is net of the cost to generate those gains, depending on what our expense level is to the level of capital gains in a given year, we can end up with an effective tax rate on capital gains that can be even more than the 39.9 percent that we have in current law.

So that if the objective of the committee and the intent of reduction of capital gains is to stimulate venture capital, as Jim Morgan said, our industry has treaded water since 1987. The amount of new capital coming into our industry has been stagnant. During that same period the mutual fund industry has multiplied four times.

If you want to stimulate venture capital, if you want to create more venture capital firms that can be receptacles for all forms of capital, tax exempt and otherwise, the signal that ought to be given to the industry is that whatever capital gains rate comes out of this committee as advertised and is ultimately approved is the rate that, in fact, we pay when we are done filing our taxes.

Mr. COLLINS. Thank you. I would like to see a repeal of alternative minimum tax altogether.

Chairman ARCHER. Gentlemen—and lady, I forgot to ask each of you what your preferred holding period would be assuming you are not going to have different holding periods with different rates. I don't want to get into that issue. If we have one holding period should that holding period be 1 year, 2 years, 3 years, 4 years or 5 years?

Mr. MORGAN. I understand you want a number, but it is a political judgment. The ideal would be that as we take our companies from illiquid, long-term investments, which is what a venture capital investment is, we are migrating them into the public markets where there is liquidity and where a holding period would interfere with the smooth functioning of that market. But that is the progression of our train, if you will.

So the deal would be that at each step along that train there would be the most efficient capital market and that would imply no holding period for the purpose of calculating capital gains treatment.

In the absence of anything else I guess 1 year is probably as good as any.

Mr. BRODY. I agree.

There was a comment made by a witness that one of the disadvantages of our system is pressure on public companies for quarterly earnings per share performance. I think it impacts their ability to make long-term judgments. I think if you had a holding period of 1 year you would discourage people who are trading and churning in stocks and encouraging people to at least take a longer term view in the companies they invest in, and that would have a salutary impact.

Chairman ARCHER. So you think the 1 year that is in our proposal is the best holding period?

Mr. BRODY. I think it would be sufficient.

Mr. PIEDRA. One year, Mr. Chairman. From the employee side, these stock options that employees hold in the companies are usually over 4 or 5 years, so they have been working hard for that period of time and the shorter the holding period the better.

Mr. CHAPOTON. I agree. I think 1 year. It was 6 months for many years. There has been talk about a longer holding period. I think with the latter you get closer to what we refer to as targeting, and I think you ought to stay away from that.

Ms. GRAVELLE. I can't recommend a particular year. If you have a holding period that is too long and you have a differential, you create sort of a mini-lock-in problem that you need to think about. I don't have any specific——

Chairman ARCHER. One year you think is adequate to take care of the trading in derivatives and a lot of churning-type activities which many people say don't really increase capital investment?

Mr. BRODY. I think there is a tradeoff. One year will have a significant impact. Obviously, 5 will have a greater impact. But there are disadvantages if you go out further than 1 year in terms of investment behavior.

Chairman ARCHER. Thank you.

Mr. English will inquire.

Mr. ENGLISH. Dr. Gravelle, welcome. I note in your testimony that you indicate that the evidence is ambiguous on the dynamic

effects of capital gains tax. And perhaps that is because the methodologies would have difficulty dealing with many of the other factors that might be in place. Is that fair to say?

Ms. GRAVELLE. There are two kinds of effects. You are thinking about the realizations response?

Mr. ENGLISH. Yes.

Ms. GRAVELLE. All studies done of the realizations response—they had a lot of problems, and that is really—and they produced very wide variations and estimates.

Mr. ENGLISH. So, really, the jury is not in on the dynamic effects from the standpoint of academic research of a capital gains tax. Is that fair to say?

Ms. GRAVELLE. I don't think anybody could pinpoint the number. The research that I did simply showed that you don't have that much room to expand realizations. You can never realize more than you accrue. So if you look over history and you have already realized a lot of what you accrue that only leaves so much room and that room is not big enough to accommodate some of the investments already done.

And we are going to see this—if we estimate big capital gains reductions, your realizations will be so large with some estimates it would be implausible.

Mr. ENGLISH. But there are economists that would come at it from a different angle and might suggest there would be more dynamic effects?

Ms. GRAVELLE. There is certainly room for disagreement, yes.

Mr. ENGLISH. I want to focus the balance of my questions on the equity side.

First of all, is it not fair to say that, just from a factual standpoint of tax returns claiming a capital gain, that nearly 50 percent of those returns are filed by taxpayers with less than $40,000 of adjusted gross income?

Ms. GRAVELLE. I don't know those numbers, but I wouldn't find that surprising.

Mr. ENGLISH. Of tax returns claiming a capital gain, nearly 60 percent of those returns are filed by taxpayers with less than $50,000 of adjusted gross income. My source on that is the Statistics of Income bulletin, fall of 1994. It is a good source.

So I would take from that that just from a pure equity standpoint the beneficiaries of capital gains are certainly not confined to the upper-income bracket?

Ms. GRAVELLE. It depends if you want to look at the number of beneficiaries or how many dollars they get.

Mr. ENGLISH. Frankly, I think probably the distribution of benefits is a more useful approach. Many of the so-called rich who would benefit from a capital gains cut are in a king-for-a-day category. In other words, they have liquidated assets in a particular year so they show up on the tables as being an upper-income taxpayer for 1 year; but as a practical matter, looking at their history of income, they are not rich. They are middle class. Is that fair to say?

Ms. GRAVELLE. Most of the data that I cited used a 5-year average to try to deal with that problem. Those studies found that, in most cases, the people realizing gains and in those high-income cat-

egories were there most of the time. That is a phenomenon, but it is not a dominant one.

Mr. ENGLISH. You don't think that makes up a large portion of the capital gains?

Ms. GRAVELLE. No.

Mr. ENGLISH. That is interesting.

I have no further questions. Thank you, Mr. Chairman.

Mr. ZIMMER [presiding]. Mr. Christensen.

Mr. CHRISTENSEN. I just have a brief question.

For 2½ weeks now we have heard testimony from everybody from academia to bureaucrats to real, live people that are out there in the world fighting with the government each day. Why is it that lifetime government employees and lifetime professors, who have never ever been out in the real world, almost unanimously oppose a capital gains tax reduction.

Dr. Gravelle, please explain to me what it is that we are missing.

Ms. GRAVELLE. First, I would like to make my position straight. I am not here to say I oppose the capital gains tax cut, but I am here to say that it is going to cost a lot of money I think to make these tax changes. And if you are concerned about savings and investment you are going to have to be concerned about that revenue.

I think the efficiency issues for capital gains tax cuts are mixed. Some kinds might be better than others. A lot of this capital gains cut will go to real estate. Maybe the ones that go to corporate stock would be more efficient.

I have written a lot about this that I couldn't put in my testimony.

Mr. CHRISTENSEN. I appreciate that. If you weren't working for the taxpayers at the Congressional Research Service and say you were on the other side of the fence in the private sector, do you think you might have a different opinion?

Ms. GRAVELLE. I can only tell you as an economist, and I think my opinion as an economist is, hopefully, totally unaffected by my personal situation and would be then, hopefully, too.

Mr. ENGLISH. Let me comment that I am a lifetime policy analyst and government employee that supports cutting the capital gains tax. Thank you.

Mr. CHRISTENSEN. That is refreshing.

Mr. ZIMMER. Thank you very much, members of the panel. We appreciate your joining us.

Will panel number three please come forward?

I thank our third panel for joining us.

We will first hear from Robert DeHaven, who is the president and chief executive officer of Quality Systems, Inc., on behalf of the American Electronics Association.

STATEMENT OF ROBERT C. DEHAVEN, FOUNDER AND CHIEF EXECUTIVE OFFICER, QUALITY SYSTEMS INC., FAIRFAX, VA., ON BEHALF OF THE AMERICAN ELECTRONICS ASSOCIATION

Mr. DEHAVEN. Thank you, Mr. Chairman. You have my testimony.

I grew up on a farm in Pennsylvania, and I am sorry that Mr. Stark isn't here. I wanted to point out that I first became an entrepreneur at the age of 9. I received 5 cents for each cow that I

milked. And I was fortunate enough. I went to college on an athletic scholarship and at 35 mortgaged everything that I had to start a company.

I am founder and CEO of Quality Systems Inc. We employ 400 scientists and engineers in Northern Virginia. Today, we are a subsidiary of Tracor, a good Texas company. I have firsthand experience with the impact of capital gains tax on small private businessowners.

I am also chairman of the board of the American Electronics Association, the largest high-tech trade association in the world. We represent over 2.3 million workers, and we have 300 corporate members ranging from Microsoft, Intel, to AT&T, to small, rapidly growing firms. Seventy percent of our companies employ fewer than 200 people.

I believe we have empirical evidence that suggests that reducing the capital gains tax creates jobs, promotes high risk, high return investment, increases competitiveness; and it is fair. I would like to touch on each briefly.

Creates jobs. Starting a new company, cash is king. The cost of capital is the most important cost. New ventures not pursued are generally abandoned because of cost of capital. Successful new ventures create jobs. How many will H.R. 9 create? I don't know.

After 1978 and 1981 cuts, we enjoyed 1 million new U.S. electronics jobs between 1978 and 1984. We witnessed numerous successful startups. In fact, 15 years ago 65 percent of our 3,000 members did not even exist. Now we have Sun, Microsoft and Compaq. A direct result of a reduction in the capital gains tax? No, but it was helpful. A reduction in the capital gains rate helps create high-tech, high-paying jobs.

Competitiveness. It is a global economy. Even the smallest U.S. companies compete with Japanese and European firms. Cost of capital is the most important cost of doing business in a growing firm. If that cost is significantly higher than in the United States, our companies are at a disadvantage.

Our competitors understand this. That is why in Japan the rate is 20 percent, France 16 percent, Germany zero, Austria zero, Hong Kong zero, Singapore zero and in Belgium zero. A reduction in the capital gains tax rate increases the competitiveness of U.S. technological and financial firms in the global market.

Three, a reduction in capital gains promotes high risk, high return investment. As you all know, high technology products improve the quality of life for American citizens. It also saves American lives. Developing these technologies is expensive, and it is risky. Taxes, including capital gains taxes, are simply a cost of doing business. If the tax rate goes down the cost of investing in new technology goes down; and, therefore, more money becomes available for projects.

I hope this doesn't make me one of those terrible trickle-down terrorists that I have been reading about, but it is John Maynard Keynes who said the engine who drives enterprise is not thrift but profit.

This thought brings me to my final point: Capital gains is fair. The responsible literature suggests that H.R. 9 will have a minor impact on the Treasury. Some say, as we heard this morning, it

will be negative. Some say it will be positive. It depends upon how you ask the question and what answer you want.

H.R. 9 has been attacked as unfair because most investment capital comes from so-called wealthy taxpayers and that they will benefit. Some feel this is inherently bad.

I know the 70 percent of AEA's members who are building private companies that employ fewer than 200 people—I was one—they are not wealthy, but they will benefit. I know the employees of the 84 percent of our high-tech growth companies who own stock or have stock options—I was one—they are not wealthy, but they will benefit. And I know the many small investors that have their money broadly invested in funds for their retirement—I was one—they are not wealthy, but they will benefit.

Mr. Chairman, when I consider the benefit to these people, the jobs H.R. 9 will create, the technologies it will help develop and how it will make U.S. companies more competitive, I think it is fair. On the other hand, is it fair to tax these businessowners, these employees and these investors on the inflated values of their holdings? I don't think so.

If you invested $10,000 in 1973 at a rate of 7.4 percent for 20 years it becomes worth $42,000. That is a $32,000 capital gain. At 28 percent, you would owe a tax bill of $9,000. But if you adjust that $32,000 for inflation over that time it is worth $9,500. After you pay your tax bill you are left with $500 on your 20-year investment. That is not fair. How can a middle-class worker retire on that kind of return?

Furthermore, is it fair to tax the shareholder of a business twice? For every $100 a business makes, it pays $35 in income tax. The remaining $35 is put back into the company. It increases the value of the stock of the company and, therefore, is considered a capital gain and is taxed at 28 percent, for a total tax rate of 53.2 percent. Is that fair? I don't think so.

It seems to me that rather than agonizing over how to redistribute the wealth pie among Americans we should seize the opportunity to make it bigger. H.R. 9 is such an opportunity. It creates jobs; it increases investment; it increases competitiveness; and, Mr. Chairman, it is fair.

Mr. Chairman, AEA endorses the capital gains provisions of the Job Creation and Wage Enhancement Act. Thank you.

[The prepared statement follows:]

Statement of
Robert C. DeHaven

Chief Executive Officer, Quality Systems Inc.
Chairman, American Electronics Association

Good afternoon, Mr. Chairman, and members of the Committee. My name is Robert C. DeHaven and I am the founder and Chief Executive Officer of Quality Systems Incorporated -- a company based in Fairfax, Virginia -- employing over 400 scientists and engineers. I am also Chairman of the Board of the American Electronics Association (AEA) -- an organization that represents some 3,000 U.S. technology companies based in 44 states. These companies, which range from small start-ups to the Fortune 500, span the breadth of the electronics industry, from silicon to software, to all levels of computers, communications networks, and systems integration. More than 70 percent of AEA members employ less than 200 people.

I am pleased to be here this morning to present AEA's views on H.R. 9, The Job Creation and Wage Enhancement Act, with specific reference to the provisions relating to capital gains. Mr. Chairman, the AEA first testified before this committee on capital gains in 1978. As you may recall, those hearings led to the enactment of the Steiger Capital Gains Amendment and, in our opinion, set the stage for the explosion of the electronics and computer industry during the 1980's.

The U.S. economy is growing -- not by leaps and bounds -- but nonetheless growing. Long-term interest rates are still -- historically speaking -- comparatively low and inflation appears to be under control. Worker

productivity has steadily increased and corporate America has become less bloated, more competitive. These are the building blocks for enhanced competitiveness and economic growth, yet millions of Americans still feel insecure about their economic future. Many of the high wage, high skill jobs that were eliminated during the 1991 recession are simply not coming back.

So what should we do to get these Americans back to work? What should we do to increase global competitiveness? AEA believes one important step is to work towards a "growth friendly" and "investment friendly" tax code. And that is why we enthusiastically support the capital gains provisions contained in H.R. 9.

As this Committee moves forward with these hearings and as H.R. 9 moves through the Congress, I want to stress that unlike most other legislative proposals, there is solid empirical evidence to support our conclusions regarding capital gains. Simply stated, a capital gains tax reduction will 1) create jobs; 2) promote high risk, high return investment; and 3) increase competitiveness. In addition, and perhaps most important, the evidence confirms that a capital gains tax cut is fair.

1) CAPITAL GAINS CREATES JOBS

Mr. Chairman, economists generally agree that the tremendous entrepreneurial growth of the electronics industry during the 1980's was due, at least in part, to the 1978 and 1981 cuts in the capital gains tax rate. This boom of investment produced such start-ups, turned giants, as Sun Microsystems, Microsoft, Compaq Computer, and Conner Peripherals. These four companies have produced billions of dollars in exports and created thousand and thousands of new jobs. The explosive growth of new investments helped fuel the creation of over one million new jobs in electronics between 1978 and 1984[1]. Another indication of the electronics industry's growth is reflected in the fact that 15 years ago 65 percent of AEA's 3,000 member companies did not exist.

While the circumstances of each company's formation were and are different, those of us who have "been there" and "are there" starting and running companies know that many firms might not exist today had Congressman Steiger and others not acted in 1978. Likewise, we know that the 1986 Tax Reform Act, which increased the tax rate on capital gains income from 20 percent to 28 percent – a 40 percent tax hike -- has discouraged

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[1] Source: American Electronics Association

entrepreneurship and caused many investors to hold on to assets they would otherwise prefer to sell.

Once again, the U.S. needs to provide incentives to encourage low-cost capital and seed capital held over the long term. As you know, Mr. Chairman, capital gains is in some ways a voluntary tax. Like it or not, annual income taxes are due every April 15th. Capital gains taxes are due only when an individual decides to sell an asset. And since selling is taxed and possessing is not (the tax is deferred), high rates tend to limit the availability of investment dollars and low rates tend to move investment dollars into the most productive parts of the economy. It is not possible to create the kind of investment necessary to create jobs without allowing the free flow of investment capital. A reduction in the capital gains tax rate helps create high technology, high paying jobs.

2) CAPITAL GAINS WILL INCREASE COMPETITIVENESS

We must also understand – as do our major trading partners -- that lower capital gains taxes lead to increased competitiveness. For mid-sized and larger companies, we compete in a truly global financial marketplace where investment dollars are no longer constrained by national borders. For smaller companies and start-ups, that do not yet have the access to the international

marketplace, those companies are constrained by the high cost of domestic equity capital. In either case, because the capital gains tax is an important component of the cost of capital, the rate at which countries tax capital can be an important competitive advantage. Certainly international investment decisions are driven by more than relative tax burdens, but global investment dollars will flow to countries where the aggregate return on investment is greatest.

Virtually all of our major trading partners understand this concept and most of our competitors provide much lower tax rates on capital gains or do not tax capital gains at all. We saw this disadvantage first hand during the 1980's when the cost of capital was at least twice as high in the U.S. as it was in Japan. As a result, many U.S. technology companies obtained investment capital in Japan and, in return, traded critical technology. Currently, the long term capital gains tax rates in Japan and France are 20 percent and 16 percent, respectively. Countries like the Netherlands, Germany, Argentina, Austria, Egypt, and Singapore don't tax long term capital gains at all. A reduction in the capital gains tax rate increases the competitiveness of U.S. technological and financial firms in the global marketplace.

3) CAPITAL GAINS PROMOTES HIGH-RISK / HIGH-RETURN INVESTMENT

The third point I want to make is that there is a high payoff to society, and a clear improvement in the quality of life, from investment in high risk products. Examples might include the development of capital intensive medical devices, which clearly provide significant, long-term returns to society. Or high-speed computing, which helps to give the U.S. the edge in global information markets. Or software development, which has education benefit far in excess of any initial tax expenditure.

While some people may believe that it is inherently wrong for certain individuals to make more money, this country was based on the premise that the return on an investment should be commensurate with the risk. It was Keynes who said "the engine which drives enterprise is not thrift, but profit." And, if we truly want to "push the envelope" on high-risk investments, we must understand that the large majority of high-risk investments have value only because of the prospects of producing future income.

If successful, these investments -- a new computer chip or bio-tech drug -- will pay huge dividends throughout the economy, save lives, increase our quality of life, and -- yes -- will provide a reward to the investors who placed their capital at risk. We will see more jobs, greater productivity, and a broader

tax base. But if unsuccessful the risk takers will get nothing, and run the risk of losing everything. If we want to move money into high-risk investments, we must understand that the risk / reward ratio operates on the margins -- the lower we can push the cost of capital, and the higher we can get the potential rate of return, the better we will do in promoting high-risk, high return investments. A reduction in the capital gains tax rate encourages investors to support risk, high return investments.

4) CAPITAL GAINS IS FAIR

Mr. Chairman, finally I want to emphasize that a capital gains tax cut is fair. As the issue of a capital gains tax cut is debated, few people will challenge the fact that the capital gains tax reductions of 1978 and 1981 "worked" to create new jobs and new companies. Rather, opponents will focus on the peripheral issue of fairness and will argue that the rich will receive a windfall. These same people feel that increasing the financial returns to the wealthy is inherently bad. Presumably they believe that the benefits to the rich will come at the expense of the poor. But the point of reducing the capital gains rate is to invest in our country's long-term economic health for all Americans.

The fact is that the benefits realized as a result of lower capital gains taxes will be reinvested in the American Economy, not in the pocketbooks of the rich. When we reduce the capital gains tax rate we are providing the investment capital necessary for a long-term economic expansion. We are providing jobs for all Americans. We are creating technologies which provide secondary and tertiary societal benefits, far in excess of the cost of a tax deduction. And, we are laying the foundation for the industries of tomorrow.

I would also add that from the perspective of the high technology community, a capital gains tax cut is a middle class tax cut. That is because of the broad based use of employee stock options. Fifty four percent of high growth companies offer stock options – a piece of America's future -- to every single employee. And the practice is even more widespread among smaller high-growth companies. A recent survey of our members showed that eighty-four percent of companies with fewer than one hundred employees offered stock options to every single employee. This is equity we are talking about. Equity for hundreds of thousands of middle class, mid-level employees. Equity which some day will be recognized as capital gains. For these employees, a capital gains tax cut is a middle class tax cut.

CONCLUSION

Mr. Chairman, do we want a tax system that imposes high rates on capital gains, significantly reducing the attractiveness of high-risk / high return investments, and resulting in fewer new jobs, fewer new technologies, and fewer new innovations? Or do we want a tax system with low capital gains rates that encourages investment in emerging high technology and other high-risk ventures that offer great societal and economic returns? From the perspective of high technology companies the choice is clear. Low capital gains taxes encourage risk and capital formation. High capital gains taxes discourage risk and capital formation. It's that simple. Capital formation equals high paying jobs. In order to increase the standard of living for all Americans we should focus on how to make the pie bigger rather than agonizing over how to redistribute the size of the pie we have today.

So, as we go forward with this debate I want to stress that capital gains is about jobs; capital gains increases high-risk investment; capital gains increases competitiveness; and, perhaps most important, capital gains is fair. AEA enthusiastically endorses the capital gains provisions of the Job Creation and Wage Enhancement Act.

I would be pleased to respond to your questions.

Mr. ZIMMER. Thank you.

I would like to remind the witnesses that when the red light goes on your time is up.

Our next witness is David Lietzke, vice president, human resources, Bay Networks Inc., on behalf of the Coalition for American Equity Expansion.

STATEMENT OF DAVID LIETZKE, VICE PRESIDENT, HUMAN RESOURCES, BAY NETWORKS INC., SANTA CLARA, CALIF., ON BEHALF OF THE COALITION FOR AMERICAN EQUITY EXPANSION

Mr. LIETZKE. Mr. Chairman and members of the committee, I am David Lietzke, vice president of human resources for Bay Networks in Santa Clara, Calif.

Bay Networks is a new company reflecting the merger of Synoptics Communications and Wellfleet Communications. Our combined company employs over 3,000 employees and generates over $1 billion in revenue. We design and manufacture computer networking equipment.

Like most fast-growing technology companies, Bay Networks has to compete aggressively for the most talented and productive people at all levels. Therefore, we offer our employees an opportunity to share in the company's success. At present, over 90 percent of our employees receive stock options; and 74 percent of them opt to purchase stock through our employee stock purchase plan.

I appear before you on behalf of the Coalition for American Equity Expansion. CAEE is a group of growth-oriented companies and professional organizations dedicated to the promotion of equity compensation in the American economy. CAEE was a leader in the recent battle to prevent the Financial Accounting Standards Board from destroying broad-based employee equity plans.

Mr. Chairman, I am not here to talk about the impact a capital gains tax might have on my company's tax returns. I am here because of the terrific benefit a capital gains tax cut would give to my employees.

I want to say that the old charge that a capital gains tax cut helps only the wealthy is simply wrong. The capital gains provisions of H.R. 9 will give a significant tax cut to many millions of middle-income American households. I will give you two reasons why this is so.

First, H.R. 9 offers a capital gains tax break for every taxpayer at every income level. It is a much more fair and much more populist approach than current law, which limits capital gains benefits to people in the top two tax brackets.

The second reason this bill is a significant tax cut for middle-income Americans is that there are a lot more people in the 15 and 28 percent tax bracket who have equity investments than we ever realized. I am talking about the millions of employees who invest regularly through employee stock purchase plans and broad-based employee stock option plans. These plans are very different from ESOP, employee stock ownership plans. In the plans I refer to, employees purchase stock with their own aftertax money; and, unlike ESOPs, they are able to hold and vote their own stock.

Both stock options and stock purchase plans are widely used in growth-oriented companies like Bay Networks. However, the participation rate in these plans is hard to quantify, and yet a tremendous number of people are involved.

In his landmark study of employee ownership called "The New Owners," Rutgers professor Joseph Blasi says, "The seemingly quiet purchase of stock in a variety of non-ESOP defined contribution and defined benefit plans constitute almost half the employee ownership in public corporations."

Today CAEE is releasing a new study that begins to document for the first time how many employees are eligible to participate in companywide stock options and stock purchase plans. At our request, Executive Compensation Reports of Fairfax Station, Va., reviewed the proxy statements of more than 1,000 of the Nation's largest firms. They identified 80 firms that go out of their way to volunteer the fact that every employee in the company is eligible to participate in their stock option plan. These companies employ over 2.5 million people.

Additionally, another 230 firms offer section 423 employee stock purchase plans to all of their employees. So these 310 companies alone employ over 7 million people. The great majority of these people are the very middle-income taxpayers that H.R. 9 would help.

And this is just the tip of the iceberg. For every one of these major companies there are many smaller firms that offer stock options or stock purchase plans to all or nearly all of their work force. So we think it is fair to conclude that a politically significant population of middle-income people already have a major stake in this tax cut.

In fairness, I should say these numbers are far from exact, but it is also fair to say that I can't imagine a more effective way to expand the percentage of participation for middle-income people than to enact the capital gains incentive of H.R. 9.

Can I cite you evidence that employees really care about these plans? Yes, I can. Let me remind you that it was these little-noticed stock options and stock purchase plans that led to the recent conflict with the Financial Accounting Standards Board. Never before has FASB had to retreat from a proposal after issuing an exposure draft.

I would like to conclude by saying that cutting the capital gains tax will enhance the return on investments of many millions of middle-income American households. We thank you for proposing H.R. 9, and we urge you to pass it as quickly as possible.

[The prepared statement and attachment follow:]

Statement of David Lietzke
Vice President, Human Resources
Bay Networks Inc., Santa Clara, California
on Behalf of
The Coalition for American Equity Expansion

Before
The House Ways and Means Committee
January 25, 1995

Mr. Chairman, and members of this distinguished Committee. I am David Lietzke, Vice President, Human Resources for Bay Networks Inc.

About Bay Networks

Bay Networks is a new company reflecting the merger of Synoptics Communications of Santa Clara CA and Wellfleet Communications of Billerica MA, outside Boston. Our combined revenues exceed $1 billion. We employ about 3,000 people. Bay Networks designs, manufactures and sells computer networking equipment. Our equipment is a basic building block of the emerging information superhighway.

Like many other fast-growing technology companies, Bay Networks competes aggressively for the most talented and productive people at all levels in our organization. A key to our ability to attract and retain all of our employees is the opportunities we offer them to share in the growth of the company through our company-wide stock option plan and our employee stock purchase plan. At present 97% of our employees receive stock options and 74% have opted to purchase Bay Networks stock through our employee stock purchase plan.

About CAEE

I'm appearing before you today on behalf The Coalition for American Equity Expansion. CAEE is a group of growth-oriented companies and professional organizations dedicated to the promotion of equity compensation in the American economy. CAEE was a leader in the recent successful battle to prevent the Financial Accounting Standards Board from wounding America's best-managed companies by making their company-wide employee equity compensation plans prohibitively expensive.

SUMMARY OF TESTIMONY

Mr. Chairman, I'm not here to talk about what a capital gains tax cut would do for my company's tax return. I'm here because of the terrific benefit such a cut will provide to my company's employees and the employees of thousands of other firms with broad-based employee equity plans like ours.

The old charge that a capital gains tax cut just helps the wealthy is simply wrong. Your capital gains proposal would provide a significant tax cut for many millions of middle income American households. I'll offer two arguments to support that statement.

First, unlike the capital gains provision in current law, H.R.9 specifically extends a significant capital gains differential to middle income taxpayers in the 15 and 28 percent tax brackets. That's the right thing to do. This vital investment incentive shouldn't be restricted to people with the highest incomes as it is today.

Second, there are a lot more people in the 15 and 28 percent tax brackets with equity investments in plans sensitive to a capital gains cut than most of us realize. In the last 20 years there has been a huge increase in employees owning stock in their own companies through company-wide stock purchase plans and broad-based stock option plans. These non-ESOP employee ownership plans are widespread and growing, but they're hard to quantify. Their aggregate impact has escaped most of us because these plans don't have to be registered in any one place and because they don't generate a tax expenditure that forces them to be quantified and reexamined every few years.

> "The seemingly 'quiet' purchase of stock in a variety of non-ESOP defined contribution and defined benefit plans constitute almost half the employee ownership in public corporations."
>
> Joseph Blasi, *The New Owners: The Mass Emergence of Employee Ownership in Public Companies*, HarperCollins, NY, 1991, pg. 28

Today we are presenting a new study that begins to document how many more people are benefiting from stock options and stock purchase plans than is commonly recognized. A review of the proxy filings of 1,013 of the nation's largest firms reveals that nearly a third of these companies (310) already offer company-wide stock options or employee stock purchase plans to their employees. (Some companies offer both.) When we added up the numbers we were amazed to discover that these 310 companies alone employ over seven million people! See Appendix 1 & 2.

And we can show that this is just the tip of the iceberg. For every one of these giant companies with employee equity plans there are many smaller firms that offer stock options to all or nearly all of their workforce. And every Sec. 423 stock purchase plan is required by statute to be open to all employees after two years service. A series of industry surveys has documented this trend. Therefore, we think it's fair to conclude that a politically significant population of middle income people already have a major stake in this tax cut.

Cutting the tax on capital gains will increase the return tens of millions of middle income households receive from their equity investments. It will make employee equity programs much more valuable to both employees and companies. That will dramatically accelerate the spread of these programs and increase the income security of millions of additional families.

DISCUSSION AND DOCUMENTATION

I. The Populist Capital Gains Provisions of H.R. 9 Are More Equitable Than Current Law

Capital Gains Under the 1993 Tax Act

The Clinton Administration's Omnibus Budget Reconciliation Act of 1993 raised the top marginal tax rate from 31 percent to 39.6 percent, while keeping the top rate for long term capital gains at 28 percent. This had the beneficial effect of restoring a meaningful broad-based capital gains differential that encourages long term equity investment.

But the only people who have derived any benefit from this new differential are the tiny fraction of Americans with income that puts them into the tax brackets above 28 percent. To be helped by the 1993 provision, married taxpayers filing jointly, must have *taxable income* higher than $91,850—after all their deductions and exemptions. Single taxpayers must have a taxable income above $55,100 to benefit. As the supporters of the 1993 bill like to point out, its provisions only affected two percent of America's households. That approach provides no relief for the vast majority of Americans with mutual funds, employee stock purchase plans, stock options or homes to sell.

Under the 1993 tax act, taxpayers in the 15 and 28 percent tax brackets who sell assets they've held for several years are forced to pay tax on artificial gains caused by inflation. And they're taxed at their full ordinary income rates, while those in the top brackets enjoy a substantial break. Investment income earned over several years is taxed as if it had been earned in a single year, which can unfairly push taxpayers into higher tax brackets.

Capital Gains Under H.R.9

By contrast, H.R.9 offers a capital gains tax break for taxpayers at every income level. The bill would allow all taxpayers to exclude fifty percent of their gain on long term assets and pay tax on the remainder at their ordinary income rates. Taxpayers in the 15 percent bracket would pay an effective tax rate of 7.5 percent, those in the 28 percent bracket would pay 14 percent, and those in the 39.6 percent bracket would pay 19.8 percent on their capital gains.

The capital gains provision of H.R. 9 would build the U.S economy by encouraging the vast majority to Americans to make long term equity investments and prevent their gains from being destroyed by inflation. It offers a much more equitable approach than current law which reserves these vital incentives for those at the top.

II. Millions of Middle Income American Households Already Have a Stake in a Capital Gains Tax Cut Because of Company-Wide Stock Options and Stock Purchase Plans

What are Employee Stock Purchase Plans?

These statutory plans (IRC Sec. 423) allow employees to purchase their company's stock at up to a 15% discount, generally through payroll withholding. In an approved plan, after a holding period, taxes on the discount and any gain in the underlying stock are deferred until sale of the stock. At sale, the original purchase discount is taxed at ordinary income rates and any gain on the stock receives capital gains treatment. By law every employee with more than two years service must be allowed to participate equally in these plans. For example, at Bay Networks, we have a ceiling of $10,800 per year for employee stock purchases through our plan. Employees at all levels have the same ceiling.

What are Employee Stock Option Plans?

Employee stock options are rights granted to employees to purchase stock in their company for a specified time (no more than ten years) at a specific price (usually the fair market price of the stock at the time the option is granted.) Both stock option and employee stock purchase plans require shareholder approval.

Both these plans differ from ESOPs in that the employees purchase their own stock with after tax money. They hold and vote their own stock. They may sell it anytime or hold it. In the absence of a capital gains differential most employees today sell immediately when they purchase their stock. H.R. 9 would provide a strong tax incentive to encourage more employees to hold onto more of their stock after exercise to earn a better return.

Employee Equity Plans are Vitally Important to America's Growth Companies

Both stock options and stock purchase plans are widely used in growth-oriented companies. Stock options allow young, cash-strapped firms to start up and compete against more established companies for scarce technical talent. They help create new jobs by stretching scarce venture capital. Stock purchase plans allow employees to share in the growth of their company on a discounted, tax deferred basis. Equity ownership aligns the interest of employees with shareholders and creates an entrepreneurial climate that enhances competitiveness. This is employee empowerment through ownership. Employees in these firms aren't just a factor of production called "labor," they're stakeholders.

Company-wide stock options and stock purchase plans are the greatest mechanism for sharing wealth since the family farm. Their emergence is a uniquely American development. None of our foreign competitors have yet learned how to generate the kind of company-wide employee commitment and creativity that these plans generate. As Senator Lieberman said during the recent FASB debate, "Employee equity is America's edge in global competition. It's our secret weapon."

FASB Can Vouch For The Intense Commitment of Both Employees and Companies to These Plans

If some of these arguments sound familiar, it's because you heard a lot of them recently during the battle over FASB's attempt to change the accounting treatment of these very plans. In its twenty year history FASB had never had to retreat from a proposal after issuing an exposure draft. But when they threatened to extinguish these broad-based plans, they were inundated and eventually overcome by the intensity of the opposition of America's growth companies.

And what a boring topic to get excited about! Most people would rather snort a skunk than have to get up to speed on an accounting issue—but not this one. It's hard to imagine a rally in Silicon Valley—the first ever, on any topic—with over four thousand people from 130 companies turning out—with a marching band—to protest an esoteric accounting change. But that's what happened.

I want to emphasize that it was the threat to company-wide stock options and stock purchase plans that generated this unprecedented war. No one fought FASB over ESOPs. They weren't affected. No one fought FASB to save their 401(k). They were barely affected. What was threatened was the chance for rank-and-file employees to share an equity stake in their own companies. It's this populist dimension and the widespread use of these plans that made fixing the FASB problem a political priority in states like California, Texas, New Jersey, Oregon and Washington.

While I'm here, I'd like to personally thank the members of this committee who helped persuade FASB to withdraw its damaging proposal. We're especially grateful to those who sponsored H.R. 2759, The Equity Expansion Act: **Mr. Payne, Mrs. Johnson of Connecticut, Mr. Archer, Mr. Herger, Mr. Johnson of Texas, Mr. McDermott, Mr. Thomas, and Mr. Zimmer.** Your work on that issue has made it possible for millions of American families to continue to benefit from broad-based employee equity plans that would have disappeared under FASB's proposal.

Nearly a Third of the Nation's Largest Firms Already Offer Stock Options or Stock Purchase Plans to All Their Employees

Mr. Chairman, when we set out to try to make these non-ESOP employee equity programs more visible to you, we had no idea what big numbers we'd be uncovering. But the employment of these giant firms really adds up.

Fortunately, we learned that Executive Compensation Reports, of Fairfax Station, Virginia regularly reviews the proxy statements of more than a thousand of the nation's largest firms taken from *Fortune 500* Service and Industrial lists, and the *BusinessWeek* Corporate Scoreboard 1,000. At CAEE's request, ECR examined 1013 major firms, using its ECRInfo data base. They identified 80 major firms that report their entire workforce is eligible to participate in their stock option plan. When we checked the employment these companies report to *Standard and Poor's*, we discovered they employ over 2.5 million people! These firms are listed in Appendix 1.

ECR was also able to identify 230 that offer Section 423 employee stock purchase plans to all of their employees. Even though a few of these companies don't list their employees with *Standard and Poor's*, the rest employed over 4.5 million people in 1994. They are listed in Appendix 2. That's a total of over 7 million people from just these 310 companies!

(We deleted companies that offer both company-wide stock options and stock purchase plans from the purchase plan list and counted them only once in the combined total.)

Over 7 Million Employees are Eligible to Benefit From the Capital Gains Cut From These Large Companies Alone

Since both stock options and 423 plans share the same equity investment characteristics, it's fair to say that over 7 million employees of these major firms have a direct stake in the capital gains tax cut that is before you. In almost all of these companies, the great preponderance of the employees are in the middle income categories that H.R. 9 targets for relief.

Mr. Chairman, I hope you and the other members of this Committee will look at this list. You're likely to find constituent companies and other allies of yours that grant stock options and option-like stock purchase plans to their entire workforce. Please remember this list the next time someone tries to tell you that stock options are just a rip-off for fat cats.

Many Smaller Firms Offer Broad-Based Employee Stock Plans

For every one of these giant firms that offer company-wide equity compensation programs, there are many smaller companies doing the same thing. They're just harder to quantify. A series of industry surveys consistently shows that smaller growth-oriented firms use broad-based employee equity programs extensively.

As part of the effort to persuade FASB to drop its proposal, in November 1993, the NASDAQ Stock Market surveyed the companies it lists and received a large response (2185, almost 53% of their listed companies). Significantly, a full 30 percent of these companies reported that if FASB dropped its proposal,s they planned to broaden the scope of their stock option plans to include lower levels of employees. And this was before a capital gains tax cut, which should accelerate that trend even more.

More recently an electronics industry survey by the American Electronics Association and ShareData in September 1994 received 600 respondents. Over 300 of those companies grant stock options to all their employees. 83.3% of the companies with fewer than 100 employees grant options to every employee. Employees below the senior management level received 65% of all the stock that was granted by all the companies. A 1990 survey by the Biotechnology Industry Organization found that 75% of its companies used stock options and 60% granted them to their entire work force.

It's also important to notice that professional venture capital firms are strong advocates of broad-based employee equity plans. American venture capitalists are among the most sophisticated corporate investors, directors and shareholders in the world. They consistently insist that their portfolio companies establish and maintain extensive employee stock compensation plans that cover all or nearly all of their work force. And they're not hesitant to say why. The professional venture capital industry has learned over the years that broad-based employee stock ownership is essential to achieving the dramatic returns that professional venture capital investors seek.

H.R. 9 Will Increase Participation in Existing Plans

Mr. Chairman, I want to emphasize that we're not able to give you precise numbers here. We're just trying to help you see an important movement in the economy that has been under reported in the past. We recognize that these employment numbers overstate the population that actually benefits from these programs today. First, these are world-wide employment figures. Some of the people included live in other countries and may or may not pay U.S. taxes. We couldn't adjust for that in time for this hearing. Second, we know that not all employees choose to participate in their company's plans today. But I can't think of a more effective way to expand the percentage that do participate than to enact the capital gains incentives of H.R. 9.

CONCLUSION

FASB's proposed accounting change left a cloud of uncertainty over equity compensation programs in the U.S. for a full decade. Despite that, these plans continued to proliferate because they're so valuable to employees. The demise of FASB's threat, combined with a significant new capital gains tax incentive, could usher in a golden age of employee ownership and employee empowerment.

We strongly urge you to enact the capital gains provisions of H.R.9.

C A E E
The Coalition for American Equity Expansion
1155 15th St. NW, Suite 710, Washington, DC 20005 (202)659-9101 Fax: (202)775-9078

Appendix 1

80 Major Firms With Employee Stock Option Plans Open to All Employees

Company with number of employees

Advanced Micro Devices	11,380
AirTouch Communications	n/a
Allied Signal Inc	89,300
Amgen Inc	2,225
Amoco Corporation	47,000
AST Research Inc	2,855
Avnet Inc	6,700
Baker Hughes	10,600
Bed Bath & Beyond, Inc	1,600
Beverly Enterprises	109,000
Best Buy Co., Inc	2,500
Block, Inc	62,000
Boeing Co	142,543
Brinker International	12,400
Chesapeake Corp/Virginia	6,062
Cintas Corp	7,000
Cirrus Logic, Inc	478
Clark Equipment Co	6,316
Century Communications	2,000
Consolidated Papers	4,782
Commonwealth Edison Co	19,000
Compaq Computer	9,800
Computer Sciences Corp.	28,000
Crestar Financial Corp	6,495
Cyprus Amax Minerals	7,011
Dean Corp	35,000
Data General Corp.	8,530
Dell Computer Corp	1,300
Dexter Energy	625
Dupont (E.I.) de Nemours	135,000
Duracell International	9,000
Edwards (A.G.)	10,029
Eastman Chemical Co	12,000
Equifax Inc	12,400
Ethyl Corp	6,000
Forest Laboratories, Inc	1,200
GEICO Corp	7,322
General Mills, Inc	130,000
Helene Curtis Industries	3,200
Hewlett-Packard Co	94,800
Honeywell,Inc	55,440
Huntington Bancshares	6,819
IBECEA Group Inc	10,000
Intelligent Electronics	625
Itel Corp	24,800
Jostens, Inc	9,000
Kansas City Southern Inds	3,724
Kellogg Co	16,500
Kemper Corp	9,800
Kroger Co	170,000
Lotus Development Corp *	4,000
Marion Merrell Dow	9,122
Master Corp	9,600
Medtronic, Inc	6,308
Meredith Corp	2,200
Merck & Co, Inc	26,400
Minnesota Mining & Mfg Co	87,015
Nordson	2,937
Oracle Systems Corp	3,180
Outboard Marine Corp	8,449
Pacific Enterprises	9,800
PepsiCo, Inc	308,000
Perkin-Elmer Corp	6,000
Pfizer, Inc	42,000
Premark International	22,000
QUALCOMM Inc	619
Rehr Industries	7,000
Scott Paper Co	22,800
Southtrust Corp	6,454
Texas Instruments, Inc	60,577
Tosco Corp	1,760
Toys "R" Us	80,000
TRINOVA Corp	15,923
Union Texas Petroleum	1,000
USF&G Corp	n/a
Vons Companies, Inc	35,000
Wal-Mart Stores, Inc	298,000
Wang Laboratories,Inc	16,757
Warnaco Group, Inc	11,700
Warner-Lambert Co	33,000

Appendix 2

230 Major Firms With Employee Stock Purchase Plans Open to all Employees

Company with number of employees

ADC Telecommunications	2,308
American Elec Power Inc	2,441
American Internat'l Group	22,000
Alco Standard Corp	22,800
Alltel	12,576
Alexander & Baldwin	3,128
Alza Corp	1,020
Amdahl Corp	9,400
American Medical Holdings	20,600
American Premier Underwrt	n/a
Anacomp, Inc	5,800
Analog Devices, Inc	5,300
Andrew Corporation	3,000
Anheuser-Busch Cos	44,835
Applied Materials, Inc	3,900
Apple Computer	14,835
Armstrong World Industr's	22,820
Ameritech Tel & Tel Co	812,700
Automatic Data Processing	21,000
Autodesk, Inc	1,808
Ball Corp	14,000
Baxter International, Inc	61,200
Beckman Instruments, Inc	6,900
Bain (A.H.)	2,788
Beneficial Corp	6,800
Biogen, Inc.	280
BJ Services Company	2,600
Bank of New York Co., Inc	12,947
Brooklyn Union Gas Co	2,625
Black & Decker Corp	22,800
Bank South Corp	2,888
Bostonian's Bancshares, Inc	6,400
Burlington Northern Inc	23,000
Cablevision Systems Corp	4,500
Cabletron Systems	1,200
Capital Cities/ABC, Inc	19,250
Carnival Cruise Lines	1,400
CBI Industries, Inc.	14,000
Centerior Energy Corp	8,582
Charming Shoppes, Inc	8,300
Chiquita Brands Internat'l	45,000
Chiron Corporation	1,900
Chemical Banking Corp	29,687
Chris-Craft Industries	1,200
Chubb Corp	10,100
Circuit City Stores Inc	20,000
Cisco Systems, Inc.	1,941

Citicorp	88,500
Citizens Utilities	2,300
CML Group, Inc	5,000
Continental Bank Corp	4,158
Coastal Corp	19,700
Columbia/HCA Healthcare	6,300
COMSAT	1,644
ConAgra, Inc	80,787
Conner Peripherals, Inc	3,000
Consolidated Edison - NY	18,718
Cooper Industries, Inc	50,000
Corning Inc	32,500
Cray Research, Inc	5,000
CUC International	6,000
Cummins Engine Co, Inc	23,400
Dauphin Deposit	2,127
Deere & Co	34,500
Deluxe Corp	17,400
Digital Equipment Corp	124,000
Donnelley (R.R.) & Sons	2,500
Dow Chemical Co	62,000
Dow Jones & Co, Inc	9,400
Eastern Enterprises	4,300
Edwards (A.G.)	10,029
EG&G, Inc	20,000
Engelhard Corp	6,400
ENSERCH Corp.	11,000
First Bank System	10,337
Food Lion	60,000
Federal Express Corp	93,000
Federal Home Loan	50
Federal Nat'l Mortgage Assn	2,400
First Fidelity Bancorp	135
First Financial Mgmt Corp	9,600
First Security Corp	5,606
Fleming Cos, Inc	22,900
Flight Safety Internat'l	2,500
Fourth Financial Corp	2,100
First Chicago Corp	17,000
First Union	23,459
G-I Holdings	4,163
Georgia Gulf Corp	1,074
Georgia-Pacific Corp	52,000
Gateway 2000	n/a
Genentech, Inc	n/a
GTE Corp	131,000
Hannaford Brothers Co	14,000
Hanson Inds. N. America	41,000
Hercules Inc	72,000
Holnam	3,000
Home Depot	45,000
HON Industries	5,700
Hudson Foods	7,659
Hunt (J.B.) Trans Svcs	8,478
International Bus Machine	201,000
Imperial Holly Corp	1,840
Inland Steel Industries	12,000
Integra Financial Corp	5,000
Intel	24,600
Interpublic Group of Cos	16,500
Intergraph	10,000
John H. Harland Co	6,200
James River Corp of VA	39,000
Kaman	5,424
KLA Instruments Corp	950
Knight-Ridder, Inc	22,000
Lafarge	8,300
Louisiana-Pacific Corp	13,000
Legent Corporation	2,000
Leggett & Platt, Inc.	11,400
Long Island Lighting Co	6,500
Limited, Inc	90,000
Lincoln Electric Co	6,600
LG&E Energy Corp	n/a
LSI Logic Corp	3,300
Lubrizol Corp	4,600
M/A-COM Inc	4,763
Marriott International	21,000
Martin Marietta Corp	55,670
Maytag Corp	21,407
McCormick	7,501
MCI Communications	34,000
McKesson Corp	14,150
Medtronic, Inc	6,303
Mercantile Bancorp	4,417
Mercury Finance	572
Merrill Lynch & Co	40,000
Microsoft Corp *	12,500
Midwest Resources, Inc	3,100
Miller (Herman)	5,400
Minnesota Mining & Mfg Co	87,015
Minnesota Power & Light	3,200
Marshall & Isley Corp	6,001
Marsh & McLennan Cos, Inc	25,800
National Gypsum Co	n/a
NICOR, Inc	3,500
NIPSCO Industries, Inc	4,646
NorAm Energy Corp	n/a
Novell Corp	3,500
National Semiconductor	26,200
New York State Elec & Gas	4,888
New York Times Co	10,100
Office Depot, Inc	12,400
PacifiCorp	15,216
Pacific Telecom	21,891
Pennzoil Co	11,634
Pentair	8,700
Peoples Energy	3,441
Philip Morris, Inc	161,000
Pier I Imports	10,350
Pittston Co	20,100
PNC Bank Corp	18,815
Policy Management Systems	4,383
Portland General Corp	2,745
Price (T.Rowe) Assoc	1,371
Public Serv Enterprise Gp	12,761
PSI Resources, Inc	n/a
Quantum Corp	1,762
Questar Corp	2,658
Raychem	10,000
Reader's Digest Assn, Inc	7,400
Reebok International Ltd	4,200
Reliance Electric	14,000
Ryder System, Inc	40,000
Safety-Kleen Cor	6,800
Salomon Inc	8,900
Schlumberger Ltd	51,000
Scientific-Atlanta Inc	3,000
SciMed Life Systems, Inc	1,300
Seagate Technology	39,000
Service Corp Internat'l	11,500
ServiceMaster Ltd Partners	21,800
Shoney's, Inc	29,000
Signet Banking Corp	4,697
Silicon Graphics	3,400
St. Jude Medical, Inc	674
Snap-On Tools Corp	7,000
SONAT	4,000
Sprint	50,000
Stanley Works	19,000
Storage Technology Corp	1,300
Stride Rite Corp	3,700
Sunbeam-Oster Company Inc	11,000
Sun Microsystems, Inc	12,500
Southwest Airlines Co	11,400
SynOptics Communications	1,700
SYSCO Corp	23,000
Tambrands	3,800
Tandem Computers	10,784
Tandy Corp	41,000
Tektronix, Inc	10,200
Tele-Communications	34,000
Telephone & Data Systems	3,803
Teradyne, Inc	4,150
Texas Instruments, Inc	60,577
Thermo Electron Corp	6,166
Torchmark Corp	5,968
Transatlantic Holdings	240
The Travelers, Inc	30,000
Tribune Co	12,900
Triton Energy Corp	945
Total System Services	750
Tyson Foods	49,686
Universal Corp	n/a
United States Cellular	160
United HealthCare Corp	3,113
Universal Foods Corp	5,400
United States Surgical Co.	8,100
UNUM Corp	7,000
UtiCorp United	4,300
Vanguard Cellular Systems	600
Varian Associates	9,300
Wallace Computer Services	3,300
Walgreen Co	50,000
Wells Fargo & Co	21,300
Western Digital Corp	7,300
Willamette Industries	12,000
Winn-Dixie Stores, Inc	39,000
Woolworth Corp	74,000
Washington Water Power Co	1,401
Westinghouse Elec Corp	109,000
Xilinx, Inc	550
York International	12,500

Sources

Company Listing: ECRInfo data base, Executive Compensation Reports, Fairfax Station, Virginia

Employee Numbers: *Standard & Poor's Register of Corporations*, Vol 1, 1994 McGraw-Hill Inc., NY, NY

n/a = not available in S & P

* American Electronics Assn. 1994 Membership Directory

Mr. ZIMMER. Thank you.

The next witness is Richard Herring, vice chair for advocacy, National Small Business United, and general manager of the Gloucester Co., Franklin, Mass.

STATEMENT OF RICHARD HERRING, VICE CHAIR FOR ADVOCACY, NATIONAL SMALL BUSINESS UNITED; AND GENERAL MANAGER, THE GLOUCESTER CO., INC., FRANKLIN, MASS.

Mr. HERRING. Thank you, Mr. Chairman and members of the committee.

As you say, I am Richard Herring. I am general manager of Gloucester Co., Inc., in Franklin, Mass. Gloucester Co. employs 40 and is a small manufacturer of caulking compound. Our caulking compounds are under the brand name of Phenoseal.

In New England, I am a past board member of the Smaller Business Association of New England, which is a member association of National Small Business United. Nationally, I serve as vice chair for advocacy for National Small Business United.

We at National Small Business United very much appreciate the opportunity to be here. NSBU represents over 65,000 small businesses in all 50 States. Our association works with elected and administrative officials in Washington to improve the economic climate for small business growth and expansion. We have always worked on a bipartisan and proactive basis. In addition to individual small businessowners, the membership of our association includes local, State and regional small business associations across the country.

Discussion of the enormous use of informal and middle-class investors in small business raises one of the most hotly debated and widely misstated products of a capital gains differential, that it primarily benefits the wealthy. The statistics suggesting that recipients are rich are misleading. Many small businessowners work a lifetime to build a growing and successful business. The business' one-time sale is a capital gain, but it really represents a lifetime of earnings that got ploughed back into the business to make it grow and to create jobs. To be sure, 1 year's income with a capital gain may seem substantial but is not recurring and does not make them rich.

Let me discuss Gloucester Co. a little bit. When my father decided to start Gloucester Co., he had no investment. There were no venture capitalists interested in helping him start his business. Gloucester Co., in essence, was just another undercapitalized small business.

Over the first 5 years, my mother and my father reinvested all their earnings to grow the company. Today, 35 years later, Gloucester Co. still believes in ploughing our earnings back into the company; and, as a result, we are now seeing the success of those earlier years.

The question today is this: Should reinvestment be encouraged or discouraged? Currently, the capital gains tax discourages reinvestment. And while the proposed cut in capital gains recommended in the Contract With America encourages reinvestment, what I would

propose is that a long-term, graduated capital gains tax will do more to reward reinvestment.

More importantly, we must realize that small businessowners face regular decisions about how much income to take out of the business and how much to reinvest back into business growth and expansion.

To the extent that investment and other income are taxed at the same rates and given the time value of money, the Tax Code strongly encourages businessowners to take profits now and not wait for future growth. This mistake is a fundamental one that can have a profound effect on the ability of a business to grow and create jobs.

In order to make the taxation of capital gains beneficial for investment, NSBU has long recommended the establishment of a broad-based capital gains exclusion, such as the one proposed in the GOP Contract. But in order to assure that the exclusion is helping long-term investment rather than short-term gain, NSBU has further recommended the graduation of that differential based on the holding period of the asset. Essentially, we would lower the rate as the holding period rises.

The proposal in the Contract would give all capital gains the same reduced tax rate. While this is certainly beneficial to small business, focusing the proposal on long-term gains would maximize its benefits. Such a structure might also reduce or eliminate the statically scored revenue loss attributed to a capital gains rate reduction.

One of the ways that the proposal could help long-term investment and small business is indexing gains to inflation. This provision exclusively benefits long-term gains, and capital gains in small businesses are almost exclusively long term.

The indexing debate is about fairness. A small businessowner should not be taxed on profits that come only from inflation and have not been truly realized. This problem was fixed for ordinary income tax "bracket creep" almost 15 years ago. It is time to correct this inequity on the capital gains side as well.

Thank you.

[The prepared statement follows:]

Statement of
Mr. Richard Herring, Gloucester Company
Franklin, Massachusetts
Before the House Ways & Means Committee
Regarding Capital Gains & Other Small Business Tax Issues
On Behalf of National Small Business United

January 25, 1995

Mr. Chairman and Members of the Committee:

My name is Richard Herring, and I run the Gloucester Company in Franklin, Massachusetts. The Gloucester Company is a small manufacturer of caulking compounds. In New England, I am a board member of the Smaller Business Association of New England (SBANE). Nationally, I serve as the Vice Chair for Advocacy for National Small Business United (NSBU). We at NSBU very much appreciate the opportunity to be here.

National Small Business United represents over 65,000 small businesses in all fifty states. Our association works with elected and administrative officials in Washington to improve the economic climate for small business growth and expansion. We have always worked on a bi-partisan and pro-active basis. In addition to individual small business owners, the membership of our association includes local, state, and regional small business associations across the country.

We are here today to address small business tax policy, chiefly the capital gains tax. First, I would like to make some general comments about the tax code. Though NSBU had many serious concerns about the 1986 Tax Reform (such as the elimination of a capital gains differential), NSBU was very encouraged by one aspect of its passage: there was an attempt by the framers of the 1986 Tax Reform Act to elevate the new code to a more permanent status and resist significant future change. We all know that this protection of the code did not last long. After the relatively significant tax code changes in 1990 and again in 1993, it must be recognized that the present tax system has become a fluid set of rules which bend to influence. But business owners need a clear set of rules they can count on for the future. This need is even greater for taxes with long-term implications, such as capital gains taxes. If capital gains reform is enacted in this Congress, there must be a long-term commitment to keep the new rules in place.

When the next major tax debate is over and a new tax code is in place, we should make a stronger national commitment to its permanence. The underpinnings of any tax code are supposed to be simplicity, fairness, and consistency. While we are always debating our system's adherence to the first two principles, we clearly violate the third. Small businesses simply cannot cope with the ever-changing nature of the tax code.

Given this overview, I will next try to make the clear small business case for a capital gains tax rate reduction, especially on long-term investments. In addition, I will take this opportunity to comment on several other small business tax proposals found in the Contract with America and add some additional ideas, as was suggested by the Committee.

- **Capital Gains**

A reduction in the capital gains rate is critical for the economic future of this country and its small businesses. The economic boom of job creation witnessed especially during the first half of this decade was mostly a product of small businesses, and a reduced capital gains rate will add the necessary incentive for small businesses to continue start-ups, growth, innovation, and job creation.

The bases of small business success have traditionally been entrepreneurship, innovation, and risk-taking. For these elements to occur in unison, they must be properly rewarded. Few things can provide that reward better than a capital gains differential, as has been recognized since 1921 when the differential was first introduced. But the tax reform measures of 1986 brought elimination of any capital gains differentials or exclusions. In the last few years, a capital gains differential has come into existence, only because ordinary income tax rates have risen, while the top capital gains tax rate has remained at 28 percent. In addition, a smaller targeted capital gains tax cut was passed as part of the 1993 law. This provision allows an individual who invests in the original issue of stock from a "C" Corporation valued at less than $50 million and holds it for five years to exclude half of the gain from taxation. But this provision is of no benefit to the S Corporations, partnerships, or sole proprietorships which constitute the lion's share of the small business community.

Capital gains incentives have traditionally been seen as a tool of venture capitalists and wealthy investors. But we must remember the vast networks of informal investors in the small business community. Research conducted by the Small Business Administration shows that informal equity investors in small firms are a much larger financing factor than venture capital. Annual informal investment is very conservatively estimated to be 2 to 3 times the $4 billion invested annually by venture capital companies in the U.S. Other studies have estimated the annual flow of informal equity to be over $30 billion.

One of the primary impediments to the economic success of smaller enterprises is the incredible scarcity of capital for that sector. Banks either will not provide funds for small businesses (finding it too risky) or will only provide the necessary capital at prohibitively high interest rates or under other adverse terms. Meanwhile, venture capitalists require enormous growth potential for most of their investments. So, most small business capital comes from family, friends, and the personal resources of small business owners. The capital gains tax levied on these people can reduce their incentive to invest in the first place. A reduction in the capital gains rate would not only give some relief to these overburdened individuals, it would also create additional entrants into the small business capital markets.

Discussion of the enormous use of informal (and middle class) investors in small business raises one of the most hotly debated and widely misstated products of a capital gains differential: that it primarily benefits the wealthy. The statistics suggesting that recipients are rich are misleading. Many small business owners work a life-time to build a growing and successful business. That business' one-time sale is a capital gain, but it really represents a lifetime of earnings that got plowed back into the business to make it grow and to create jobs. To be sure, that one-year's income (the one with the capital

gain) may seem substantial, but it is not recurring, and it certainly does not make them "rich."

More importantly, we must realize that small business owners face regular decisions about how much income to take out of the business and how much to reinvest back into business growth and expansion. To the extent that investment and other income are taxed at the same rates (and given the time value of money), the tax code strongly encourages business owners to take profits now and not wait for future growth. This mistake is a fundamental one that can have a profound effect on the ability of a business to grow and create jobs.

In order to make the taxation of capital gains beneficial for investment, NSBU has long recommended the establishment of a broad-based capital gains exclusion, such as the one proposed in the GOP Contract. But, in order to assure that the exclusion is helping long-term investment rather than short-term gain, NSBU has further recommended the graduation of that differential based upon the holding period of the asset. Essentially, we would lower the rate as the holding period rises. The proposal in the Contract would give all capital gains the same reduced tax rate. While this is certainly beneficial to small business, focusing the proposal on long-term gains would maximize its benefits. Such a structure might also reduce (or eliminate) the statically scored revenue loss attributed to a capital gains rate reduction.

One of the ways that the proposal could help long-term investment in small business is indexing gains to inflation. This provision exclusively benefits long-term gains, and capital gains in small businesses are almost exclusively long-term. Really, the indexing debate is about fairness. A small business owner should not be taxed on "profits" that have come only from inflation and have not been truly realized. This problem was fixed for ordinary income tax "bracket creep" almost 15 years ago. It is time to correct this inequity on the capital gains side as well.

- **Taxes on Estate**

An issue of long-standing concern for many small business owners is the tax on inherited property. For years, families have been faced with the problem of liquidating the family business in order to pay for the taxes on its inheritance. In order to help these small business owners pass on their businesses in its entirety, the federal government has allowed the first $600,000 of an inherited company's worth to be nontaxable. The problem, of course, is that many small businesses are worth much more than $600,000, and liquid assets for taxation can be hard to come by. Furthermore, this exemption was instituted more than a decade ago, and inflation has greatly diminished its value since that time.

NSBU is supportive of the Contract's proposal to raise the exemption (really, the unified credit) level to $750,000 and index it for inflation. This step will halt the erosion in the tax position of many small family businesses. But NSBU is eager to find more innovative and equitable ways to allow the continuation of family businesses. For instance, there have been proposals to treat tangible, illiquid, productive assets (such as a small business) more generously than other assets (such as cash or collectibles) for estate tax purposes. One way of doing this is to eliminate the tax entirely for the inheritance of a family business (with a carryover basis) as an elective alternative. Not

only would such a change make it easier for a small business to survive the death of a principle owner, it would encourage others to make productive investments with their assets.

- **Improving Depreciation: Expensing and Neutral Cost Recovery**

The Contract with America contains a very helpful small business provision, an increase in "expensing" from a maximum of $17,500 per year to $25,000 per year. This provision allows small businesses to immediately deduct (expense) this amount of equipment purchase in the year of the transaction. This increased deduction would be very helpful for cash-strapped small businesses that are ready to grow and improve or enlarge their capital base. Increased ability to expense these investments should enhance the long-term productivity of American small business, and we recommend that the expensing provision be further increased to perhaps as much as $100,000.

Another proposal in the Contract is called neutral cost recovery, which essentially factors inflation into the depreciation schedule and allows businesses to claim, in the long run, more depreciation than the actual cost of the asset. Under the scheme, depreciation would be less in the early years, but considerably higher in the out years. This new depreciation system is very complex, which greatly reduces that likelihood that small businesses will make wide use of it. The backloading effect of the benefit is also likely to be unpopular with small businesses, since they often have poor cash flow and a limited line of credit. In general, small businesses would prefer to have an immediate write-off (such as the expensing provision) or at least be allowed to write-off depreciation sooner rather than later. While there may be small businesses who can benefit, it appears that this provision was primarily written with certain large industries in mind. But there is another alternative which would create a strong investment incentive and relatively little real revenue cost: a business expansion tax deferral.

Given the need for both tax-based incentives to encourage business growth and expansion and continued deficit reduction, new and creative tools need to be identified that fit both of these bills. Following is one idea that could create exactly this sort of win-win situation: a business expansion tax deferral.

There should be a dollar-for-dollar one year deferral of all net income tax liabilities, to the extent that there are increases in net depreciated value of fixed assets (other than real estate) and the book value of inventory. In other words, for every dollar that a business increases its net assets by investing in plant and equipment, it can defer a dollar of federal income tax. Since such a plan does not reduce total tax liabilities, a fair model would score it as at least budgetarily neutral over time; if the economic growth the deferral will stimulate were counted, there would be revenue gains. But since the plan would ease tax burdens *in the years in which growth is actually occurring*, economic growth should be markedly strengthened. Though the deferral would only extend for one year, further increases in net depreciated assets could further extend the deferral.

Further details of the plan include:

1. The deferral amount would be based upon the net increase in the depreciated value of the fixed assets and the tax basis of the inventory;
2. If the increase exceeds the tax liability, the excess could be carried over.
3. In order to avoid taxpayer "game-playing", the immediately preceding year's

decrease in assets would be subtracted from the current year's increase in assets, so that taxpayers would not plan their acquisitions only in alternate years.

4. The tax deferral would be interest free.

We believe this idea holds a great deal of promise. The deferment could be a great help to rapidly growing companies (the ones where most of the job gains occur) while not seriously affecting total federal revenues over time. We hope the Committee will be able to give it serious attention.

- **Home Office Deduction**

NSBU was very pleased to see that the Contract deals with correcting the current inequity in the home office deduction. Created by a Supreme Court ruling two years ago, the new interpretation of the deduction greatly restricts the ability of a home-based business to take an appropriate deduction for the use of their home as an office. The language in the Contract should be very helpful to these businesses and should effectively address the issues raised by the Court's ruling.

- **Health Care Deduction for the Self-Employed**

This Congress holds out the very real hope that the 25% deduction for the health insurance expenses of the self-employed can finally be made permanent and ultimately raised to a full 100%. We are very happy that Chairman Archer has indicated his desire to move forward with retroactive enactment of the 25% deduction.

The annual ritual of suspense and last-minute decisions surrounding whether this deduction will be extended is frustrating, unnecessary, and unprofessional. Right now, *there is no health care deduction for the self-employed.* It expired at the end of 1993, and did not get renewed in 1994. If nothing is done soon, April 15 will come and go and small business owners will miss an important deduction on which they have come to rely. The temporal nature of this deduction always makes it a likely target for elimination when Members go shopping for the revenues to off-set some favorite tax break or spending project. The deduction cries out to be made permanent simply for procedural reasons; but there are also strong policy and fairness issues which compel us to the conclusion that the deduction should be made permanent--and expanded to 100%.

Thank you for holding this hearing and giving NSBU a chance to relay its views on tax policy. Please contact us if we can be of any further assistance.

Mr. ZIMMER. Thank you, Mr. Herring.

The next witness is Robert J. Beckman, chairman, emerging company section of Biotechnology Industry Organization, and president and CEO of Intergen Co. in Purchase, N.Y.

STATEMENT OF ROBERT J. BECKMAN, CHAIRMAN, EMERGING COMPANY SECTION, BIOTECHNOLOGY INDUSTRY ORGANIZATION; AND PRESIDENT AND CHIEF EXECUTIVE OFFICER, INTERGEN CO., PURCHASE, N.Y.

Mr. BECKMAN. Thank you, Mr. Chairman.

My name is Robert J. Beckman, and I am chairman of the emerging company section of the Biotechnology Industry Organization. I am testifying on behalf of BIO and the emerging company section, which is the entrepreneurial segment of that industry, and as president and chief executive officer of Intergen and as an entrepreneur.

My testimony will outline tax incentives for capital formation for entrepreneurs in emerging companies which has been endorsed by BIO. BIO represents about 600 companies of all segments of the biotechnology industry—biomedicine, bioagriculture and bioremediation.

My own company began in December 1987, with only eight employees. Today, we support jobs in three States with five manufacturing and distribution facilities, three offices in Europe and a partnership in Kobe, Japan, if it is still standing.

Intergen's biological products are used in innovative research throughout the world and could be found in breakthrough therapies and detection systems for things like cancer, heart disease, hemophilia, hepatitis and other important diseases.

I understand that my prepared testimony will be part of the record, so I will limit my discussions today on only one of four tax policy recommendations that BIO is making.

The issue for entrepreneurs in the biotechnology industry really is very clear. It is capital formation. Bringing a biotechnology drug to market today is a very lengthy and costly process. It takes about 10 to 12 years at a cost of $150 to $360 million to bring a drug to market.

After raising enormous amounts of capital, conducting cutting-edge research and lengthy and very costly clinical trials, a company can find that its product is not approvable by the FDA. And even if it is approved there is no assurance that there is going to be market success. So risk in our industry is extraordinarily high.

Unfortunately, our industry right now is in the middle of one of its worst financial crises. We believe largely because of the threat of drug price controls in the health care debate last year. In the past 2 years, the AMEX biotechnology stock index has declined over 50 percent. This trend has deprived most biotechnology companies of the ability to raise sufficient capital to continue their research. Many are close to broke.

Because of this urgent problem, I want to focus not on broad-based tax incentives, which I think we have seen a tremendous amount of support, but we would also like to talk about a targeted capital gains exclusion.

We support the enactment of the capital gains incentive which is included in the Contract With America, but we also support a second tier, perhaps more powerful incentive, targeted at direct investments in the stock of emerging companies. We support both incentives because in our industry we depend almost exclusively on direct equity investment to fund our research.

BIO's proposal for a two-tiered capital gains incentive originated with Senator Packwood in 1989. He proposed that qualified venture capital stock held for 4 or 5 years receive a gains tax reduction which was roughly twice as great as the incentive for nonventure capital stock.

The definition, by the way, of venture capital stock was based on a capital gains bill proposed by Senator Bumpers and Congressman Matsui. During the 1992 Presidential campaign this same venture capital incentive was later endorsed by President Bush, Governor Clinton and Senator Gore. Others who have endorsed the targeted incentive were the National Federation of Independent Businesses, the National Venture Capital Association and the American Electronics Association.

Unfortunately, after the election, drastic limitations were included in a 1993 budget reconciliation bill which, although enacted, effectively gutted the incentive. It reduced the market capitalization ceiling. It did not provide an incentive for corporate taxpayers, who are major investors in our industry. It imposed dollar limits on the benefits to any individual taxpayer. It did not provide enough of an exemption for the alternative minimum tax, and the working capital rules are simply not workable. As a result, the biotechnology industry has been unable to use this incentive at all in raising capital.

We are delighted that Congress is poised to finally enact across-the-board capital gains tax reduction. We support that. BIO also continues to support a supplementary targeted gains incentive. This targeted gains incentive would assure there exists a distinct and more powerful incentive for high risk, long-term investments and entrepreneurial firms and emerging companies.

Thank you.

[The prepared statement follows:]

TESTIMONY OF ROBERT J. BECKMAN
CHAIRMAN, EMERGING COMPANY SECTION
BIOTECHNOLOGY INDUSTRY ORGANIZATION (BIO)
AND
PRESIDENT AND CEO OF INTERGEN COMPANY
PURCHASE, NEW YORK

My name is Robert J. Beckman and I am Chairman of the Emerging Company Section of the Biotechnology Industry Organization (BIO). I am testifying today on behalf of BIO and its Emerging Company Section and as President and CEO of Intergen Company of Purchase, New York.

My testimony will outline tax incentives for capital formation for entrepreneurs and emerging companies endorsed by BIO. BIO represents 570 biotechnology companies and others involved in every sector of the biotechnology industry -- biomedical, bioag, bioremediation and bioenzymes. BIO's Emerging Company Section, which I chair, has 216 members ranging in size from one person virtual companies to well-established medium-sized biotech companies with approximately 150 employees. The principal role of this entity within BIO is to focus attention on entrepreneurial issues affecting emerging biotech companies, recognizing that many of these companies are responsible for the innovative research which has led to new breakthrough biotech products.

Intergen as an Entrepreneurial Company

Our company, Intergen, is an example of a business that has grown, created jobs, supported the development of many critical breakthrough drugs, paid taxes, and invested in facilities, plants and equipment. We are also an example of how tax law can help create jobs and investments. All of our initial capital came from partnership investors who were seeking opportunities for capital appreciation as well as passive income to offset passive losses, which cannot otherwise provide tax benefits to taxpayers.

Intergen is a unique biotechnology company. We already manufacture and market products and services and we already generate profits. Our company is in business to support the research and development and the manufacturing of biopharmaceuticals, diagnostics, and vaccines. Our products are primarily biological proteins which are used in innovative research throughout the world and are found in new breakthrough therapies and detection systems for cancer, heart disease, hemophilia, hepatitis and other important disease areas. We are also a contract manufacturer of pharmaceuticals produced from biological sources.

Our manufacturing involves very sophisticated and expensive technology to ensure the

absolute purity of the proteins we manufacture. Only fifteen years ago the manufactur of many of these proteins was not feasible. We didn't know that many of them existed, and when we did we were not sure whether they could be used to detect or treat diseases.

Intergen began in December 1987 with only eight employees through the acquisition of a small biochemical process business, the Armour Biochemical Company. Today, we support more than 150 jobs in three states with five manufacturing and distribution facilities, three offices in Europe, and a partnership in Japan.

Intergen is a growth company. Our future, however, depends to a large extent on a economic health biotechnology industry, the available of risk capital, and continuation of innovative research. We are an example of how tax policy can influence investment resulting in job creation, tax revenues, and the development of important products that benefit society.

Capital Formation is the Issue

The issue for entrepreneurs in the biotechnology industry is capital formation. Bringing a biotech drug product to the market today is both a lengthy and expensive process. From the initial testing of the drug to final approval from the Food and Drug Administration can take 10-12 years, and this process can cost anywhere from $150 to $359 million. Both the length and cost of this process are a tremendous impediment for small biotechnology companies to be successful bringing a product to the market.

After raising enormous amounts of capital, and conducting cutting-edge research, a company can find that its lead product is not approved by the Food and Drug Administration. We work in an industry which cannot sell and market its products without government approval and the requirements for approval are onerous.

The biotechnology industry consists of over 1,300 companies, of which 265 are publicly traded. The biotechnology industry is one of the most capital intensive industries in the history of civilian manufacturing. R&D accounted for 43% of total costs and expenses incurred by public biotechnology companies in 1994 and expenditures averaged $68,000 per employee. This compares with expenditures of $7,500 per employee for all manufacturing companies.

Total sales for the biotech industry were $7.7 billion in 1994. However, since the industry spends such a large percentage of it's capital on research and development, the industry experienced a net loss of $4.1 billion in 1994, and has lost approximately $14 billion over the last 5 years.

The industry is in-the-middle of one of the worst financial crisis in its history. A major contributing factor to this crisis was the Administration's assault on drug prices. The AMEX

biotechnology stock index has declined by 50% since January, 1993.

Ernst & Young reports that there are currently only 27 biotechnology therapeutics and vaccines on the market, with 270 in human development, and over 2,000 in early research stages. Forming capital to fund research and coping with an economic crisis in its capital markets are the keys to the ability of the biotechnology industry to maintain its current competitive dominance in world markets.

Tax Code Skewed Against Entrepreneurs

It should not be surprising that the tax code does not recognize the special strengths and needs of the biotechnology industry. The tax code is old and relatively inflexible and it reflects the values of our economy as it was in the past. The problems entrepreneurs have with the tax code is similar to the problems they have with agency regulations. They may be well intentioned, but they do not work in the real world. We urge this Committee to look at the tax code much as are other committees which are developing a regulatory relief program.

The Congress should ensure that our tax code recognizes the needs and reality of today's entrepreneurs. As this testimony will outline, this mostly requires that existing incentives be made permanent and/or restructured -- the targeted capital gains incentive, the R and E Credit, Section 382, and the Orphan Drug Credit. With the exception of enactment of an across-the-board capital gains incentive, all of these proposals are for amendments to current law, not the enactment of new incentives. That is what is needed to ensure that our tax code does not discriminate against or ignore America's most entrepreneurial industry

Let me now outline our four proposals in more detail.

Capital Gains Tax Incentives

BIO supports enactment of both an across-the-board capital gains incentive and a second tier incentive targeted at direct investments in the stock of emerging companies.

Biotechnology companies depend on direct equity investments to fund research. With so few products approved and so little in sales as compared to expenses, equity investments are the principal source of funding for research. Investors are asked to take tremendous risk with these investments; a risk that the firm's science will be successful, that the products will be approved for sale by government regulatory agencies, and that the market sales will produce profits commensurate with the risk. This risk must be sustained over the 5-10 year period which is involved in biopharmaceutical drug development.

Capital gains tax incentives are important in encouraging investors, including venture capital

investors, to purchase the stock of biotechnology companies, to put their capital at risk with a long-term, speculative investment. Tax policy is one of the only variables which the government can influence with respect to the risk involved with these investments.

BIO proposes a two tier capital gains incentive. This proposal originated with Senator Robert Packwood who proposed a combined across-the-board capital gains tax cut and targeted venture capital gains incentive during the crucial 1989 capital gains debate in the Senate. The 1989 debate was the critical capital gains debate during the Bush Presidency because this Committee and the House had adopted a capital gains incentive in its version of the Budget Reconciliation bill -- the Jenkins amendment. Senator Packwood sought to include a gains tax reduction in the Senate bill to ensure that a gains incentive would emerge from the conference. The proposal he advanced was a two-tier incentive which BIO here recommends.

The Packwood capital gains proposal included a sliding scale capital gains tax reduction depending on the length of time the capital asset had been held. It proposed that "qualified venture capital stock" held for four or five years receive a gains tax reduction which was roughly twice as great as the incentive for non-venture capital stock.[1] The definition of "venture capital stock" stock in his proposal was based on a capital gains bill proposed by Senator Dale Bumpers and Congressman Bob Matsui, a bill which is discussed below. Senator Packwood said, "The amendment includes an even more favorable capital gains rate for new venture capital investments. Frankly, this is an idea we picked up from Senator Bumpers." (November 14, 1989, Congressional Record) The Packwood two-tier gains proposal was blocked in the Senate and did not become law.

This same venture capital incentive was later endorsed by President Bush during the 1992 Presidential campaign. President Bush had long endorsed an across-the-board gains tax reduction and in a September 23, 1992, announcement he also endorsed the targeted capital gains proposal. (September 23, 1992, White House Small Business Plan).

Governor Clinton and Senator Gore also endorsed a targeted capital gains incentive during their 1992 campaign. (September 30, 1992, Small Business Plan) A reprint from the October 1, 1992 BNA report on the Bush and Clinton endorsements of the targeted capital gains incentive is printed as an appendix to my testimony.

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[1] The exclusion of gains from tax in the Packwood amendment to the reconciliation bill for non-venture capital stock held for four years was set at 20% and for five years was set at 25%. The exclusion for venture capital stock held for four or five years was set at 40%. The exclusion for non-venture capital stock held for six years was set at 30% and for seven years was set at 35%. The exclusion for venture capital stock held for six or seven years was set at 50%.

BIO, and its predecessor organization, the Industrial Biotechnology Association (IBA), have long endorsed an across-the-board reduction in capital gains taxes. With the deadlock in the Congress on an across-the-board capital gains tax rate reduction in 1989, and the failure to include it in the Bush-Congressional budget deal of 1990, a number of trade associations representing high technology firms -- including IBA, the National Federation of Independent Business, National Venture Capital Association, and American Electronics Association -- endorsed a targeted capital gains incentive. They relied, in part, on the endorsement of this concept by Senator Packwood and were encouraged by the endorsement of it by President Bush and the Clinton/Gore campaign.

These associations continued to endorse an across-the-board gains tax reduction, but with that proposal effectively stymied in the Senate, they sought enactment of an incentive which both Republicans and Democrats could support.

The targeted incentive which Senator Packwood, President Bush and the Clinton/Gore Campaign endorsed provided for a 50% reduction in capital gains taxes for direct investments in the stock (stock bought directly from a company, not secondary trading of the stock after it is issued) of a small business (defined as having $100 million or less in aggregate capitalization) if the investment is held for at least five years. The incentive applied to investments by individual and corporate taxpayers and applied only to investments made after the effective date of the law (not to the sale of investments previously acquired).

Unfortunately, after their election President Clinton and Vice President Gore proposed drastic limitations on the targeted capital gains incentive during the Fiscal 1994 budget debate, incentives which effectively gutted the incentive. These limitations included the following six ways:

1. lowering the capitalization limit to $50 million;
2. not indexing this figure for inflation;
3. applying the incentive only to individual taxpayers;
4. limiting the per taxpayer benefits to 10 times the basis of the investment or $10 million (whichever is greater);
5. exempting only half of the excluded gains from the Alternative Minimum Tax (AMT); and
6. substantially modifying the definitions dealing with "working capital" requirements.

The reduction in the number of companies which qualify (the capitalization ceiling) is particularly critical to the biotechnology industry, which needs to raise huge amounts of capital to fund research. Corporate taxpayers are major investors in small companies, so it is important to cover them with this incentive. The per taxpayer limits reduces the prospects for an investor generating sufficient gains on one investment to cover losses of capital with many others. The AMT provision is important as the AMT recaptures the gains tax benefits and for many taxpayers cancels out any incentive to make the investments. And, the working capital rules are completely unworkable.

This incentive, with the Clinton-Gore Administration proposed limitations, was included in the 1993 Budget Reconciliation bill and became law. An informal survey of our members finds that this incentive has not been a factor in forming capital for entrepreneurs and emerging companies.

BIO is delighted that the Congress is poised to finally enact an across-the-board capital gains tax reduction for investments in any "capital asset" (many types of investments) if it is held for one or more years. The incentive would apply to the sale of assets acquired prior to the date of enactment of the incentive. The Congress appears ready also to endorse indexing the basis of the capital assets for inflation. BIO strongly supports both of these proposals and urges the Congress to enact them into law.

BIO continues to support a targeted gains incentive which supplements this across-the-board incentive. This targeted incentive would ensure that there exists a distinct and more powerful incentive for high-risk, long-term investments in entrepreneurial firms and emerging companies. We believe there is a bipartisan consensus on the merits in favor of a targeted gains incentive.

The second tier incentive would build on the false-start of the 1993 incentive in the following eight ways:

1. Increase the capitalization ceiling to at least $100 million, or eliminate it altogether, and index any capitalization ceiling for inflation
2. Apply incentive to corporate taxpayers
3. Provide a gains exclusion which is greater than that which is provided for all other capital assets (e.g. if regular capital gains exclusion is 50%, exclusion for targeted incentive should be 75% or 100%)
4. Eliminate the "10 times or $10 million" per taxpayer limitation
5. Exempt all of the excluded gains from the alternative minimum tax
6. Fix the "working capital" rules
7. Provide for a deferral of gains taxes (a rollover provision) for those who reinvest proceeds from sale of any capital asset into stock covered by this incentive (set time period in which rollover must occur) and
8. Apply the incentive to investments which were made before effective date for 1993 law.

BIO endorses this targeted capital gains incentive as a second tier incentive to be adopted in combination with an across-the-board incentive. The targeted incentive would ensure that the tax code acknowledges the exceptional risk which is involved with investments in biotechnology and other emerging industries. BIO does not propose this incentive as a substitute for the Contract for America across-the-board incentive, which it strongly supports, and would oppose it if it is deemed inconsistent with adoption of the across-the-board incentive.

Research and Experimentation Credit

It is critical that the Research and Experimentation Credit (R and E Credit) be made permanent or extended for 18 months from the date it scheduled to expire, June 30, 1995. This extension would have the Credit expire on December 31, 1996. In addition, BIO supports

restructuring the R and E Credit by reducing the fixed base limitation from 16% to 8% and raising or eliminating 50% cap.

If the Credit is extended and not made permanent, the Congress should at least ensure that most biotechnology companies qualify for the credit; due to the peculiar structure of the credit many biotech companies do not now qualify for it. There is something fundamentally wrong with an R and E Credit if biotech companies, with their intensity of research, cannot claim it.

The restructuring which we propose would lower the fixed-base percentage limitation from 16% to 8%. The 16% maximum base percentage is the limitation on qualified research (as a percentage of sales) which may be used to calculate the R and E Credit. Many biotech companies' research and development-to-sales ratio exceeds 16% in their early years. In short, the 16% is far too high.

As biotech companies mature and begin to generate sales, their research-to-sales ratio begins to move closer to the average for pharmaceutical companies, about 15%. This pharmaceutical average ratio is itself three times higher than the all industry average, so you can see how high the ratio is for biotech companies.

The problems with the 16% fixed base limitation is compounded by the fact that roughly 50% of a biotech company's financial statement R and D expenses do not quality for the R and E Credit. Overhead and other costs of R and D do not qualify for the R and E Credit. A 16% limitation, therefore, requires a biotechnology company to invest over 32% of its sales in R and D (per its financial statement) to get any R and E Credit. This is clearly too high. The practical effect is that the most biotech companies will never receive an R and E Credit until they are mature, even if they invest far more revenue in R and D than any other type of company.

To correct the inequity of the current law, the 16% fixed base limitation should be reduced to 8%. This will still require biotech companies to spend at least 16% of sales on R and D in order to qualify for the R and E Credit.

In addition the 50% cap on R and E Credits should be eliminated. It makes no sense that biotech companies which finally do qualify for the R and E Credit should be hit with a 50% maximum credit.

Orphan Drug Credit

BIO supports making the Orphan Drug credit permanent or extending it for 24 months until December 31, 1996, the same minimum extension we recommend for the R and E Credit. As I will explain the R and E and Orphan Drug Credits are closely related and should be considered in

tandem. BIO also supports restructuring the Orphan Drug Credit so that it can be carried forward by companies with no tax liability with respect to which to claim the credit. Most biotech companies have no sales and, therefore, no tax liability, so a credit which cannot be carried forward is of no value to them as an incentive for research on orphan diseases. We also recommend that pre-clinical trial expenses be covered by the Credit and that taxpayers paying the alternative minimum tax be permitted to reduce this tax by the amount of their Orphan Drug Tax Credits.

If the Orphan Drug Credit is extended and not made permanent, the Congress should at least ensure that the credit is restructured. As with the R and E Credit, there is something fundamentally wrong with an Orphan Drug Credit if biotech companies, with their intensity of research on orphan diseases, cannot use it.

An orphan disease is statutorily defined as one that afflicts fewer than 200,000 people in the United States. As many as 20 million Americans suffer from one of about 5,000 rare diseases. Diseases falling into this category include cystic fibrosis, hepatitis B, multiple sclerosis, renal cell carcinoma and pituitary dwarfism. An "orphan drug" is a drug or biological product designated for treatment of a rare disease.

The U.S. biotechnology industry is a leader in the development of drugs to treat rare diseases, many of which are life threatening and seriously debilitating. The unique scientific methods of biotechnology -- which focus on the genetic and molecular bases of disease -- make biotechnology companies especially capable of developing safe and effective treatments for rare genetic and metabolic disorders.

This cost, risk and delay is the most powerful argument in favor of a permanent credit. When the Bush Administration proposed in 1992 that the Credit be made permanent, it stated, "Clinical testing is long-term in nature, and taxpayers should be able to plan their activities knowing that the credit will be available when the clinical testing is actually undertaken. Thus, if the orphan drug credit is to have its intended incentive effect, it should be made permanent."

The Orphan Drug Tax Credit is an alternative to the Research and Experimentation Credit (R and E). The Orphan Drug Credit focuses on clinical trial expenses for orphan drugs and the R and E Credit focuses on all research expenditures. Firms with research which qualifies for the Orphan Drug Credit do not claim the R and E Credit for the same expenditure. The Orphan Drug Credit is 50% and the R and E credit is only 20%.

Unfortunately the Orphan Drug Credit is not helpful to many biotechnology companies because, if it can only be used in the tax year in which the research expenditures are made, it cannot

be carried forward for 15 years, as is the case with other business tax credits. Most biotechnology companies do not, in fact, have tax liability with respect to which the credit may be taken, so they reap no value from the Credit. Permitting 15 year carryforwards, which is the norm for other business credits, would ensure that all biotech companies, including those with no current tax liability, are given an incentive to conduct research on orphan diseases. This would permit companies whose first product is an orphan drug to carryforward their credits until they begin to generate revenue based on sales of that first product.

Only clinical trial expenditures are covered, not pre-clinical trial expenses. Pre-clinical trial expenses for research on cures and therapies for orphan diseases can be substantial and should be covered.

Finally, current law provides that the alternative minimum tax (AMT) is not reduced by any credits except the AMT foreign tax credit. A company incurring tax under the AMT and earning Orphan Drug Credits can not receive any benefit from the credit. This puts companies paying the AMT at a disadvantage vis-a-vie companies paying the regular tax. Companies should be permitted to reduce their AMT payments by the amount of their Orphan Drug Credit.

The last extension of the Credit was in the 1993 Budget Reconciliation Act. The Joint Committee on Taxation estimated that the limited 1993 extension of the credit would cost $18 million during Fiscal Years 1994-1998. We do not yet have an estimate for our proposals to restructure the Credit.

Conclusion

The biotechnology industry is a major success story in the making in America. It is the more entrepreneurial industry in terms of research intensity and capital formation. It thrives on innovation and long term risk-taking. We should ensure that our tax code recognizes its unique characteristics and needs.

Thank you for the opportunity to testify here today.

Mr. ZIMMER. Thank you, Mr. Beckman.

Next, we will hear from Dr. Norman Ture, president of the Institute for Research on the Economics of Taxation.

STATEMENT OF NORMAN B. TURE, PH.D., PRESIDENT, INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

Mr. TURE. Thank you, Mr. Chairman.

I ask to have my full statement included in the record, and I will provide a brief summary. Let me say, the remarks I am about to offer are my own, not necessarily shared by the board of directors or other staff of the Institute.

The reduction in capital gains tax rates and the inflation adjustment of the bases of capital assets proposed in title I of H.R. 9 would contribute significantly to moderating the bias against savings imposed by the existing Federal tax system. In view of the projected preemption of virtually all of the Nation's saving by Federal entitlement spending, easing the antisaving tax bias is of the utmost urgency and should command top tax policy priority.

The existing tax treatment of capital gains increases the cost of saving compared to consumption uses of current income. This antisaving impact is exacerbated by taxing nominal rather than inflation-adjusted gains. Moreover, taxing realized gains, particularly without inflation adjustment, immobilizes accumulated saving and impairs the capital market's critically important function of assigning savings to their most productive uses.

The proposed deduction from adjusted gross income of 50 percent of net long-term capital gains and inflation adjustment of basis would significantly improve the tax treatment of capital gains. These revisions would materially reduce the income tax bias against all saving, not merely that invested in property identified as capital assets.

Both business and household saving are likely to increase substantially above levels that would otherwise occur, although the desirability of the proposed capital gains reform does not depend, in my judgment, on how large the saving response will be.

Both of these proposed reforms would also contribute significantly to reducing tax impediments to investors changing the composition of their asset holdings in response to market signals and would improve the efficiency of the market's performance.

The committee should recognize that reducing the capital gains tax will increase the differential between the tax burden on distributed and retained corporate earnings. Enactment of title I will increase the desirability of providing some relief at the corporate level for dividend distributions.

The revenue effects of the proposed capital gains reform should be defined as the difference in revenues realized in any given period of time with and without the proposed reforms. They should not be defined as the difference in revenues realized in any one year compared to the prior year.

Estimates of the revenue effects of title 1 should take account of the resulting changes in the market value of existing capital assets and the increased saving and economic activity and the tax revenues generated thereby that would occur, not merely the increase in gain realizations.

More severely taxing saving and consumption uses of income is grossly unfair as well as economically damaging. Title I of H.R. 9 is a welcome initiative for addressing this unfairness.

Thank you.

[The prepared statement follows:]

CAPITAL GAINS REFORM, TITLE I OF H.R. 9, THE JOB CREATION AND WAGE ENHANCEMENT ACT OF THE CONTRACT WITH AMERICA

STATEMENT OF NORMAN B. TURE, PRESIDENT
INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION (IRET)
PRESENTED TO
THE COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
JANUARY 25, 1995

Mr. Chairman, members of the Committee, I appreciate the opportunity to discuss with you the significant improvement in the federal income tax that will be provided by enactment of Title I of H.R. 9. Both of the principal features of the proposed capital gains reform — the reduction in the marginal tax rates applicable to capital gains and the inflation adjustment of basis — are highly commendable as well as long sought. For those of us who have over the past thirty-five years devoted their efforts to calling tax policy makers' attention to the severe anti-saving, anti-investment bias in the income tax and to the seriously adverse economic consequences of that bias, Title I is a constructive and encouraging initiative. Its enactment would, itself, contribute to moderating that unwholesome tax bias and would afford promise of additional efforts to eliminate it completely.

The urgency of reducing, if not entirely eliminating, the income tax's anti-saving bias was highlighted last year by the findings of the Bipartisan Commission on Entitlement and Tax Reform. As you know, the Commission found that projected spending under existing federal entitlement programs would exceed the entire amount of revenues projected to be provided under existing tax laws by about the year 2025. The resulting deficit would preempt all of the saving undertaken by American households and businesses, leaving no saving for investment in private capital formation and other growth-generating private uses. Moreover, in those budget circumstances, the American economy could not rely on foreign saving to finance the additions to the stock of capital needed to maintain, let alone advance, labor's productivity and the nation's real living standards.

Even if one discounts the Commission's projections to a substantial degree, an economic holocaust is looming. The economy is accelerating down a slippery slope that ends at the edge of a cliff. The longer the delay in addressing the growth in entitlement spending and in removing tax barriers to household and business saving, the more difficult it will be to apply the brakes before we go over the edge.

In view of the obvious disinclination to deal constructively with entitlement spending, particularly the Social Security and Medicare Systems, the need to reduce the tax bias against saving is all the more demanding of the Congress's attention. This Committee is to be commended for having begun the work of seeking out and remedying the provisions of the Internal Revenue Code that produce that bias. Title I of H.R. 9 is an important step in that effort.

The Anti-Saving Tax Bias

The anti-saving, anti-investment bias in the income tax results from the fact that both income that is saved and the income produced by investing that saving are subject to tax, often several times over, while income that is used for current consumption is taxed only once. The consequence is that the amount of current consumption that must be forgone to obtain any given amount of after-tax return on one's saving is greater than if either the income that is saved or the return it produces were excluded from the tax base. The forgone consumption is, of course, the real cost of obtaining that future income. In other words the income tax increases the cost of saving compared to the cost of current consumption. Moreover, the income-tax induced increase in the relative cost of saving is greater the higher is the tax rate to which the person is subject.

The appendix to my statement provides a number of simple arithmetic examples that show how the individual and corporate income taxes and the taxation of capital gains raise the cost of saving relative to consumption uses of income.

The anti-saving bias is accentuated by the separate income taxation of corporate income. The appendix includes an illustration of the additional increase in the relative cost of saving imposed by the separate income taxation of income generated by corporate businesses.

The taxation of capital gains also contributes to raising the cost of saving relative to the cost of current consumption. If instead of distributing its after tax earnings, the corporation retains and reinvests them in assets yielding at least the same rate of return that was obtained before, the market value of the corporation's stock is likely to increase by the amount of the retained earnings per share. If the person decides subsequently to sell the shares, the excess of the sales proceeds over the person's investment — the realized capital gain — is subject to the individual income tax. Because the capital gains tax is deferred until the accumulated after-tax corporate earnings are realized by the sale of the shares, the present value of the capital gains tax is less than the present value of the taxes paid on distributed corporate earnings over the period the shares are held. Notwithstanding, the capital gains tax adds to the amount of current consumption that must be given up per dollar of after-tax returns on one's saving. An example in the appendix illustrates the effect of the capital gains tax on the cost of saving.

The anti-saving, anti-investment bias of the income tax system is further accentuated by the federal transfer (estate and gift) taxes, by State income taxes, by State and local property taxes and by numerous selective taxes on capital or the returns capital produces imposed by State and local governments.

Moreover, the anti-saving bias is exacerbated by the imposition of the tax on the nominal rather than on the inflation-adjusted returns on saving and investment. The expectation of inflation, *per se*, adversely affects saving and investment. Inflation expectations increase the rate at which the returns on saving must be discounted to determine their amount in real terms; unless the expected returns increase at least as rapidly as the expected inflation rate, the value of the expected *real* returns will be depressed, thereby increasing the cost — the forgone current consumption — of any given amount of real future income.

Taxing nominal capital gains aggravates this effect of inflation in increasing the cost of saving. This effect is likely to be particularly severe in the case of gains realized on the sale of corporate stock the market value of which has not kept pace with inflation. It may well result in taxing real losses, not merely overtaxing real gains that are less than nominal gains.

Taxing realized capital gains also impedes transaction in capital assets. An investor will be reluctant to sell his or her capital assets in order to purchase other assets unless the present value of the expected net returns on the replacement assets exceeds that of the expected returns on the existing holding by enough to defray the tax on any gain realized on the sale of the latter. For any given amount of accrued gain, the higher is the capital gains tax rate, the more imposing is the tax barrier to such changes in the composition of a person's assets.

This locking-in effect of the tax on capital gains impedes the assignment of accumulated savings to their most productive uses. As a result, it impairs the essential function of the capital market — to facilitate the exchange of property rights. This tax-induced barrier to these exchanges distorts the market's function in assigning values to competing uses of saving. The effectiveness with which this function is performed has a critically important bearing on how efficiently our saving is assigned to competing businesses and their use of our saving in expanding production- and income-generating capacity. Misusing our saving — directing it into companies and capital uses that are less productive than alternatives — is just as wasteful and costly as misallocating any other production inputs. To the extent that taxing capital gains locks in holdings of capital assets, it impairs the capital market's functioning and contributes to less than optimum uses of our saving and capital formation.

Benefits From Enactment Of Title I

Both the proposed deduction from adjusted gross income of 50 percent of net long-term capital gains and the adjustment for inflation of the basis of capital assets would be significant improvements over the existing law treatment of capital gains. Of these provisions, the 50 percent exclusion is likely to be more significant in improving the tax climate for saving and investment.

Section 1001. 50 Percent Capital Gains Deduction

The proposed deduction from adjusted gross income of half of net long-term capital gains has the effect of cutting the marginal tax rates in half for individual taxpayers in the 15 percent and 28 percent brackets and of affording smaller, but still significant percentage reductions in the capital gains tax rates for people in higher brackets. For corporations, the proposed deduction would cut the top effective marginal rate on capital gains to 17.5 percent from 35 percent. These rate reductions would mitigate the adverse effects, discussed above, of the existing tax treatment.

Reducing the tax bias against saving

The fundamental economic benefit that would be realized from enactment of Title I would be the reduction in the severe bias against saving imposed by the existing federal tax system, particularly the personal and corporate income taxes. As the discussion above shows, even outright elimination of the capital gains tax would not fully rid the tax system of its anti-saving, anti-investment bias. There should be no doubt in the Committee members' minds, however, that the proposed 50 percent gain deduction would make an important contribution in moving the tax system in the direction of neutrality between saving and consumption uses of income. It would, in other words, significantly reduce the extra cost of saving relative to consumption.

This highly desirable effect on the cost of saving would not be confined, it must be stressed, to saving invested in capital assets, as defined in the Internal Revenue Code. In an efficiently operating capital market, changes in market valuations in response to tax changes impel reallocations of saving until risk-adjusted net-of-tax returns are substantially equalized among all assets. Reducing the marginal tax rate on capital gains will reduce the cost of saving invested not only in capital assets but in all other uses, as well.

The desirability of the 50 percent deduction and consequent reduction in marginal tax rates on capital gains does *not* depend on how large the saving response to the overall lower cost of saving will be. The objective of this reform is to reduce the existing anti-saving tax bias, not to dictate to households or businesses what uses they make of their income claims and property rights. Reducing capital gains taxes is constructive tax policy whether the resulting increase in saving is great or small.

Having said this, I believe that reducing taxes on capital gains will indeed result in significantly more saving than would otherwise be undertaken. Sound economic analysis urges that tax changes that reduce the cost of saving relative to consumption uses of income will lead to higher levels of saving than would otherwise occur. Opponents of capital gains tax reform insist that saving is little if any responsive to changes in its cost. They obviously fail to note that in making that assertion they are also maintaining that consumption is little if any responsive to changes in its cost. In other words, according to these folks, people and businesses pay no attention to taxes in deciding anything about their economic activities. The Committee should recognize in this viewpoint a license for imposing any amount of any kind of taxes without regard for the damage that will result.

Improving capital market efficiency

Reducing the marginal rate of tax on capital gains will also ease the lock-in effect described above. It will, therefore, reduce the existing tax impairment of the market's function in facilitating the exchange of property rights, hence the market's efficiency. This enhancement of market efficiency is a very important benefit to be obtained from the proposed reduction in

marginal tax rates on capital gains, irrespective of the magnitude of the change in the amount of gains realized.

Section 1002. Indexing The Bases Of Capital Assets For Purposes Of Determining Gain Or Loss

Adjusting the basis of assets for purposes of determining gain or loss upon the disposition of the assets would avert accentuating the income tax's anti-saving bias in an inflationary environment. Clearly, this proposed change in the tax treatment of capital gains and losses would be inconsequential in an economic setting in which savers were absolutely confident that no inflation would occur over the time period that is relevant for their saving-investment decisions. By the same token, it would afford greater benefits the higher is the expected rate of inflation. Even if the expected inflation rate is quite modest, however, adjusting asset bases for inflation will forestall the adverse effect of the risk of inflation on saving and investment, discussed earlier in this testimony.

Indexing the bases of capital assets for inflation will also contribute, clearly, to freeing up currently locked-in savings. It will, therefore, make an important contribution to enhancing the efficiency with which the capital market performs its functions.

The Committee has heard testimony from the Treasury Department to the effect that in combination with the 50 percent deduction, adjusting the basis of capital assets for inflation "...provides too large an adjustment for inflation."[1] In making this assertion, Assistant Treasury Secretary Samuels erroneously identifies the proposed deduction of 50 percent of net long-term capital gains as aimed at offsetting inflation, suggesting that there would be no occasion for this change in the absence of inflation. In fact, as discussed above, the 50 percent deduction aims at partially offsetting the incremental tax penalty on saving, irrespective of expected inflation. By the same token, the proposed indexing aims at offsetting the additional tax penalty imposed by taxing nominal rather than real gains. In combination these two provisions can, contrary to Secretary Samuels' assertion, provide too large an adjustment *only* if one believes that good tax policy calls for penalizing saving uses of current income relative to consumption uses and for taxing more gains than people actually realize.

The Treasury testimony also asserts that indexing the basis of capital assets without indexing the debt used to finance the acquisition of the assets would encourage tax arbitrage and enable taxpayers to reduce their effective tax rates to zero. Mr. Samuels' example is a person who purchases $100,000 of undeveloped land, financing the purchase with $20,000 of his or her own cash and borrowing $80,000. The person later sells the land for $130,000, "with the $30,000 gain representing an inflationary increase in the value of the property." The person repays the $80,000 mortgage debt and pockets the remaining $50,000, paying no tax because the basis of the asset was indexed. According to Samuels, "...only $6,000 ...of the taxpayer's total $30,000 gain...represents the inflationary gain on the taxpayer's $20,000 investment...."[2] Presumably, according to Samuels, the correct result in principle would be to tax the person on the remaining $24,000 of *nominal* gain.

Notice, however, that in terms of constant purchasing-power dollars, the $50,000 in cash the person has left after paying off the mortgage indebtedness is only $20,000, exactly the amount of the person's original *cash* investment. If the person were subject to tax on the $24,000 of gain allocated by Samuels to the mortgage component of the investment, as Samuels suggests, the person would net only $17,280. The tax would subject the person to a net loss of $6,720 on the original investment. In fact, the arbitraging that Samuels asserts would result from indexing the basis of the asset but not the debt protects the person from having to pay tax on a zero gain. The Treasury's complaint is without merit.

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[1] Statement of Leslie B. Samuels, Assistant Secretary (Tax Policy) before the Committee on Ways and Means, January 10, 1995, page 16.

[2] The person's investment, contrary to Samuels' assertion, is $100,000, not $20,000. The person has undertaken an indebtedness for the discharge of which the person is legally responsible.

There is much to commend extending inflation adjustments to indebtedness and the interest flows thereupon. There is, however, no downside of the sort the Treasury has asserted to indexing capital assets alone.

This is not to say that the indexing proposal is free of problems. For one thing, in the case of financial assets such as corporate common stocks, the proposed basis adjustment would apply as a rule only to the initial investment. The proposed indexing would not apply to the additions to basis represented by the corporation's retaining and reinvesting some of its after-tax earnings. The proposed indexing, accordingly, would apply to a smaller and smaller share of the accumulating basis of the stock the longer the stock is held, leaving larger and larger amounts of nominal gains exposed ultimately to tax. I urge the Committee to address this deficiency, and I'll be happy to provide the Committee and its staff such assistance as it may request in doing so.

I also urge the Committee to extend indexing of basis for the purpose of determining gain or loss on the disposition of equipment subject to a net lease when the proposed neutral cost recovery system is not used. The differences in contractual arrangements for the acquisition and use of property in a trade or business should not enter into determination of the eligibility of property for the inflation adjustment of basis. Even under modest inflationary expectations, denying this basis adjustment to property subject to a net lease would expose lease arrangements to a significant market place disadvantage with no discernible gain concerning tax principles.

Dividend Tax Relief

Desirable as I believe to be the capital gains tax reforms the Committee is considering, the Committee should be aware that their enactment will tend to bias corporate decisions in favor of retaining after-tax earnings rather than distributing them as dividends to shareholders. As noted earlier in this discussion, the fact that the tax on capital gains is deferred until the gains are realized somewhat abates the punitive effect of taxing income generated by corporate businesses both to corporations and their shareholders. There can be little doubt that this somewhat influences corporate distribution policies, although the magnitude of this influence is by no means certain.[3] Expanding the differential in effective tax burdens on retained vs. distributed earnings by reducing capital gains taxation should urge the Committee to add to its agenda careful consideration of ways to integrate the income taxation of corporations and their individual owners. An initial step in this direction would be to provide some relief at the corporate level for dividend distributions.

Revenue Effects

At one time or another, the case for reducing the marginal tax rates on capital gains and for inflation indexing of the bases of capital assets has rested on the claim that either or both of these reforms be tax revenue raisers. As the Committee might well infer from my discussion to this point, I believe the case for these reforms rests on the very substantial economic benefits that would be obtained, not on their revenue consequences. I believe that enactment of Sections 1001 and 1002 of Title I of H.R. 9 would very likely prove to be a revenue raiser, but I strongly endorse these reforms notwithstanding.

Much of the arguments among economists and other tax specialists about the revenue effects of these changes in the tax treatment of capital gains has hinged on estimates of the magnitude of the unlocking effects of these changes. Most of the empirical analyses that have been directed to this question have relied on time series of changes in capital gain realizations to measure the response to changes in the tax treatment of these gains. But an enormous number of other variables also affect the amount of capital asset transactions and the amount of gains realized thereby every year. Making allowances for these myriad other factors in efforts to

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[3] In the last decade and a half, an important academic literature has been produced that strongly suggests that some of the serious problems of corporate governance noted during the 1980s are attributable to corporate executives' efforts to maximize their welfare at the expense of maximizing the net worth of corporate owners. Excessive retention of corporate earnings may have contributed to these problems.

determine the influence of changes in the tax law in such year-over-year analyses is a daunting undertaking. The Committee should not base its decisions about capital gains reforms solely or even primarily on such revenue estimates.

The conceptually correct measure of the effect of the change in the law is the difference between the amount of gains actually realized in any particular time period and the amount that *would have been realized* in the absence of the change in the law. This, too, is difficult to estimate, but it at least aims at providing a relevant answer to the question.

For the most part, the revenue estimates have been driven only by estimating the increase in capital gain realizations resulting from reducing the capital gains tax; they have ignored the virtually instantaneous increase in the market value of existing capital assets that would result from reducing the tax. This valuation effect would augment the amount of gain realized on the sale of any given amount of capital assets. To be sure, this valuation effect is one shot; because it would result in higher bases of capital assets in the hands of those purchasing the unlocked assets, it would tend to reduce the amount of taxable gains realized thereafter. Nevertheless, this valuation effect will tend to increase revenues, on balance, and should not be ignored in estimating the revenue consequences of reducing the marginal tax rates on realized capital gains.

Also ignored in most of the revenue estimates are the broader, very likely most consequential economic effects resulting from reducing the marginal tax rates on capital gains — the resulting increase in saving. The consequent increase in the stock of capital would itself generate additional taxable income; additionally, the increase in capital would contribute to an increase in labor's productivity, hence to employment and wages, leading to additional tax revenues from income, payroll, and other federal taxes.

"Fairness"

Finally, a word about the "fairness" issue. Congressional consideration of tax proposals aimed at reducing tax barriers to saving, capital formation, and entrepreneurship has far too often been blocked by redistributionist assertions that such proposals are unfair because they would benefit rich people and/or business. It is well past time for policy makers to recognize that the goodness or badness of a policy does not depend on the specific attributes of the people who are immediately affected by them. A tax change that reduces the existing tax penalty on saving compared with consumption uses of income is not unfair because it may well more substantially reduce the tax liabilities of people who pay a great deal of taxes and who will greatly increase their saving in response to the tax change than it will the taxes of people who pay little or no taxes.

There is no meaningful social, let alone economic policy goal that is served by punitively taxing saving; such punitive taxation is not made "fair" because its weight is greater on the rich or on business than on others. And when one considers that the principal beneficiaries of increases in saving, capital formation, entrepreneurship, and other growth generating activities are labor and consumers, redistributionist objections to easing the differentially heavier tax burdens on these various activities should be dismissed out of hand.

Addressing the unfairness in more heavily taxing income that is saved than income used for current consumption promises substantial dividends in higher standards of living for everyone. Title I of H.R. 9 is an effective beginning.

APPENDIX

Basic Income Tax Bias Against Saving

Pretend, for a moment, a no-tax world in which someone earns an extra $1,000. The person can either use the $1,000 for additional consumption or to purchase a perpetuity — a bond with no maturity date — paying, say, 10 percent a year. The person's choice is to enjoy $1,000 of additional consumption now or to have an additional $100 of income every year. The cost of each dollar of the additional income — the forgone consumption — is $10.

Now assume an income tax of the same basic configuration as the existing income tax is levied at a rate of, say, 25 percent. On the additional $1,000 of current income there is a tax of $250, leaving the person with $750 after tax that can be used either to buy an additional $750 of current consumables or a $750 bond paying 10 percent a year. Of course, the $75 of interest on the bond is also subject to the income tax, so that the after-tax income on the saving is $56.25. The person's choice is $750 more of current consumption or $56.25 more income each year. The cost — the forgone consumption — per dollar of that additional interest income is $13.33. The income tax increased the cost of obtaining future income compared to the cost of current consumption by 33.33 percent.

As noted in the text, this tax-induced increase in the cost of saving compared to that of current consumption is greater the higher is the marginal tax rate to which the person is subject. Suppose the tax rate to be paid by the person in the example were 40 percent instead of 25 percent. In this case, the income tax would increase the cost per dollar of additional future income from $10 to $16.67 or by 66 2/3 percent.

Additional bias imposed by the corporate income tax

Suppose that instead of buying a bond, the person in the example were to invest the additional income in corporate stock, and suppose the earnings per share were also 10 percent of the investment. Suppose the corporate tax rate were 35 percent and that the corporation were to distribute all of its after-tax earnings. In this case, the 25 percent bracket taxpayer would net $36.56 each year ($75 gross return on the $750 corporate investment, reduced by the 35 percent corporate income tax and the 25 percent individual income tax), for which he or she would have to forgo $750 of current consumption; the combined corporate and individual taxes raises this person's cost per dollar of additional future income from $10 to $20.51, a little more than 100 percent. If the person were in the 40 percent bracket, each net-of-tax dollar of return on his or her investment would cost $25.64 of forgone consumption, more than 150 percent more than in the absence of taxes.

The capital gains tax bias against saving

Suppose that the corporation retains its after-tax earnings and reinvests them in assets producing the same rate of return as before. Also suppose the 25 percent tax bracket person in our example held the stock for, say, five years before selling it. By assumption, the value of the stock will have increased from $750 to $1,027.57. On the gain of $277.57 realized on the person's sale of the stock, he or she owes $69.39, leaving an after-tax gain of $208.18. The same result would be obtained if the person were to receive an after-tax annuity of $43.48 over the five year period. With this tax treatment, the cost per dollar of future income, in terms of forgone current consumption, is $17.25 [4] Although the deferral of tax until the capital gain is realized imposes less of a tax penalty on saving than in the former case, it nevertheless substantially raises the cost of obtaining future income, in this example by 72.5 percent, compared to the cost in a no-tax world.

Section 1001 of H.R. 9 would significantly reduce the cost of saving compared with present law. If the person in the example were required to include only half of the net long-term gain in taxable income, the capital gains tax due upon the sale of the stock at the end of five years would be $34.70, leaving a net gain of $242.87. The same result would be obtained had the person received an after-tax annuity over the five years. In this case, the cost per dollar of future income would be $15.25 or 52.5 percent more than in a no-tax world but significantly less than under the existing tax treatment.

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[4] The cost of future income, in these terms, would be lower the longer the person deferred realization of the capital gain.

Mr. ZIMMER. Thank you.

Our final witness is Robert McIntyre, director of Citizens for Tax Justice.

STATEMENT OF ROBERT S. MCINTYRE, DIRECTOR, CITIZENS FOR TAX JUSTICE

Mr. MCINTYRE. Thank you, Mr. Chairman.

I want to congratulate the new members of the committee. I have been following this committee for the last 20 years, and there are a lot of new faces here. I especially want to congratulate the new chairman, Mr. Archer. So if you would pass that on I would appreciate it.

I am before you today not as a supplicant as so many of the other witnesses seem to be. We have heard from a lot of people who are doing well in their businesses. Indeed, they are bragging about it. But in the same breath, they say they would like you to give them a pass on some of the taxes they currently have to pay. In my view, they ought to be ashamed of themselves.

Last Saturday, the Washington Post reported that Chairman Archer had told the staff of the committee to be on the lookout for any provisions in the Tax Code that aren't in the taxpayers' best interest. I was kind of cheered up by that—until I thought about the Contract. I said to myself, wait a minute. If he finds such bad provisions, he will probably double them.

Because it seems to me that the Contract, with its $100 billion a year in new tax breaks, has found the two biggest high-income and corporate breaks in the Tax Code and has proposed to double them. Those are capital gains tax breaks and corporate depreciation tax breaks.

My written testimony discusses both these issues. I will focus in my oral statement today on capital gains.

If these proposed changes are adopted, they will not only undermine tax fairness but they will also undermine the economic neutrality that we gained in the 1986 Tax Reform Act. They will put Congress and this committee back in the position of directing the allocation of private investment rather than leaving it where it belongs, which is in the hands of businesses and consumers.

We will once again face rampant tax sheltering and outrageous high-income and corporate tax dodging. And, ultimately, the price for it all will be paid by average American families through higher interest rates, reduced government services and eventually, I think, higher taxes.

So we urge the committee to reject these kinds of tax reforms and instead work to close down some of the remaining wasteful, economically harmful subsidies in the Tax Code that benefit the few at the expense of everyone else.

Now you may remember that to his great credit President Ronald Reagan was able to overcome his initial proclivity for tax subsidies. He noticed that the loophole-based policies of the early eighties hadn't worked. They had given us lots of unneeded office buildings. They had given us lots of other wasteful misallocations of our American capital effort, but they hadn't succeeded at all in increasing savings or investment.

And as a result, President Reagan reversed himself, and his leadership was critical to the enactment of the 1986 Tax Reform Act, which closed down those loopholes.

So it was very distressing, to me at least, to see a new Republican Congress, which talks about ending waste and defending the middle class and curbing unwarranted government interference in the free market, proposing vast new tax-based subsidies that look to me a lot more like central planning than any faith in market forces.

Even under current law, capital gains are treated much more favorably than other types of income, especially for the highest income people. Capital gains are not taxed at all until they are realized, generally on sale. Even when they are realized, there is the equivalent of a 30-percent exclusion for top-bracket people. In total, the current capital gains breaks now on the books are estimated to cost about $170 billion over the next 5 years.

Almost two-thirds of the total capital gains reported, by the way, go to people with incomes over $200,000. Only about 7½ percent go to people with incomes under $50,000. Thus, more than any other type of income, capital gains are concentrated at the very top of the income scale.

Now, the Republican Contract With America talks about increasing that capital gains differential tremendously. When you add up indexing plus the 50-percent exclusion, it amounts on average to about a two-thirds exclusion for capital gains. Treasury thinks that will cost about $183 billion over the next 10 years, most of it in the second 5.

That works out on a full-year basis to about $50 apiece for a middle-income family and about $16,000 apiece for the top 1 percent in total capital gains breaks if the proposal is adopted. And, of course, the proposal would also apply to timber and coal and iron ore and a few other specially favored industries who, for historical and accidental reasons, get to treat part of their profits as capital gains. Those companies, as we know from the late seventies and early eighties, could go back to paying little or nothing in Federal income tax.

The case for a capital gains cut, which you have heard over and over again here today, is that somehow it will lead to more jobs, more investment, and more economic growth. You would think we might have learned something from the past. Because we have tried capital gains tax cuts and capital gains tax increases several times over the last couple of decades, and the funny thing is that every time the tax was cut, the economy took a nosedive. Jobs went down and investment declined. And every time the tax was increased, investment did better and jobs did better and the economy did better.

So do capital gains tax cuts cause the economy to go into recession? Probably not, but the evidence they don't help the economy seems pretty overwhelming.

Now, the promises people made that cutting the capital gains tax would lead to a short-term boom were silly when they were made. They didn't even match the theory that proponents were offering. But let's look at long-term effects.

The people that are pushing capital gains tax cuts seem to believe, honestly, I guess, that the market doesn't work, that money should go to them rather than to where the market would send it.

Well, I think, and I hope that Republicans think, that the idea that the government should be making investment decisions for business is just terrible economics. The truth of the matter is that paying people or corporations to make investments that otherwise don't make any business sense undermines economic growth. It is the last thing we need.

I hope this committee will focus not on opening up new loopholes and giving new subsidies, but instead on getting the government back to doing what it ought to do, building roads, protecting children and so forth, and not on doing what it does badly, that is trying to run the economy and micromanaging it. We hope you reject these proposals.

Thank you.

[The prepared statement follows:]

Testimony of Robert S. McIntyre
Director, Citizens for Tax Justice
Before the House Ways and Means Committee
Regarding Proposed New Tax Subsidies for Capital Gains and Corporate Profits Designed to Gut the Tax Reform Act of 1986
January 25, 1995

I appreciate the opportunity to testify before the Committee on behalf of Citizens for Tax Justice. Our coalition of labor, public interest and grassroots citizens groups represents tens of millions of middle- and low-income Americans, who have a vital stake in fair, economically sound tax and budget policies.

The Republican "Contract with America" proposes an array of new tax breaks whose costs will be close to $100 billion a year once they take full effect. The bulk of these enormous revenue losses stem from two items: huge new tax breaks for capital gains and a major expansion in corporate depreciation write-offs. We strongly oppose these proposals. If enacted, they would undermine the gains in tax fairness and economic neutrality achieved in the 1986 Tax Reform Act. They would once again put Congress in the position of directing and allocating private investment, rather than leaving it where it belongs—in the hands of businesses and consumers. We would once again face rampant tax sheltering and outrageous high-income and corporate tax dodging. Ultimately, the price would be borne by average Americans, through higher interest rates and eventually, increased taxes. We therefore urge the Committee to reject these tax deforms, and instead to work to close remaining wasteful, economically harmful tax subsidies that benefit the few at the expense of most families.

Introduction

At the heart of the GOP Contract appears to be the premise that our current income tax is biased against savings. The drafters of the Contract seems to believe that this alleged bias has caused a lower national savings rate than we otherwise would have. And thus, they conclude, we need to tilt the tax code so that it rewards saving and punishes consumption.

This is an interesting theory, but it hardly squares with reality. The truth is that the current tax code includes huge tax breaks for savings and investment. The loopholes range from no tax at all on some kinds of investment income, to outright "negative" tax rates on the profits from some kinds of corporate investments, to industry-specific tax breaks targeted to the politically powerful. In fact, the $200-billion-plus annual cost of tax expenditures for savings and investment is now almost equal to the total annual amount of personal savings! It seems rather apparent that if our savings rate is too low, tax breaks have been part of the problem, rather than the solution.

Savings and investment tax breaks are not simply a failed experiment in macroeconomic engineering. They also cause significant distortions in business decision making—to the detriment of overall economic growth. Worst of all, most savings and investment loopholes seriously undermine tax fairness, because they are extremely tilted toward the very best-off people in the country. To his great credit, President Ronald Reagan was able to overcome his initial inclination toward favoring loopholes, and his leadership was crucial to enactment of the Tax Reform Act of 1986. Thus it is distressing to see the new Republican Congress—supposedly dedicated to ending waste, defending the middle class and curbing unwarranted government interference in the free market—proposing vast new tax-based subsidies that look much more like central-planning than trust in market forces.

Capital gains

Capital gains are profits reflecting increased values of stocks, bonds, investment real estate and other "capital assets." Under current law, capital gains are treated much more favorably than other types of income, especially for the highest income people. In fact, total current capital gains loopholes are estimated to cost $170 billion over the next five years. In terms of cost and maldistribution—not to mention contentiousness—tax breaks for capital gains are without parallel.

Capital gains are not taxed at all unless and until they are "realized"—generally upon sale of an appreciated asset. And even when gains are realized, top-bracket individuals pay lower tax rates on capital gains than on so-called "ordinary" income.

As a result, investment markets that primarily service the well off are often designed to maximize the share of profits that are in the form of capital gains—both realized and unrealized. Indeed, on individual tax returns, total realized capital gains exceed total reported stock dividends by about 43%.

Which is not to say that capital gains are common for most taxpayers. In fact, only one tax return in every twelve filed reports any capital gains at all. Up to $100,000 in total income, dividends exceed reported gains. But for the highest income people—making more than $200,000 a year—realized capital gains exceed the total combined amount of both dividends and taxable interest.

Average Capital Gains, Dividends & Taxable Interest
By Family Income Group, 1994

Income ($-000)	Capital Gains	Dividends	Taxable Interest
<$10	$40	$70	$400
$10–20	70	200	820
$20–30	130	260	1,020
$30–40	210	390	1,360
$40–50	320	480	1,780
$50–75	660	870	2,180
$75–100	1,560	1,720	3,290
$100–200	4,630	4,110	6,310
$200+	66,070	27,120	33,660
All	$1,320	$920	$1,920

Averages for all taxpayers in group.
Source: CTJ Tax Model, January 1995

Almost two-thirds of total capital gains reported on individual tax returns go to people whose incomes exceed $200,000. In contrast, only 7.6% of the total gains are reported by the three-quarters of tax filers with incomes of $50,000 or less. Thus, more than any other type of income, capital gains are concentrated at the very top of the income scale.

Because the taxation of capital gains is more important to the rich and politically powerful than the treatment of any other type of income, capital gains taxation has been extremely controversial over the years. At the onset of the income tax, realized gains were taxed at the same rates as other income—up to 77% during the World-War-I period. When the GOP regained the White House after the war, however, the top capital gains rate was set at 12.5%—half the regular top rate of 25% from 1925 to 1931. The top regular rate rose to 63% in 1932, but the 12.5% top capital gains rate was briefly retained.

The onset of the Great Depression and public disillusionment with stock speculation of the Roaring Twenties, however, led to increased capital gains tax rates in the 1930s. For a brief period, realized gains were taxed under a complicated schedule that taxed gains from very short-term investments in full, but excluded as much as 70% of gains from sales of assets held for more than 10 years. This system was widely criticized as unwieldy and complex, and in the early 1940s it was scrapped. For the next 25 years, taxpayers had the option of excluding half of their capital gains or paying a maximum rate of 25% (useful to those whose regular tax brackets exceeded 50%).

In the late 1960s, the special 25% maximum rate was repealed. In conjunction with other tax changes, the top capital gains rate rose to about 39% by the mid-1970s. Then in 1978, congressional Republicans joined by a substantial minority of Democrats pushed through a major capital gains tax cut. It lowered the top rate to 28%, by excluding 60% of realized capital gains from tax. The 1981 cut in the top regular tax rate on unearned income reduced the maximum capital gains rate even further, this time to only 20%—its lowest level since the Hoover administration.

In conjunction with sharply increased depreciation write-offs in 1981 (see below), the 1978 and 1981 capital gains tax cuts caused a proliferation of tax shelters. Unneeded, unprofitable and often empty office buildings sprung up all across the country in response to the new tax subsidies (helping set the stage for the savings and loan crisis later in the decade). Esoteric capital-gains-based tax shelters in items like collectibles, freight cars and llama breeding abounded. Tax-shelter "losses" reported on tax returns jumped from about $10 billion a year in the late seventies to $160 billion a year by 1985. And since the goal of most of the shelters was not only to defer taxes, but to convert ordinary income into lightly-taxed gains, reported capital gains jumped as well.

Proponents of low capital gains tax rates like to argue that the surge in capital gains after 1978 and 1981 proves that capital gains tax cuts cause the

well off to cash in more unrealized gains, thereby mitigating (if not eliminating) the apparent revenue loss from a special low capital gains tax. To be sure, reported gains before exclusion did increase rapidly in the late seventies and early eighties. In nominal terms, they rose from $45 billion in 1977 to $80 billion in 1980 to $176 billion by 1985. Adjusted for the growth of the economy, this represents a 90% increase in reported gains from 1977 to 1985, and a 48% increase from 1980 to 1985. Since the maximum capital gains rate was cut in half between 1977 and 1985, even these figures indicate that the tax cut lost revenues. More important, since a very large share of the increased capital gains in the first half of the eighties represents tax-shelter conversions of ordinary income into gains, the surge in reported gains actually indicates a much greater revenue loss.

If, as Michael Kinsley and I have noted, we cut taxes in half for people named "Newt," then we surely would find that Newts reported much more income on tax returns. Indeed, total taxes paid by people named Newt might even go up. But that would merely reflect millions of people changing their names to Newt to avoid taxes, not some magical supply-side effect on Newts' incentives to work, save and earn money. The same is true of tax breaks for income called "capital gains."

Of course, looking only at national, aggregate data, it's hard to isolate the effects of capital gains tax changes from other factors that might affect capital gains realizations, such as the performance of the stock market and the overall economy. A recent study by Congressional Budget Office economists Leonard Bermun and William Rudolph, however, compared capital gains realizations by a large sample of taxpayers in various states, with widely different tax rates, over time. They found large transitory effects when the federal government made major changes in capital gains taxation.[1] But on a long-term basis, the study found very little correlation between capital gains tax rates and levels of realizations. In fact, in technical terms, the study found that "[t]he permanent elasticity is not significantly different from zero."

Despite all the debate over how much reduced capital gains taxes might affect the level of asset sales in the short run, it's really a side issue. The heart of the case for a capital gains tax break is that it encourages savings, investment, jobs and economic growth. And that case is astonishingly weak. Just look at what happened when capital gains taxes were cut in the past.

The 1978 Revenue Act, enacted in November of 1978, cut the maximum capital gains tax rate from 39% to 28%. Over the 12 months *prior* to enactment of that change, the real GDP grew by 5.8%. But *after* the 1978 capital gains tax cut was approved, the economy faltered. In fact, the GDP *dropped* by 1% over

[1]Most notably, in Sept. of 1986, Congress approved the Tax Reform Act of 1986, which increased the maximum capital gains tax rate from 20% to 28%, effective Jan. 1, 1987. This caused a rush by investors to cash in capital gains before what had become a temporary 20% rate expired. As a result, realized capital gains in corporate stock were nearly seven times as large in Dec. of 1986 as they had been in Dec. of 1985.

the next year and a half. The annual growth rate for the two years following the 1978 capital gains tax cut was only 0.3%—5.5 percentage points lower than the growth rate prior to the cut.

In August of 1981, another capital gains tax cut was enacted, this time cutting the top rate to 20%. Over the 12 preceding months, the economy had grown by 3.5%, but in the 12 subsequent months the GDP *fell* by 2.8%. In the two years after the 1981 capital gains tax cut was enacted, the annual growth rate was only 1%—2.5 percentage points below the growth rate prior to the cut.

Contrary to the assertions of capital gains tax cut proponents, capital gains tax cuts have never led to improved economic performance. Tax laws that have *increased* the capital gains tax, however, typically *have* been followed by increased growth. After the 1976 Tax Reform Act was enacted, for example, the economy's growth rate jumped from 3.9% in the preceding 12 months to 5.2% over the next two years. Likewise, following enactment of the 1986 Tax Reform Act, the growth rate rose from 2.2% in the previous year to 3.8% over the next two years.

Date of Capital Gains Tax Cut	Jobless Rate	Two years later	Change
November 1978	5.8%	7.3%	+1.5%
August 1981	7.3%	9.3%	+2.0%
Date of Capital Gains Tax Hike	**Jobless Rate**	**Two years later**	**Change**
October 1976	7.6%	5.7%	-1.9%
October 1986	6.8%	5.2%	-1.6%

Source: U.S. Dept. of Labor, Bureau of Labor Statistics.

The record of capital gains tax cuts when it comes to jobs is equally dismal. In fact, the unemployment rate *rose* sharply after both the 1978 and 1981 capital gains tax cuts. Conversely, the jobless rate *fell* notably after the 1976 and 1986 capital gains tax hikes were enacted.

History belies the claims that low capital gains taxes stimulate the economy. The long-term economic case against capital gains tax loopholes is even stronger. In essence, capital gains tax cut proponents seem to believe that free markets don't work, that government needs to step in with subsidies designed to override the signals the market sends about the level and allocation of capital. But this idea that the government should be making investment decisions for business is terrible economics.

The truth is that paying people and corporations to make investments that otherwise make no business sense undermines economic growth. Capital gains tax breaks and other supply-side loopholes of the first half of the 1980s inspired construc-

Capital Gains Tax Changes & Economic Growth
(Changes in Real Gross Domestic Product)

Date Enacted	Growth in Prior Year	Annual Growth Rate Over Next 2 Years	Change in Growth Rate
Capital gains tax cuts:			
Nov. 6, 1978	+5.8%	+0.3%	-5.5%
Aug. 14, 1981	+3.5%	+1.0%	-2.5%
Capital gains tax increases:			
Oct. 4, 1976	+3.9%	+5.2%	+1.3%
Oct. 22, 1986	+2.2%	+3.8%	+1.6%

NOTE: Growth rates are from date of enactment of the capital gains changes.
Source: U.S. Dept. of Commerce. Compiled by Citizens for Tax Justice, 1992.

tion of tens of thousands of unneeded office buildings and led to myriad other dramatic and wasteful misallocations of American capital and effort. But they completely failed to produce increases in total savings or investment.

One of the key goals of the 1986 Tax Reform Act was to curb the harmful, tax-motivated economic distortions that the supply-side policies had produced. As the official report on the Act notes, in the loophole era "the output attainable from our capital resources was reduced because too much investment occurred in tax-favored sectors and too little investment occurred in sectors that were more productive but which were tax-disadvantaged."

Certainly, the last thing our economy needs is to divert our nation's capital stock into other tax-motivated schemes at the expense of more productive investments. The right thing for our economy is to reduce the government's monstrous long-term budget deficits and to close—rather than expand—economically harmful tax loopholes.

Details on existing capital gains tax breaks:

28% maximum rate: One of the greatest achievements of the 1986 Tax Reform Act was to tax realized capital gains at the same rates as wages, dividends or other income. (Previously, realized capital gains had been 60% tax-exempt). But in 1990, Congress reinstated a small capital gains preference, by capping the capital gains rate at 28% while setting the top regular income tax rate at 31%. In the 1993 budget bill, this capital gains preference was greatly expanded to provide what amounts to a 30% capital gains exclusion for top-bracket taxpayers (the difference between the new 39.6% top regular tax rate and the continuing 28% maximum capital gains rate). The 1993 act provided an additional 50% capital gains exclusion for profits from certain "risky" investments that are considered likely to fail. A staggering 96% of the tax savings from the current 28% maximum capital gains tax rate for individuals goes to the best off 1 percent of all taxpayers.

Current Capital Gains Tax Break (28% Maximum Rate)
By Family Income Group, 1994

Income Group ($-000)	% with Capital Gains	% of Total Capital Gains	Average Tax Break (all returns)	% of Total Tax Break
<$10	1.9%	0.5%	$ –	–
$10–20	3.5%	1.1%	–	–
$20–30	5.1%	1.7%	–	–
$30–40	7.2%	2.0%	–	–
$40–50	8.7%	2.3%	–	–
$50–75	13.3%	7.1%	–	–
$75–100	21.5%	6.2%	5	0.2%
$100–200	31.8%	13.8%	105	3.6%
$200+	48.5%	65.3%	8,510	96.2%
All	**8.5%**	**100.0%**	**$ 115**	**100.0%**

Source: CTJ Tax Model, January 1995

Indefinite deferral of tax on unrealized capital gains: Capital gains are not taxed until assets are actually sold. As a result, investors can put off tax on their gains indefinitely. (They can also avoid tax on realized gains by selectively realizing losses on other investments in the same year.) This deferral is

unavailable, of course, to most other kinds of income (such as savings account interest, even if the money is left in the bank). Multibillionaire Warren Buffett, for example, is said to pay extraordinarily little in federal income taxes despite his enormous wealth, because he has structured his investment company so that it hasn't paid a dividend since 1966. Instead, Buffett's $12 billion or so in accrued capital gains remain unrealized and thus untaxed.

Capital gains tax breaks for gifts and inheritances: Currently, heirs can sell inherited property and pay no tax on capital gains that accrued prior to the time they inherit. In other words, capital gains taxes on inherited property are completely forgiven. In the case of gifts, the recipient takes over the giver's "basis" in the donated property—generally the cost when the property was first acquired. That carryover of basis—rather than taxing the gain—allows a continued deferral of unrealized capital gains.

Special additional industry-specific capital gains tax breaks: Historically, favorable capital gains treatment has normally been limited to profits from the sale of investments (stocks, bonds, etc.). But several industries have succeeded in getting part of their normal business profits treated as capital gains. Special capital gains treatment is currently available for sales of timber, coal, and iron ore and for certain farm income.

Other special capital gains breaks include:

- Indefinite tax deferral for so-called "like-kind exchanges" of real estate. Normally, when someone sells appreciated property he or she must pay tax on the capital gain. But someone who sells rental real estate and later purchases other rental property can put off paying capital gains taxes on the sale indefinitely by pretending to have "exchanged" the properties with another investor.

- The refinancing loophole. Owners of investment assets that have gone up in value can cash in their capital gains without tax by borrowing against the appreciation. This is an enormous tax shelter for, among others, wealthy real estate speculators.

- An exception from the normal $3,000 annual limit on net capital loss deductions for losses on the sale of certain "small business corporate stock." Except for a $3,000 a year *de minimis* rule, realized capital losses can only be used to offset realized capital gains. Otherwise, investors with a portfolio of winners and losers could realize losses to wipe out taxes on their wages and other income, even though their total capital gains position (realized and unrealized) was positive. But for certain "small business corporate stock" investments, up to $100,000 in losses can be deducted. This subsidy is presumably designed to ease the pain of backing money-losing operations, and thereby encourage wealthy investors to invest in businesses that are unlikely to succeed.

- Indefinite deferral of tax on the sale of a broadcasting facility or cable system to a "certified minority-owned business," i.e., a company at least nominally owned or controlled by "a black, Hispanic, Asian American or Native American." The federal government has approved an astonishing 303 such "tax-deferral certificates" since this program began in 1979 (presumably using complex apartheid-style rules to assure that the potential nominal

buyers met the racial classification requirements). On Wednesday, Jan. 4, 1995, the *Washington Post* reported on a particularly egregious example of how this tax subsidy works:

> "Viacom, the New York-based entertainment and media conglomerate, intends to sell its cable television systems for more than $2 billion to a minority-controlled enterprise under a program that would give Viacom a federal tax break of as much as $400 million, sources close to the company said. . . .
>
> "[C]orporate investors are putting up nearly all of the money for the purchase, but [black business executive Frank] Washington's management control of the [purchasing] partnership qualifies the group as minority-owned under FCC rules. Washington himself is investing slightly more than $1 million."

Apparently, this deal's "several giant corporate investors, including Tele-Communications, Inc., the world's biggest cable company," are paying Mr. Washington handsomely to use his name and race. In fact, Mr. Washington seems to have made his living on such deals since he came up with the idea for this particular racial preference while an official in the Carter administration. The *Post* reports that the Viacom deal would be Washington's fifth gorging at the "tax-deferral certificate" trough just since 1988. But whatever Mr. Washington personally clears on Viacom before he moves on to still another of these boondoggles, the bottom line is that the federal government has spent $400 million merely to make one multimillionaire, who happens to be black, even richer.

If the goal is to remedy the effects of racial discrimination, there must be better ways to spend $400 million than this offensive tax loophole.

Republican proposed additional capital gains tax breaks:

The GOP Contract with America proposes to replace the current 28% maximum capital gains rate with much bigger tax breaks. They include a 50% exclusion and indexing the basis of assets for inflation—applicable both to individuals and corporations. According to the Treasury Department, these changes would cost $183 billion over the next ten years—mostly benefiting the very rich.

Total Capital Gain Tax Breaks If the GOP "Contract" is Adopted (1994 Income Levels)

Income	% of Total	Average
<$10,000	0.1%	$-2
$10-20,000	0.8%	-12
$20-30,000	1.2%	-22
$30-40,000	1.6%	-37
$40-50,000	1.9%	-61
$50-75,000	6.0%	-128
$75-100,000	5.3%	-310
$100-200,000	12.9%	-1,000
$200,000+	70.2%	-16,372
All	100.0%	$-304

The combination of indexing and a 50% capital gains exclusion would on average exclude about two-thirds of all capital gains from taxation. For assets held for relatively short periods of time before sale, the exclusion could be close to 90%, while it would generally be lower for gains from sales of long-term holdings.[2]

The GOP's capital gains tax breaks would apply to corporations as well as individuals. As a result, large timber companies and certain other industries

[2]If an asset is going up in value by, say, 8% a year, while inflation is 3%, then indexing alone would cut the tax by 35% on the sale of the asset after one year. But if the asset is held for 20 years, indexing (alone) would cut the tax due by only 20%. When the GOP's proposed 50% exclusion is added on as well, the total exclusion for the one-year asset would be almost 70%, compared to 60% for the 20-year asset.

that are allowed to treat a large portion of their profits as capital gains could end up paying little or nothing in income taxes.

The tax-sheltering potential of the Republican capital gains breaks is staggering. Investments in depreciable property that actually lose money before tax could become highly profitable after tax under the plan.

Testifying before this Commitee a few weeks ago, the Treasury noted:

> "Increasing the preferential treatment of capital gains would create economic efficiency losses and make the tax system more complex by encouraging taxpayers to convert ordinary income into capital gains."

Even some conservative economists have expressed serious reservations about the GOP's proposed capital gains tax cuts. They note that capital gains are already the lowest taxed form of capital income (due to deferral and preferential rates), and they fear the likely waste of capital resources from new tax shelters. These are among the reasons why indexing, although it might seem attractive at first glance, is particularly inappropriate in the case of capital gains. In fact, indexing *any* type of capital income for inflation (whether interest, dividends, or whatever) is inappropriate unless interest costs are also indexed downward.

If the GOP capital gains tax plan is adopted, capital gains tax breaks going to the richest 1 percent of the population would soar to an average of almost $16,400 each per year. That's a very expensive subsidy to encourage uneconomic investments.

Accelerated depreciation

Born in scandal during the Nixon administration and the cause of many tax scandals thereafter, accelerated depreciation now is the largest of all corporate tax loopholes. Technically, accelerated depreciation lets companies write off the costs of their machinery and equipment faster than it actually wears out. In practice, that means sharply lower tax bills for companies that can take maximum advantage of the tax breaks.

In 1970 after the repeal of the investment tax credit the previous year, the Nixon Treasury Department sought a new way to subsidize corporate profits. What it came up with was called the "Asset Depreciation Range" or "ADR" system. Put into place by executive fiat, it shortened depreciation periods by 20% across the board and also allowed accelerated write-off methods that concentrated deductions in the early years that equipment is used.

Nixon's ADR approach was immediately challenged in court by public interest tax attorneys as far beyond Treasury's authority under the tax code and therefore an unconstitutional and shameful giveaway to big business. But while the lawsuit was pending, a heavily lobbied Congress passed Nixon's 1971 revenue act. That infamous bill retroactively ratified the ADR system, and reinstated the investment tax credit to boot. The combination was deadly

for the corporate income tax. A sharp decline in corporate tax payments quickly ensued. Coincidentally or not, productivity growth also collapsed soon thereafter.

By the late seventies, widely publicized studies by the congressional Joint Committee on Taxation and the nonprofit Tax Analysts and Advocates were finding that many companies and even whole industries were paying effective tax rates far below those envisioned in the tax code. But worse was to come.

In 1979, Sen. Lloyd Bentsen (D-Tex.), Barber Conable (R-NY) and James Jones (D-Okla.) introduced a huge corporate tax cut bill. In it, they proposed to shorten depreciation periods and accelerate write-offs much more radically even than ADR. Disingenuously, Bentsen et al. claimed that their plan would cost only $2 billion a year. That was indeed the estimated cost of the plan in its first nine months. But the sponsors knew full well, although they never mentioned, that by its fifth year the plan was expected to cut business taxes by a staggering $50 billion annually.

Urged on by a massive corporate lobbying campaign, believing the low-cost promises of the sponsors and naively hoping to help the economy, hundreds of congressmen and Senators signed onto the Bentsen-Conable-Jones accelerated depreciation bill. In conjunction with an expanded investment tax credit, a version of the depreciation plan was adopted as part of President Reagan's hugely expensive 1981 tax cut act (and made retroactive to the start of 1981).

With that, the floodgates opened. By 1983, studies by Citizens for Tax Justice found that half of the largest and most profitable companies in the nation had paid no federal income tax at all in at least one of the years the depreciation changes had been in effect. More than a quarter of the 250 well-known companies surveyed paid nothing at all over the entire three-year period, despite $50 billion in pretax U.S. profits. General Electric, for example, reported $6.5 billion in pretax profits and $283 million in tax rebates. Boeing made $1.5 billion before tax and got $267 million in tax rebates. Dupont's pretax profits were $2.6 billion; after tax it made $132 million more! Subsequent CTJ studies found similar outrages in 1984, 1985 and 1986.

In response to public clamor, his own newfound misgivings and the disappointing economic results of the 1981 corporate tax cuts, Ronald Reagan helped lead the fight for the loophole-closing Tax Reform Act of 1986. The 1986 act repealed the investment tax credit and sharply reduced depreciation write-offs for buildings. The changes greatly scaled back corporate tax avoidance opportunities and made taxpayers out of most of the former corporate freeloaders.

While companies paid more in taxes after 1986, however, business investment flourished. To the chagrin of the supply-side advocates of corporate tax cuts, real business investment grew by 2.9% a year from 1986 to 1986. That was 43% faster than the paltry 1.9% growth rate from 1981 to 1986. Even more significant, while construction of unneeded office buildings tapered off after tax reform, business investment in industrial machinery and plants boomed. As money flowed out of wasteful tax shelters, industrial investment jumped by 5.1% a year from 1986 to 1989, after actually *falling* at a 2% annual rate from 1981 to 1986. As former Reagan Treasury official, J. Gregory Ballentine, told *Business Week*: "It's very difficult to find much relationship between [corporate tax breaks] and investment. In 1981 manufacturing had its largest tax cut ever and immediately went down the tubes. In 1986 they had their largest tax increase and went gangbusters [on investment]."

Despite its advances, the 1986 Tax Reform Act did not end corporate depreciation abuses. Even today, businesses are allowed to write off the cost of their machinery and equipment considerably faster than it actually wears out. This remaining loophole has proven much more expensive than originally anticipated by the drafters of the 1986 Tax Reform Act. In fact, accelerated depreciation tax breaks are expected to cost $164 billion over the next five years.

Like any tax break targeted to corporations, accelerated depreciation is primarily a windfall for the very well off. In fact, tax breaks from accelerated depreciation are worth more than $11,000 a year to people making more than $200,000.

Economists also complain—rightfully—that accelerated depreciation often skews investment decisions away from what makes the most business sense and toward tax-sheltering activities. This can, for example, favor short-term, tax-motivated investments over long-term investments. Moreover, when equipment is purchased with borrowed money, the current tax system produces outright "negative" tax rates—making such investments more profitable after tax than before tax! As a result, corporate buying and selling of excess tax breaks through equipment "leasing" deals have remained widespread (albeit not on the scale of the first half of the 1980s). General Electric, for example, avoided a total of $1 billion in federal income taxes from 1986 to 1992 due to activities of its leasing subsidiary, GE Capital Services.

Shares of Total Corporate Tax Breaks By Family Income Group 1994

Income Group ($-000)	% of Total Corporate Tax Breaks
<$10	0.6%
$10–20	4.2%
$20–30	4.4%
$30–40	4.7%
$40–50	4.7%
$50–75	10.4%
$75–100	7.6%
$100–200	14.7%
$200+	48.7%
All	100.0%

Based on shares of reported capital income. CTJ Tax Model, Jan. 1995.

Republican proposed additional depreciation tax breaks

With its huge cost, terrible distribution and sad economic record, accelerated depreciation might seem to have little going for it. Indeed, some might see curbs on excessive depreciation as a promising target for reducing the federal budget deficit. The new GOP leadership in Congress, however, has promised quite the opposite in its Contract. In fact, through it's so-called "neutral cost recovery system," the GOP has proposed to expand depreciation tax subsidies far beyond their current levels. A quirk in the GOP approach causes it to raise corporate taxes in the very short run, and in a replay of the past, the Republicans are trying to count it as a revenue raiser. But the plan soon would add $30 billion a year or more to the budget deficit.

Under the Republican plan, rather than writing off the cost of machinery and buildings as they wear out, companies would write off considerably *more* than the actual cost. On a $10 million investment in machinery, for example, the GOP would allow almost $11.5 million in tax deductions over five years. Currently, excessive depreciation tax write-offs for a corporation buying $10 million in machinery are worth about $460,000 (in what economists call "present-value" terms). The Republican plan would boost value of the tax subsidy on such a purchase to more than $800,000.

Today's depreciation rules already reduce the effective tax rate on the profits from typical investments in machinery to about half the statutory 35% rate. But the GOP plan is intended to be the mathematical equivalent of writing off the full cost of capital investments—in machinery, buildings, land, etc.—immediately. Thus, the effective tax rate on profits from new corporate investments would be—at most—zero! For even partially debt-financed investments, the effective tax rates under the GOP plan would be sharply negative. Such investments thus would be much more profitable after-tax than before-tax.

If the Republican depreciation changes are adopted, there is no doubt that corporate tax-sheltering would proliferate, and that many major corporations would once again pay little or nothing in federal income taxes.

Mr. ZIMMER. Thank you, Mr. McIntyre.

We in the new majority appreciate your kind words for Ronald Reagan which follow the praise for President Reagan that we heard last night from President Clinton in the State of the Union Address.

As I recall Ronald Reagan's understanding of the 1986 Tax Act and the reason he signed it, there was a tradeoff. In exchange for the elimination of a wide array of deductions, some of which we consider incentives, the marginal—the top marginal tax rate was reduced to 28 percent.

You are very vocal and very passionate in arguing that we would undercut the understanding, the deal that was made in 1986. I did not hear your organization complain that the top marginal tax rate has been increased 40 percent higher than it was in the 1986 arrangement.

Mr. MCINTYRE. Well, you weren't listening, Mr. Chairman. We were very concerned—not that the top rate was not going to be increased some, it had to be to deal with the deficit—but about creating this large new capital gains differential. We argued very strenuously that a much lower top rate than we have now would be more appropriate if all income were treated the same.

We also argued very strenuously that rather than raising rates that loopholes ought to be closed. The solution they came up with, raising the top rate, was it horrible? No, I don't think so. But it was not what we recommended at all.

We felt very strongly in 1986 and we feel very strongly today that we should have a tax system with the lowest possible but progressive rates. The way you get there is not to have special subsidies for this or that activity that currently has favor in the Congress.

Mr. ZIMMER. Well, I believe what Ronald Reagan looked for was not so much progressivity or steeply graduated rates but rather rates that were as flat as possible. You say that fairness is undermined by this proposed legislation. I ask you, is it fair to tax someone on a gain that is solely attributable to inflation?

Mr. MCINTYRE. Well, most of the witnesses we have heard here today are from the venture capital area where to a very large degree the rate of return on these investments, successful ones, is so high that the inflation factor is negligible.

Now, there are investments where inflation matters. There are also many investments where deferral matters. And I don't think that anyone who has looked at it has done anything but conclude that capital gains are the lightest taxed form of capital income.

There was an op-ed piece by a very conservative University of Chicago professor in the Washington Post last week that made exactly that point, and suggested if you want to cut taxes on capital, the last place you would look would be capital gains because they are taxed so lightly already.

This proposal gets the rate down to something on the order of an 11 or 12 percent maximum rate if gains are realized. That seems to me to be far too low compared to other kinds of income.

Mr. ZIMMER. Could you answer my question? Do you believe it is fair to tax a gain, a nominal gain which is solely the result of inflation?

Mr. McINTYRE. Yes, as long as we allow interest deductions that are solely the result of inflation, yes, I do.

Mr. ZIMMER. What do you mean by that?

Mr. McINTYRE. I mean if you are going to index gains for inflation, you have to index debt for inflation. Otherwise, as one of the previous witnesses from the New York Bar Association pointed out, you would be giving people deductions for "losses" on investments that make money or break even. As you may recall from your previous career, we call that a tax shelter.

Mr. ZIMMER. Mr. Ture, you wish to respond.

Mr. TURE. Assistant Secretary Samuels tried to make that point in his testimony. You will find in my testimony a rebuttal of his arithmetic, which I think is grossly in error. It is incidentally a rebuttal of the statement Mr. McIntyre just made.

May I take the liberty of addressing something that Mr. McIntyre has brought up over and over again, using the term subsidy?

Mr. ZIMMER. Yes.

Mr. TURE. Let's be sure that we have correctly identified what a tax subsidy is. It is a tax provision that reduces the relative cost of something or other, whatever the tax object is, compared to the cost or prices of other things from what they would be absent taxes generally.

Now, what we have under existing law is a set of provisions that artificially raises the cost of saving relative to the cost of consumption.

It does so by adding tier after tier of taxes to the returns on income that people save. That subsidy is a negative subsidy. It is an enormous tax penalty. But what the proposed title I of H.R. 9 attempts to do is to moderate that penalty. It does not remove it. But it does moderate it with respect to, initially, a particular form of return on one's savings.

Mr. ZIMMER. Thank you very much.

The next inquiry will be from Congresswoman Dunn.

Ms. DUNN. Thank you very much, Mr. Chairman.

Mr. McIntyre, you are our lightning rod, I gather. I want to ask you a question about your comment about the central government control aspects of the Contract provisions as we look at how we can benefit the private sector.

How do you explain or what is in your mind when you said to us that central planning is apparent to you in the Contract? How would you explain how a broad-based capital gains tax cut, for example, that applies equally to everybody resembles central planning?

Mr. McINTYRE. Well, as you know, Ms. Dunn, different kinds of investments pay their returns in different ways. Many of the venture capital activities, for example, pay their returns as capital gains.

In fact, overall capital gains are a bigger piece of returns than are dividends from corporate stock. But if you put in a special preference for capital gains that taxes them much more lightly than dividends or interest or other returns to capital, you will find that real estate does very well, that certain types of corporate investment do very well, and that that happens to the detriment of other kinds of investments.

If you have trouble figuring out which investments are preferred, then you could say it is incompetent central planning. But it is still central planning. It is what we saw in the early eighties and it was universally decried as a horrible government policy. We ended up with all those empty office buildings that nobody wanted to rent. We ended up with people investing in llama farming and all kinds of esoteric tax activities that made no sense in the market, but were undertaken because the Ways and Means Committee and the Senate Finance Committee put in tax incentives that encouraged such investments.

That is what I mean. If you believe in markets, you don't favor one investment over another. You can bring in every industry in America to testify here and they will explain that their products are wonderful and do great things. You can't subsidize them all and still run the government, so you end up choosing to subsidize some over others and you end up with bad economic results.

Ms. DUNN. Would any other panelist care to respond?

Mr. TURE. If I may, Mr. McIntyre has again used the word subsidy. What we have had since the creation of the contemporary income tax in the early 1900s is a tax system which not only taxes the amount of income that people save but then taxes the returns on that saving and taxes it and taxes it and taxes it.

Under the existing system, it is taxed if the returns are directly paid to the individual. Those returns are taxed. You have got a double tax right there. If, in fact, the individual has directed his saving into the ownership of corporate equity, the corporate returns on that corporate equity is taxed to the corporation. Insofar as the corporation distributes those as dividends, they are taxed to the individual recipient again. If instead the corporation retains those earnings, the value of the equity goes up, when the individual realizes the gains on that, that, too, is taxed. There are taxes at the State and local level on the same returns. There are property taxes. There are finally estate and gift taxes, transfer taxes.

It is as if we regard capital and the returns on it as sources of great evil in our society rather than as the primary sources of increases in productivity, real wage rates, and employment. We do not subsidize particular industries or particular activities by reducing one of those levels of additional tax on the returns on saving.

I think it is a gross error to assert that that is the case, as Mr. McIntyre has done. Rather, reducing the tax rate on capital gains will represent a small but very important bite in reducing one of those extra tiers on the returns on saving.

It is a highly constructive measure. I wish that the committee were in a position, as Mr. Archer has frequently suggested, to go—to take a somewhat more thoroughgoing revision.

Ms. DUNN. Mr. Chairman, may I do one followup to Mr. McIntyre's statement?

Mr. ZIMMER. Yes.

Ms. DUNN. Mr. McIntyre, what in your mind would a fair Tax Code include?

Mr. MCINTYRE. What would it look like? Well, it would look like the system we established after 1986 minus another couple of hundred billion dollars in loopholes, which would then mean much lower rates.

So, for example, Representative Gephardt has suggested he is working on a sort of "Tax Reform, Part 2" plan, which would get rid of some of the remaining tax breaks in the code and lower the rates. I assume that would be attractive to some. It would be unattractive to those who benefit from the current breaks enough that they already pay less than the lower rates that would be proposed.

I think Representative Gephardt's approach would be a much better system. The top rate might end up being 30 percent, the bottom rate might be 12 or 13 percent, and that would mean that even if you tax capital gains like dividends and interest, the top rate wouldn't be much different than it is now.

Ms. DUNN. Thank you.

Mr. ZIMMER. Mr. Ensign.

Mr. ENSIGN. Thank you, Mr. Chairman.

First, let me start by saying that I guess by some of the comments that have been made by our last speaker that the previous speakers are not nice people. I mean, you have raped the system, you have unfairly profited, and I am sure it is at the expense of other people.

I don't think that we can ever have a system where all people will benefit. God forbid that we would have a system where the rich and the poor benefit. I don't think that we can have a system like that. There is no way that a job is good when you are making profits on it off of your businesses. So shame on all of you for the work that you have done in the past.

I brought up this question a couple of days ago and it has to do with competitiveness in the world. We talk about small entrepreneurs and biotech fields. One of the problems that we have in a global economy is making sure we have businesses that are competitive on a global market.

From what I understand, a lot of the developments don't just come from larger companies, a lot of the research and development and innovations come from startup companies, come from small companies. Can you address how you think that the reduction in the capital gains tax would help keep America competitive and therefore keep jobs in America?

Mr. DEHAVEN. If I might. As per your first comment, I would like to thank Mr. McIntyre. I now know what I am. I am a bragging supplicant. I didn't realize that until I got here.

I tried to make that point, Mr. Ensign, in my discussion that we find in the American Electronics Association that our smallest members are in competition with the Japanese and how the Chinese and as a matter of fact, we will in the next day or so, we will be releasing the latest statistics on trade with Japan and China and the deficit in the high-tech area is the worst it has ever been in history. The fact is that Japan isn't the major problem anymore; it is really China, and our deficit with China is huge and it is going to be shocking when those numbers come out.

This research and development is very expensive, as was pointed out, not only in the biotech field but in the electronics field. And the most important costs involved in subsidizing such a venture is the cost of capital.

All of the costs involved, which would include the cost of the tax system, market to cost of capital, the cost of labor and the cost of

customer support, are generally ranked in that order such that the cost of access to the market and the cost of capital are by far the most, and by reducing the capital gains rate, it is going to put more money into the marketplace and it will reduce the rate substantially.

Mr. BECKMAN. Could I address that for a moment?

Clearly in the biotechnology sector, small entrepreneurs are the driving engine of biotechnology, and in our business, capital is the fuel of innovation. We frankly can't borrow any money because most of the companies, 90 percent or more, don't have revenues that come from product sales. There may be some interest income, but that is a dwindling asset as is our capital.

And clearly, tax issues and tax considerations which would support capital formation would be extremely important to this innovative industry. It is an industry right now that is—a good portion of it is close to imperiled, as cash balances are less than 1 year for 70 percent of the biotechnology industry. If this industry is to survive and this is a U.S.-dominated, world-class industry, we have got to find additional ways to capitalize it.

Mr. TURE. Mr. Ensign, can I relate something to you. Many years ago during the sixties, I was director of tax studies for the National Bureau of Economic Research. One of our projects was an interview study to find out what was the effect of ordinary taxes and capital gains tax on entrepreneurial activities in the high-tech, high-risk areas.

What the interviewer discovered—and I have forgotten exactly how many interviews he conducted—there was a very substantial number of them and most of them were with people who left one of the Cambridge universities for the purpose of setting up his own or her own shop to develop ideas developed in the laboratories or created in the laboratories of those universities and corporations. Without exception, every single one of them said, Had we been faced only with ordinary tax rates on whatever gains we could have realized on the development and successful development of our own innovations, we would not have left the shelter of the university and the corporation.

These products and processes and so forth to a very substantial extent would never have come into existence. It was the fact that those high risks, those very high costs of innovation could be offset to some substantial extent, those risks could be offset to some substantial extent by the less punitive treatment afforded by capital gains that allowed them to go out and venture.

I think that is something that you have been trying to say which I think is extraordinarily important to keep in mind.

Mr. ENSIGN. Thank you. Mr. Chairman, if I may make just one last comment.

Mr. ZIMMER. Yes.

Mr. ENSIGN. It is not a question. I am a veterinarian by profession. I am building my second animal hospital right now, and I would like you to think about this, Mr. McIntyre, 20 years ago when veterinarians came out of school, their sheepskin got them a loan from a bank and they were able to start up a business. They cannot get that anymore. You have to come up with 20 to 30 per-

cent downpayment. It gives an advantage to people like me that can afford to go to a bank and get those loans.

Veterinarians coming out of school now need venture capital, they need people that are willing to invest in them, and if they can get a more favorable tax treatment with their capital gains there are more and more opportunities for young people coming up in those startup businesses.

Thank you, Mr. Chairman, for your indulgence.

Mr. LIETZKE. May I make a comment please.

Mr. ZIMMER. We are under the gun. Let me consult with Mr. Christensen. Would you like to try to get in the questioning now as you know we have about 9½ minutes to get to the floor.

Mr. CHRISTENSEN. Mr. Chairman, I would make it real brief and we have got 9½ to go.

Mr. ZIMMER. Just about, yes, to be on the floor.

Mr. CHRISTENSEN. Yes, I will make it very brief.

I want to just tell Mr. DeHaven that I appreciate everything you have done and everything you have gone through, and don't ever apologize for what you stand for because you are the American dream. And no matter what anybody at this panel may think, you are the creator of jobs in this country, and I appreciate everything you have gone through, and that goes for Mr. Beckman, Mr. Herring and Mr. Lietzke. I know that even though you are a senior vice president there, you are part of the private sector and I appreciate what you guys have done. Because of a shortage of time, I can't go into things I would like to talk with you about.

And, Dr. Ture, as a researcher who understands the private economy and the private sector, I want to thank you for your testimony here today.

And, gentlemen, I appreciate everything you do and stand for. Thank you.

Mr. ZIMMER. Thank you, Mr. Christensen.

I think we have time enough for Mr. Lietzke's remark if it is brief.

Mr. LIETZKE. A quick comment. Several people have mentioned that the things that fuel companies are certainly capital and that is an important piece of it. I think there is another piece that goes with that and that is the hard work and the effort of large numbers, probably millions, of employees who participate in making these companies successful and through the hard work that the employees go through, especially those that have some equity investment in the form of stock options or stock purchase plans.

It seems to me only fair that there be some return on that hard work and effort for the millions of people who really make these companies successful. So it is not the capital alone. It is the hard work and effort of the employees.

Mr. ZIMMER. Thank you very much, and thank you to the entire panel.

We will now recess until we return from the vote. Thank you very much.

[Recess.]

Mr. COLLINS [presiding]. We will call the meeting back to order and go ahead with our last panel.

I would like to introduce the panel. Bartow Shaw, president of Shaw, McLeod, Belser, & Hurlbutt, Inc., Sumter, S.C. And we have William C. Siegel, president, Society of American Foresters; Douglas P. Stinson, owner-manager of Cowlitz River Tree Farm, Toledo, Wash.; and Hon. William Stuckey, past president, Forest Farmers Association. And we will start with Mr. Shaw.

STATEMENT OF BARTOW S. SHAW, JR., PRESIDENT, SHAW, MCLEOD, BELSER, & HURLBUTT, INC., ON BEHALF OF THE AMERICAN FOREST & PAPER ASSOCIATION, AND THE FOREST INDUSTRIES COUNCIL ON TAXATION

Mr. BARTOW SHAW. Thank you, Mr. Chairman.

My name is Bartow Shaw. I am president of the firm of Shaw, McLeod, Belser & Hurlbutt of Sumter, S.C. We are a forestry consulting firm managing timberland primarily for nonindustrial landowners.

I am also a timberlandowner myself. I am a member of the board of directors of the Forest Industries Council on Taxation, the national trade association which represents the forestry industries and nonindustrial landowners on all Federal tax issues.

In addition, I am an immediate past member of the board of directors of AF&PA, the American Forest & Paper Association. The AF&PA is a national trade association of the forest products and paper industry as well. AF&PA represents a vital national industry which accounts for over 7 percent of the total U.S. manufacturing output, employing some 1.6 million people. This industry ranks among the top 10 manufacturing employers in the United States and has an annual payroll of $49 billion on sales of over $200 billion. The industry utilizes timber grown on public lands from its own lands and from forests owned by almost 7 million nonindustrial private landowners.

I wish to thank you for providing me the opportunity to testify before this committee today on legislation that is vitally important to the landowners throughout the Nation. Forestowners are located in nearly every region of the Nation. They own 350 million acres of woodlands, encompassing more than 72 percent of all commercial forests.

The typical nonindustrial landowner is not a wealthy individual, owning an average of less than 50 acres of woodland and with an average household income of less than $50,000 per year. Our firm has served hundreds of nonindustrial clients for almost three decades, and I can relate from experience that a great many of them now face a return much lower than expected when they invested because of effects of the Tax Reform Act of 1986.

Since its enactment in 1944, capital gains treatment for timber dispositions has resulted in impressive gains in planting and productivity. However, tree planting has suffered a continual declining trend since 1986. According to the U.S. Forest Service, tree planting in the United States in 1993 was at its lowest level since 1980. The increase in the capital gains rates has been a major fact in causing this decline.

A more limited timber supply will lead to significantly greater pressure to increase timber removals from public lands at a time when those harvests are being reduced for a variety of reasons.

Less than 10 percent of the Nation's timber harvest comes from public lands. With the Nation now looking to the private sector for today's working forests and those of the future, the country's interests require a policy framework which is supportive of private forestry investments.

The House Republican Contract With America contains provisions drafted by the chairman of this committee which would cut the tax rate on capital gains by allowing all taxpayers, both individuals and corporations, to one, deduct one-half the amount of the net capital gains and two, adjust the basis for their capital assets for inflation.

This proposal is intended to encourage long-term investments and risk taking and to lower the country's cost of capital which will translate into greater economic growth and job creation.

AF&PA applauds and unequivocally endorses the Chairman's bold effort to improve the climate for long-term investments and capital formation.

Lowering the cost of the capital will help the forest products and paper industry compete in the global marketplace. The United States already imports more in forest products than it exports. In 1994 nearly 34 percent of our softwood lumber consumption was imported. Overseas suppliers, many of whom are given generous tax breaks and other subsidies, have a competitive advantage over U.S. producers in world markets. Indeed, most other industrial countries have lower capital gains rates than this country, and many countries impose no tax at all on the sale of capital assets. A reduction in the U.S. capital gains tax will help restore our industry's international competitiveness.

The Chairman's proposal would also be a powerful tool in encouraging private landowners to make important investments in reforestation. Rates of return are historically low compared to alternative investments with capital literally locked in the ground during a rotation period of 30 to 80 years or more. As subsequent shortages occur, tree growers cannot respond to short-term supply as with other commodities. Consequently, forestowners are very sensitive to recall factors that affect the economics of forestry. U.S. tax policy is one of those key elements.

In closing, let me emphasize our appreciation for the Chairman's tremendous efforts in developing the proposal before the committee today. It represents a commitment to a Federal tax policy which will provide future generations the multiple benefits of America's privately-owned forests.

The AF&PA and millions of forestowners will support your effort 100 percent, and we will work with you to ensure its ultimate enactment into law.

Thank you.

[The prepared statement follows:]

STATEMENT OF BARTOW S. SHAW, JR.

AMERICAN FOREST & PAPER ASSOCIATION

BEFORE THE

COMMITTEE ON WAYS AND MEANS

UNITED STATES HOUSE OF REPRESENTATIVES

JANUARY 25, 1995

Mr. Chairman, my name is Bartow S. Shaw, Jr. I am President of the firm of Shaw, McLeod, Belser & Hurlbutt of Sumter, South Carolina. We are a forestry consulting firm managing timberland for non-industrial landowners. I am, also, a timberland owner myself. I am a member of the Board of Directors of the Forest Industries Council on Taxation, the national trade association which represents the forestry industries and non-industrial landowners on all federal forestry tax issues. In addition, I am an immediate past member of the Board of Directors of the American Forest and Paper Association (AF&PA), the national trade association of the forest products and paper industry. AF&PA represents a vital national industry which accounts for over 7 percent of the total United States manufacturing output. Its members account for more than 90 percent of domestic paper and recycled paper manufacturing capacity. Employing some 1.6 million people, this industry ranks among the top 10 manufacturing employers in 46 States, has an annual payroll of $49 billion on sales of over $200 billion, and is a significant exporter to global markets. The industry utilizes timber grown on public lands and from forests owned by almost seven million non-industrial, private landowners. I wish to thank you for providing me the opportunity to testify before the Committee today on legislation which is vitally important to landowners throughout the nation.

CAPITAL GAINS AND TIMBER

Forest owners -- from large corporations to small farmers -- are located in nearly every region of the nation. They own 350 million acres of woodlands, encompassing more than 72 percent of all commercial forests. The typical non-industrial landowner is not a wealthy individual, owning an average of less than 50 acres of woodland and with an average household income of less than $50,000 per year. The average non-industrial landowner's investment prior to 1986 will produce considerably less for retirement or college expenses than anticipated due to the change in the capital gains treatment. Our firm has served hundreds of non-industrial clients for almost three decades, and I can say with authority that a great many of them are in this unfortunate situation.

The Tax Reform Act of 1986 eliminated the existing differential for capital gains,creating a genuine economic hardship for timber growers. Taxes were increased on capital gains but decreased on alternative forms of investment. Timberland investors awoke to discover higher capital gains rates without any provision allowing them to average their income over the life of the investment. This is important because economic circumstances such as retirement often force landowners to receive a lifetime's gain on their timber income in one year. Now, many of these landowners and their heirs are rethinking plans for reforestation, which could cause a shortage of wood in the future.

Since its enactment in 1944, capital gains treatment for timber dispositions has resulted in impressive gains in planting and productivity. Today, in spite of increased harvests to meet consumer needs, there is actually more growing stock than in

1944. However, despite the fact that we plant more trees than we harvest, tree planting per se has declined since 1986. The increase in capital gains rates has been a major factor in causing this decline. Indeed, according to the U.S.D.A. Forest Service, tree planting in the United States in 1993 was at its lowest level since 1982.

And, of course, a more limited timber supply will lead to significantly greater pressure to harvest timber from public lands at a time when more public lands are already being withdrawn from harvesting for a variety of reasons. Timber harvests on public forests have declined over 50 percent from the levels of the mid 1980s. Now less than 10 percent of the nation's timber harvest comes from public lands. This has put intense pressure on private woodlands. With the nation now looking to the private sector for today's working forests and those of the future, the country's interests require a policy framework that is supportive of private forestry investments.

The House Republican "Contract with America" contains provisions drafted by the Chairman of this Committee which would substantially cut the tax rate on capital gains by allowing all taxpayers, both individuals and corporations, to (1) deduct one half of the amount of their net capital gains and (2) adjust the basis of their captital assets for inflation. This proposal is intended to encourage long-term investments and risk taking and to lower the country's cost of capital which will translate into greater economic growth and job creation. **AF&PA APPLAUDS AND UNEQUIVOCALLY ENDORSES** the Chairman's bold effort to improve the climate for long-term investments and capital formation.

The U.S. forest and paper industry must compete globally. Lowering the U.S. cost of capital will increase timber supply and help the entire industry compete in the international marketplace. The U.S. already imports more forest products than it exports. In 1994 nearly 34 percent of the U.S. softwood lumber consumption was imported. In addition, investments in timberland are moving overseas partly because of the shorter growing periods in the Southern Hemisphere and consequent quicker return on investment. And as the investment moves so do the jobs. A $1.0 billion decrease in imports could bring 20,000 jobs back home. Overseas suppliers, many of whom are given generous tax breaks and other subsidies, have a competitive advantage over U.S. producers on world markets. Indeed, most other industrial countries have lower capital gains rates than this country has and a number of countries impose no tax at all on the sale of capital assets. A reduction in the U.S. capital gains tax will help restore our industry's international competitiveness.

The Chairman's proposal would also be a particularly powerful tool for encouraging private landowners to make the necessary investments in reforestation. It takes between 15 and 75 years to grow timber for harvest, depending on the geographic region and product, making forestry an activity that is unlike almost every other economic endeavor. Timber growing requires substantial start-up investments and is burdened with uninsurable high risks of weather, disease, insects and fire. Rates of return are historically low compared to alternative investments, with capital literally locked in the ground during the rotation period. There is very little market liquidity in the initial years because trees cannot be economically harvested before maturity. Consequently, private forest owners are very sensitive to all factors that affect the economics of forestry. U.S. tax policy is one of those key elements.

Moreover, sound economic forestry policy encourages sound forestry management practices which serve to significantly enhance the overall environmental quality of our forests and their surrounding communities. For every year there is inadequate reforestation and less effective timber management, that year's lost planting is lost forever -- **a tree cannot be planted retroactively.** Our professionally managed forests provide vital

wildlife enhancement, water quality, a hedge for soil erosion, provide for recreational needs and create aesthetic beauty. In fact, we are now learning more fully the critical role being played by reforestation in the effort to combat the so-called "greenhouse effect", while at the same time the land is growing trees for future wood supply.

We commend the Committee for putting forth a proposal that will significantly enhance the ability of the nation's tree growers to continue their stewardship of the land. We wish to emphasize that it is important that this proposal apply to all taxpayers whether corporate or individual. A preferential capital gains rate should not depend on the form in which one conducts business. If it does it is sure to promote economic distortions in the marketplace.

We also wish to note that we have met with Committee staff concerning one aspect of the proposal, in particular, the indexing provision for timber owners. We have developed an alternative to the basis adjustment concept for simplicity and the administrative ease of our many small landowners. Our alternative is embodied in legislation introduced during the last Congress, the Reforestation Tax Act, H.R. 960. This alternative reduces gain by percentage adjustments intended to approximate the rate of inflation for every year the timber was held. Our approach tries to provide a simple way to compensate tree farmers for the effects of inflation over the very long periods of time they hold their investments.

In closing let me emphasize once again our appreciation and commendation for the Chairman's long and hard efforts in developing the proposal before the Committee today. The AF&PA and millions of forest owners will support your effort 100 percent and will work with you to insure its ultimate enactment into law.

Mr. COLLINS. Thank you, Mr. Shaw.

Now, we will go to Mr. Siegel.

STATEMENT OF WILLIAM C. SIEGEL, PRESIDENT, SOCIETY OF AMERICAN FORESTERS

Mr. SIEGEL. Thank you, Mr. Chairman.

My name is William Siegel. I am president of the Society of American Foresters, more commonly called SAF. The society, 18,000 members strong, is the scientific and educational association that represents the forestry profession in the United States. I also have my own consulting business in which I specialize in forest resource taxation and the legal and estate planning aspects of forestry. I am also a timberlandowner.

I am very pleased to be here today to comment on the capital gains treatment of income derived from timber investments.

The central focus of my testimony today is embodied in the Chairman's bill, H.R. 9, the Job Creation and Wage Enhancement Act of 1995. The SAF commends the Chairman and his cosponsors on this endeavor.

I would like to begin my testimony this afternoon with a summary of my comments. The Society of American Foresters support Federal tax policies that address the unique nature of timber management programs and thus treat forestry investments fairly in comparison to other capital ventures. Affected policy should be fair to forestowners to encourage the application of sound, professional, prescribed forest management practices on private woodlands and contribute to the expected increase in national demand for timber in the years ahead.

Historically, this Nation has looked to its 347 million acres of private forest for a substantial portion of its timber needs. Approximately 72 percent of the Nation's commercial timber property is owned by individuals and companies. The rise in demand and the curtailment of harvesting from public forests will place an increasingly heavy burden—in fact, is placing an increasingly heavy burden—on these private woodlands, since as a group they are the most productive.

Investments in private forest management are unique in many respects. Forestry investments must be held for long periods of time with little return in the interim. It takes 20 to 120 years, depending upon the species and the part of the country and the landowner's management objectives, to grow timber to be used in manufacturing solid wood products such as lumber, plywood and furniture.

Furthermore, it takes 10 to 40 years to grow timber for use in the production of pulp and paper products. Because of the long-term nature of forestry investments, they are often subject to substantial natural risk. Natural disasters impose a significant adverse impact on our Nation's forests.

Timber investments also suffer from wide-range, rapid market fluctuations, due in part to some domestic situations but also to heavy international competition in the global timber market. Timber investments typically have a low degree of liquidity in much of the investment cycle because of the need to allow the resource to achieve maturity before it can be economically harvested.

Furthermore, forestry investments often yield rates of return that are less than many other capital investment opportunities. Many private woodlandowners in the United States have made substantial long-term forestry investments on the premise that the timber capital gains provisions of the Federal income tax law which were put into the Federal code in 1943 would remain in place during the lifetime of their investments.

The elimination of the long-term gain rate differential has been extremely costly to private owners in terms of return on investment. In some cases, the Federal income tax on timber sale proceeds has nearly doubled, and in some extreme cases has more than doubled under the tax prohibitions contained in the Tax Reform Act of 1986 and later legislation.

In addition, taxpayers in some of the States that use federally adjusted gross income as the State income base have experienced substantial increases in State income taxes on their timber returns.

The Society of American Foresters believes that Congress broke faith with private timberowners by passing tax changes that have had such a substantial impact on their long-term investment.

Preferential treatment of long-term capital gains income stimulates capital formation, lessens the tax burden because the bunching of gains, which is very typical of timber investments, decreases the detriments to sale of capital assets and compensates for the negative impact of inflation on capital gains taxes.

One way to address this is for Congress to amend the treatment of forestry investments currently contained in the Tax Reform Act of 1986 and subsequent legislation to allow for adjustments for inflation on the original cost of timber owned by private forestlandowners. This type of provision would tax landowners on the real gain, not the inflationary gain, from harvesting their timber investment.

A restructuring of the Tax Code to reflect this recommendation would provide a measure of compensation to those who choose to invest in forestry by recognizing the long-term nature of timber investments. Of course, a 50-percent exclusion would be more economically favorable to timber investments.

Let me close by saying that because private woodlands are vital to our Nation's timber supply, because they provide many noncommercial benefits as well as commercial benefits, and because private forestry investments are unique, the Society of American Foresters supports public policies that encourage sustained investments in private forest management, increase stability of private forest ownership, and guard against the conversion of our Nation's private forest land to nonforestry and nonrenewable natural resource use such as commercial and residential development.

This concludes my testimony this afternoon, Mr. Chairman. Thank you very much for allowing me to present my testimony.

[The prepared statement follows:]

COMMENTS ON THE CAPITAL GAINS TREATMENT OF INCOME DERIVED FROM TIMBER INVESTMENTS

Testimony by William C. Siegel, President
Society of American Foresters

before the

United States House of Representatives

COMMITTEE ON WAYS AND MEANS

January 25, 1995

Mr. Chairman, my name is William C. Siegel. I am the President of the Society of American Foresters (SAF). The Society, 18,000 members strong, is the scientific and educational association representing the forestry profession in the United States, including public and private practitioners, researchers, administrators, educators, and students. Our primary objective is to advance the science, technology, education, and practice of professional forestry for the benefit of society.

The public policy activities of SAF are grounded in scientific knowledge and professional judgment. It is from this perspective that we review proposed forestry and related natural resource programs to determine their adequacy to meet stated objectives and public needs. I am especially pleased to be here today to comment on the capital gains treatment of income derived from timber investments.

Forecasts by the U.S. Forest Service and by many private and university analysts indicate that demand for timber from U.S. forests will continue to rise over the next 50 years.

Historically, the nation has looked to its three hundred forty seven million acres of private forests for a substantial portion of its timber needs; 72% of the nation's timberland estate is owned by individuals and companies. The rise in demand, and the curtailment of harvesting from public forests, will place an increasingly heavy burden on these private woodlands since, as a group, they are the most productive.

Other demands on private forests are also steadily increasing. Urban expansion, rural homesites, highway construction, and utility rights-of-way all continually reduce the total private acreage available for timber growing. In addition, many federal forestlands have been withdrawn from timber production altogether by being designated as wilderness and other special management areas, with more withdrawals likely. Declining budgets, environmental concerns, and greater demand for nontimber uses have further reduced the public sector's contribution to the nation's timber harvest. Thus, there is increasing pressure to rely on forests established and maintained by direct private investment.

Prior to 1944, if landowners harvested their own timber and then either sold it or used it in their businesses, the gain was taxed as ordinary income. Proceeds received under a timber-cutting contract, based on an agreed price per unit measure (as opposed to one lump-sum price for all of the timber) were also treated as ordinary income. On the other hand, income

from the liquidation of a timber stand by a lump-sum sale was classified as a capital gain. Thus, if forest owners tried to manage their woodlands according to certain recommended forestry practices, the receipts were treated as ordinary income. Timber owners therefore found that liquidation worked to their distinct advantage. Instability of forest ownership and poor forestry practices were actually encouraged by the tax-law requirement that timber be liquidated to obtain capital-gains treatment.

Congress responded to a growing forest-liquidation problem and to the complaints of inequity by enacting Section 117(k) of the Internal Revenue Code in 1943 which became effective in 1944. This legislation placed owners who cut their timber themselves or who disposed of it under a pay-as-cut contract, in the same capital-gains status as nonmanaging forest owners who sold their timber outright in infrequent lump-sum transactions or who disposed of their entire property. Section 117(k) was subsequently reenacted in 1954 as Section 631. Section 631 remains in the federal tax code today despite the fact that under the 1986 Tax Reform Act there is no longer a tax-rate advantage for most timber owners in classifying timber income as a long-term capital gain.

Investments in private-forest management are unique in many respects. Forest investments must be held for long periods of time. It takes 20-120 years, depending on the species and the landowner's management objectives, to grow timber to be used in manufacturing solid wood products such as lumber, plywood, and furniture. Furthermore, it takes 12-40 years to grow timber for use in the production of pulp and paper products.

Because of the long term nature of forestry investments, they are often subject to substantial natural risk. Natural disasters impose a significant adverse impact on our nation's forests. The Mt. St. Helens eruption of 1980, Hurricanes Hugo and Andrew, the mid-South and Atlantic Coast ice storms of 1993 and 1994, Southern Pine Beetle infestation, American Chestnut Blight, and the recent wildfires in the west are just a few examples of the natural phenomena that have placed our nation's private forests at risk.

Timber investments suffer greatly from wide and rapid market fluctuations, due in part to heavy international competition in the global timber market. Virtually every major timber-producing country in the world, with the exception of those countries in the Pacific Rim, to further its public policy, provides special tax treatment and other financial assistance for private-forestry investments. These policies were enacted in recognition of the unique nature of timber growing and the special problems faced by timber investors. The benefits, in many instances, far exceed those offered in the United States.

Timber investments typically have a low degree of liquidity in much of the investment cycle because of the need to allow the resource to achieve maturity before it can be economically harvested. Furthermore, forestry investments often yield rates of return that are less than many other capital investment opportunities. On the positive side, however, woodland owners are often able to hold their timber for optimum market conditions without suffering a loss or diminution of capital. Successful reestablishment of softwood and hardwood forests following harvest usually requires large expenditures for both reforestation and for subsequent management. If appropriate practices are not followed, the site's productive potential is very likely to be lost to competition from brush, weeds, and low-value species. In recent years, many thousands of private owners have invested hundreds of dollars per acre in establishing new forest stands. These costs, and some on-going management expenditures, have to be carried for many years before a return on the investment is realized.

Many private woodland owners made substantial long-term forestry investments on the premise that the timber capital-gains provisions of federal income tax law would remain in place during the lifetime of their investments. There is also continuing debate about the effect on small non-industrial landowners who may be more affected by limits on their ability

to deduct timber-management costs. The elimination of the long-term gain rate differential has been extremely costly to private owners in terms of return on investment. In some cases, the federal income tax on timber-sale proceeds has nearly doubled under the tax provisions contained in the Tax Reform Act of 1986, and later legislation. In addition, taxpayers in some of the states that use federal adjusted gross income as the state income tax base have experienced substantial increases in state income taxes. The Society of American Foresters believes that Congress broke faith with private timber owners by passing tax changes that have had such a substantial impact on their long-term investment.

Preferential treatment of long-term capital gain income stimulates capital formation, lessens the tax burden (under a progressive tax-rate system) caused by the bunching of gains, decreases the tax deterrent to sale of capital assets, and compensates for the negative impact of inflation on capital-gains taxes. Congress should amend the treatment of forestry investments currently contained in the Tax Reform Act of 1986, and subsequent legislation, to allow for adjustments for inflation on the original cost of the timber owned by private forest landowners. The inflation rate adjustment should be obtained by utilizing the Consumer Price Index, Treasury Bill rates, or by other similar means. This provision would tax landowners on the real gain, not the inflationary gain, from liquidating their timber investment. A restructuring of the tax code to reflect this recommendation would provide a measure of compensation to those who chose to invest in forestry by recognizing the long-term nature of timber investments.

Because private woodlands are vital to our nation's timber supply, because they provide noncommercial benefits, and because private-forest investments are unique, the Society of American Foresters supports public policies that encourage sustained investments in private-forest management, increase the stability of private-forest ownership, and guard against the conversion of our nation's private forestland to non-forestry and non-renewable natural resources use such as commercial and residential development.

In summary, the Society of American Foresters supports federal tax policies that address the unique nature of timber management programs and, thus, treat forestry investments fairly in comparison to other capital ventures. Effective policies should be fair to forest owners; encourage the application of sound, professionally prescribed forest-management practices on private woodlands; and contribute to the expected increase in national demand for timber in the years ahead.

Mr. COLLINS. And thank you. And I want to assure each of you that your full statements will be entered into the record. The first two have been right noticeable to follow that light there in front of you. We appreciate it.

I am going to call on Mr. Christensen for the next introduction.

Mr. CHRISTENSEN. Thank you, Mr. Chairman. On behalf of my colleague from Washington, Congresswoman Jennifer Dunn, I am pleased to welcome Doug Stinson to the panel. Doug and his family own the Cowlitz Ridge Tree Farm in Washington State.

Doug's love for trees began in Missouri on his family's farm. When he was 14, he planted his first stand of trees. He pursued an education in forestry and received a degree in forestry from the University of Missouri in 1955. Since then, he has worked for the U.S. Forest Service in Alaska, planted his own tree farm in Toledo, Wash., married Fay Marie and has three children. He has been named Tree Farmer of the Year in Washington State and Western Regional Tree Farmer of the Year.

Doug is a member of the Olympic National Forestry Citizen Advisory Board, past president and current board member of the Lewis County Chapter of Washington Farm Forestry Association, member of the Society of Foresters, chair of the Small Landowners Advisory Committee to the Commissioner of Public Lands. Doug led forestry studies in Sweden, England, New Zealand, and Tasmania.

Mr. Chairman, on behalf of the committee and especially on behalf of my highly respected colleague from Washington State, the Huskie State, it is my pleasure to welcome Mr. Stinson to this panel.

STATEMENT OF DOUGLAS P. STINSON, OWNER-MANAGER, COWLITZ RIDGE TREE FARM, ON BEHALF OF THE AMERICAN TREE FARM SYSTEM

Mr. STINSON. Thank you, Mr. Christensen. Those are very nice words, and I appreciate being here from the State of Washington.

Yes, my wife and my three children, we do own Cowlitz Ridge Tree Farm which encompasses 900 acres near Toledo, Wash. I am here today representing the American Tree Farm System, and we are a national network of 72,000 private landowners who have each made a commitment to protect water, wildlife, soil, and recreation opportunities, and at the same time grow trees for forest products. We are committed to sustainable forestry.

Since 1941 the American Tree Farm System has worked to encourage sound forestry by the Nation's 7 million forestlandowners. Those who meet the system's high standards are certified as tree farmers. I am proud to be speaking on their behalf. We are private citizens from all walks of life who take great pride in practicing forest stewardship on our land.

My first experience was mentioned here earlier of planting trees when I was 14 in the Missouri Ozarks. I think that started me on my career. And I am certain at that time I didn't understand the important relationship between what happens in this committee and what happens in the forest.

Today, after 33 years of forest land stewardship and 24 years as an owner of Cowlitz Ridge Tree Farm, that relationship is very

clear to me. I have learned that tax policy has a major influence on how forestowners manage their land.

At Cowlitz Ridge Tree Farm we have four goals. First, is to earn a living, and second is to live in balance with nature, and third is to leave the land in better condition than when we acquired it, and fourth is to educate the public and other landowners on the value of good forest stewardship.

Our ability to accomplish the last three goals depends directly on our ability to do the first. Cowlitz Ridge is managed as an economically viable forest. We are operating on a sustained yield basis. In the last 20 years, we have harvested approximately 65 percent of our forest growth. In other words, we are growing more wood than we are harvesting.

Investing in timberland is not for the fainthearted or for people who want to make a lot of money fast. The fact is, forestry investments are a unique economic activity. If you are in forestry, you are in it for the long term. At Cowlitz Ridge, we plan our first commercial thinning 25 years after a new stand of trees is planted. The stand won't be harvested for another 35 years or more after that.

What this means, though, is that after we invest $325 per acre to establish and nurture a new stand of trees at Cowlitz Ridge, we won't generate any cash flow for 25 years and we have to wait between 60 and 80 years for the full return on our investment. That is a long time, especially when you have your capital literally locked up on the ground and subject to a host of natural risks like fire, wind, insects, and disease.

At Cowlitz Ridge, one of our most recent natural risks was a windstorm that occurred on Inauguration Day in 1993. Salvaging these trees was a real challenge. So when you add the potential for disaster to the normal financial risks associated with extremely long-term investments, you can begin to understand why tree farmers like me are sensitive to all the factors that affect the economics of forestry.

We are excellent stewards. We earn our living from the forest. We recognize our responsibilities as forestlandowners and leave our forests better than we acquired them, but the Tax Reform Act of 1986 changed the rules. Taxes were increased on capital gains from timber.

What does that mean for landowners? I am a tree farmer, not an economist, but I can tell you in plain terms what the loss of capital gains treatment meant to me and to people like me. Simply put, it reduced the amount of capital we had to reinvest in our forests.

Nonindustrial landowners like Cowlitz Ridge own 57 percent of the working forests in the United States. Many no doubt found without capital gains tax treatment for timber, that they had less to invest in their land or better places to put their money than forest lands.

In Washington State, 25,000 acres of prime forestland is annually converted to other uses. This is a definite sign that forestland investments are now a higher risk. Favorable capital gains treatment would help retain our forests for future generations.

At Cowlitz Ridge, we spend approximately $20,000 each year on forest regeneration and timber stand improvement. We protect and enhance wildlife habitat and watersheds. We exclude the 150 acres

of wetlands from commercial harvest. We minimize soil disturbance when we harvest and keep our clearcuts small, 5 to 20 acres, because we replant immediately after we harvest and use large high-quality seedlings, we minimize herbicide use and avoid aerial spraying.

Cowlitz Ridge practices environmentally sound sustainable forestry and it is repeated on the tree farms all over the Nation. But please understand the work we do is possible only when we have a stable income and adequate profits to reinvest in our land.

Thank you.

Mr. COLLINS. Mr. Stinson, if you would like to go ahead and finish your statement, you have come a long way. Feel free to continue.

Mr. STINSON. I am just about done there, but I wanted to abide by your time.

At Cowlitz Ridge, for example, if the proposal before the committee were enacted, we would be able to continue earning our living from our forestland and be able to pass the forestland on to our children. Multiply this by millions of landowners and you can see how good tax policy, good forestry, and a good environment are all linked together.

[The prepared statement follows:]

STATEMENT OF DOUGLAS P. STINSON

COWLITZ RIDGE TREE FARM
TOLEDO, WASHINGTON

BEFORE THE

COMMITTEE ON WAYS AND MEANS

UNITED STATES HOUSE OF REPRESENTATIVES

JANUARY 25, 1995

My name is Doug Stinson. I am a Tree Farmer from Washington State. I, along with my wife and our three children, own the Cowlitz Ridge Tree Farm -- four parcels of forestland that cover over 900 acres near Toledo, WA.

I am here today representing the American Tree Farm System. We are a national network of 72,000 private forest landowners who have each made a commitment to protect water, wildlife, soil and recreation opportunities and at the same grow trees fo: forest products. We are committed to sustainable forestry.

Since 1941, the American Tree Farm System has worked to encourage sound forestry by the nation's seven million forest landowners. Those who meet the System's high standards are certified as Tree Farmers. I'm proud to be speaking on their behalf. We are private citizens from all walks of life who take great pride in practicing forest stewardship on our land.

My very first experience with forestry took place when I was 14, on my family's farm in the Missouri Ozarks. I planted five acres of shortleaf pine. At the time, I'm certain I did not understand the important relationship between what happens in this Committee, and what happens in the forest.

Today, after 33 years of forest land stewardship and 24 years as an owner of Cowlitz Ridge Tree Farm, that relationship is very clear to me.

I have learned that tax policy has a major influence on how forest owners manage their land.

We have four goals at Cowlitz Ridge Tree Farm:

1. To earn a living.
2. To live in balance with nature.
3. To leave the land in better condition than when we purchased it.
4. To educate the public and other landowners on the value of good forest stewardship.

Our ability to accomplish the last three goals depends directly on our ability to do the first.

Cowlitz Ridge is managed as an economically viable forest. We are operating on a sustained yield basis. In the last 20 years we have harvested approximately 65% of our forest growth. In other words, we are growing more wood than we are harvesting.

Investing in timberland is not for the fainthearted or for people who want to make a lot of money fast.

The fact is, forestry investments are a unique economic activity. If you're in forestry, you're in it for the long-term. At Cowlitz Ridge, we plan our first commercial thinning twenty-five years after a new stand of trees is planted. The stand won't be harvested for another 35 years or more after that.

What this means, though, is that after we invest $325 per acre to establish and nurture a new stand of trees at Cowlitz Ridge, we won't generate any cash flow for 25 years and we have to wait between 60 and 80 years for the full return on that investment.

That's a long time -- especially when you have your capital literally locked up on the ground and subject to a host of natural risks like fire, wind, insects, and disease. At Cowlitz Ridge, one of our most recent natural risks was a wind storm that occurred on Inauguration Day in 1993. Salvaging these trees was a real challenge. So, when you add the potential for disaster to the normal financial risks associated with extremely long-term investments, you can begin to understand why Tree Farmers like me are sensitive to all the factors that affect the economics of forestry.

We are excellent stewards. We earn our living from the forest. We recognize our responsibilities as forest landowners and leave our forests better than we acquired them. But the Tax Reform Act of 1986 changed the rules. Taxes were increased on capital gains from timber but decreased on alternate forms of investment.

What does that mean for landowners? I'm a Tree Farmer, not an economist. But I can tell you in plain terms what the loss of capital gains treatment meant to me, and to people like me. Simply put, it reduced the amount of capital we had to reinvest in our forests and in some cases actually discouraged these investments altogether.

Non industrial landowners like Cowlitz Ridge own 57 percent of the working forests in the US. Many no doubt found, without capital gains tax treatment for timber, that they had less to invest in their land -- or better places to put their money than in forest lands.

In Washington state, 25,000 acres of prime forest land is annually converted to other uses. This is a definite sign that forest land investments are now a higher risk. Favorable capital gains treatment would help retain our forests for future generations.

At Cowlitz Ridge Tree Farm, we spend approximately $20,000 each year on forest regeneration and timber stand improvement. We protect and enhance wildlife habitat and watersheds. We have excluded the 150 acres of wetlands from commercial harvest. We minimize soil disturbance when we harvest, and keep our clearcuts small: 5 - 20 acres. Because we replant immediately after we harvest, and use large, high quality seedlings, we minimize herbicide use and avoid aerial spraying.

I hope, Mr. Chairman, if you are ever in Washington State, that you would visit Cowlitz Ridge. Along with Douglas fir, Western red cedar, red alder and Western hemlock, our tree farm has many other tree species, including grand fir, Pacific yew, cheery, maple, cascara, hawthorn, ash black cottonwood and Pacific dogwood. Species diversity is a key part of our management plan.

Cowlitz Ridge practices environmentally sound, sustainable forestry. And it is repeated on Tree Farms all over the nation. But please understand the work we do is possible only when we have a stable income and adequate profits to reinvest in our land.

At Cowlitz Ridge Tree Farm, for example, if the proposal before the Committee were enacted, we would be able to continue earning our living from our forestland and be able to pass the forestland on to our children. Multiply this by millions of landowners and you can see how good tax policy, good forestry and a good environment are all linked together.

With capital gains out of the tax code, I think the costs are just as clear: fewer trees planted, more pressure to harvest remaining woodlands, more conversion of forestland to other uses.

Last November, the American Tree Farm System had its first-ever national convention. Hundreds of tree farmers from around the country gathered in Williamsburg, Virginia. One thing was clear to me as I talked to my friends and that was; we really need favorable capital gains treatment returned. This Committee is now taking up that issue which is very important to Tree Farmers and it is one that can make a real difference in how our nation's forests are managed. If all 72,000 Tree Farmers were here with me, they would applaud your efforts to improve the climate for forestry investment.

Thank you.

Mr. COLLINS. Thank you, sir.

And our next panelist is the gentleman from Georgia, a former Member of this body, and Mr. Rangel has asked to introduce my fellow Georgian.

Mr. RANGEL. Mr. Chairman, thank you for this opportunity.

Bill Stuckey is an old friend, a former Member of the House. When I first came here, we shared offices on the same floor. He introduced me to boiled peanuts, yams, greens and even chitlins, and I understand today that he is now going to tell us about the plight of those involved in timber.

I know one thing, even though he is wealthy himself, he has always concerned himself about the working people that made this great country what it is, and I am certain that what he is going to tell us today will help us to make it easier for people to invest in America and in timber and to make us productive and competitive.

Thank you, Mr. Chairman.

Mr. COLLINS. Thank you.

Mr. Stuckey.

STATEMENT OF HON. WILLIAM S. STUCKEY, PAST PRESIDENT, FOREST FARMERS ASSOCIATION

Mr. STUCKEY. Thank you, Mr. Chairman. I am sure that was a wonderful introduction. I understood every word that you said, but I am not sure I understood every word that Mr. Rangel said, so I will go back and read that fine introduction in the record. Thank you.

Thank you, Charlie.

Mr. Chairman, members of the committee, I do appreciate this opportunity to appear here today on behalf of the Forest Farmers Association and to present to this committee their thoughts about the importance of the reduction in the capital gains tax on the sustainability and productivity of our Nation's forests.

Mr. Chairman, I am the immediate past president of the Forest Farmers Association and I am here today representing over 4,000 members whose combined holdings total over 45 million acres of privately held, nonindustrial timberland, in 17 Southern States.

Nationwide there are over 6 million independent timberlandowners in the United States that manage over 275 million acres of trees. This private, nonindustrial segment of the forestry community comprises over 60 percent of the timberland that is available to supply our Nation's lumber and paper needs.

I want to commend you and the numerous cosponsors of H.R. 9 for including capital gains reform in this legislation.

In title I, it contains a 50-percent reduction from taxation from the gains on capital assets including timber. This proposed tax reduction is extremely important to small tree farmers.

To date, the independent timberlandowner is being asked to supply more wood fiber and is being pushed to manage more intensely his acreage because of both market conditions and government policy. When government policy discourages the planting of trees through excessive taxation and increased regulation, then fewer trees will be grown, and that is not only bad for the economy, but it is bad for the environment.

In some ways, Mr. Chairman, tree growing is similar to buying a long-term bond that has a maturity date of 25 to 70 years from the present. There is no annual income, there is no Federal insurance, and there is only the hope that you will see your return on investment sometime during your children's lifetime.

The risks of fire, insects, or the reduction in the value of your timber asset from government action makes timber an even more speculative investment than a long-term bond. In that regard, tree farming is very unique and obviously very, very long term.

And, Mr. Chairman, I can assure you that it takes a very unique person who is willing to undertake such a long-term and uncertain investment. In fact, I think the ultimate act of optimism is this past year we planted about 3,000 acres of trees and I hope that I will live to harvest those trees because, as I said, I am assuming that is rather optimistic, but maybe my grandchildren will enjoy those.

Some nonindustrial timber growers own tracts of forestland that is in the hundreds, some even own them in the thousands of acres. But the truth is, most of the landowners are small, and they have 10, 20 or 30 acres of trees. These are not wealthy Americans seeking a tax break. These are forestlandowners that are hard-working, middle-class taxpayers. They are farmers, they are retirees, schoolteachers, and they are small town and rural citizens. They are the ones who love their land, and they work it diligently to manage it and make productive the natural resource asset that they are privileged to own.

Increasingly, stricter environmental regulations have placed limits on the timber acreage that is available for harvest from public lands. At the same time, since the loss of capital gains differential in 1986, the replant rates on small nonindustrial tracts of land has declined. The disparity between acres harvested and acres planted continues to grow. Environmental groups, private timberlandowners and the forest products industry all agree that it is critical that our U.S. tax policy be changed to provide greater incentives for reforestation efforts.

As a direct result of the loss of the capital gains in the 1986 act, many timberlandowners, particularly those from the South, are selling their timberland and they are investing in other investments that will provide them with a more certain return.

Others are not investing in timber management practices or in reforestation activities as they once were. While we know that lands can reforest naturally and that trees will grow with little expenditure from the owners, studies have shown that timber will regenerate significantly faster and it will produce better quality wood if it is managed and reforested properly.

The Archer capital gains bill will provide much-needed tax relief. Passing the capital gains reduction in H.R. 9 will provide this country with two very beneficial results: More trees and a better environment.

Simply put, allowing tree farmers to keep more of what they produce means that they will have more to reinvest in tree production and more to spend to ensure proper management of existing timberlands.

Mr. Chairman, since the Tax Reform Act of 1986, the Forest Farmers Association has worked very hard to see that a more favorable tax treatment of timber is restored. In the last Congress we supported H.R. 960, the Reforestation Tax Act, which was designed to provide narrow reasonable tax incentives that would encourage more active management of existing private timber lands.

The major points of that legislation were to provide a partial inflation adjustment. When timber is sold for purposes of determining section 631 gain, the gain would be reduced by 3 percent for every year that the timber was held. While this provision would not fully compensate for inflation, it would provide an incentive for those tree farmers who held their investments for a long time.

Number two, passive loss rules: The legislation would revise the material participation criteria under which tree farmers are required to actively participate for a certain number of hours each year in order to deduct normal operating expenses.

Number three, reforestation tax credit: This provision doubles the expended limit from $10,000 to $20,000, and it indexes the amount for inflation.

Number four, reforestation amortization: This provision doubles the limit to $20,000, indexes it to inflation, and reduces the 7-year amortization period to 5 years.

We have been grateful for the support of a number of Members of Congress for the goals of the Reforestation Act. In particular, I am grateful that the passive loss provision of the Reforestation Act can be introduced as separate legislation and will be considered by the Ways and Means Committee this year during the tax bill debate. This change in the treatment of passive loss for small landowners was badly needed to ensure that small tree farmers are not penalized for exercising best management practices on their land by being required to carry the expense of these activities for many years until actual harvesting is conducted.

Forestry consultants tell me that many small landowners are forgoing important management activities of their land because of unfair passive loss tax rules.

Mr. Chairman, I have exceeded my time, but I do appreciate the opportunity to present the Forest Farmers Association's views at this hearing. We applaud your efforts to provide capital gains tax relief. We are encouraged that legislation will emerge from this committee that will provide the necessary incentives to allow nonindustrial timberlandowners to invest more money in reforestation, management, and maintenance of timberlands so that they can continue to provide this country with an abundant affordable supply of timber.

Thank you, Mr. Chairman.

[The prepared statement follows:]

TESTIMONY OF
MR. WILLIAM S. STUCKEY
FOREST FARMERS ASSOCIATION
ON
CAPITAL GAINS TAX REFORM PROVISIONS
OF
CONTRACT FOR AMERICA

WAYS AND MEANS COMMITTEE
UNITED STATES HOUSE OF REPRESENTATIVES

JANUARY 25, 1995

Mr. Chairman and Members of the Committee, I am delighted to have this opportunity to appear on behalf of the Forest Farmers Association to present to this committee our thoughts about the importance of a reduction in the Capital Gains Tax on the sustainabilty and productivity of this nation's forests.

Mr. Chairman, I am the immediate past president of the Forest Farmers Association and I am here today representing our approximately 4,000 members whose combined holdings total over 45 million acres of privately held non-industrial timberland, primarily in 17 southern states. Nationwide there are over six million independent timberland owners in the U.S. managing over 275 million acres of trees. This private, non-industrial segment of the forestry community comprises over 60 percent of the timberland available to supply our nations lumber and paper needs.

I want to commend you and the numerous co-sponsors of H.R. 9, the Job Creation and Wage Enhancement Act of 1995, for including Capital Gains Reform in this legislation. Title 1 contains a 50% deduction from taxation for the gains on capital assets, including timber. This proposed tax reduction is extremely important to small private tree farmers.

Today, the independent timberland owner is being asked to supply more wood fiber and is being pushed to manage more intensely his acreage because of both market conditions and government policy. When government policy discourages the planting of trees through excessive taxation and increased regulation, fewer trees will be grown which is not only bad for the economy, but bad for the environment.

In some ways tree growing is similar to buying a long-term bond with a maturity date 25 to 70 years from the present. There are no annual annuities, there is no federal insurance, there is only the hope that you will see your return on investment sometime during your children's lifetime. The risk of fire, insects or diminution in value of your timber asset from governmental action makes timber an even more speculative investment than a long-term bond. In that regard, tree farming is very unique and obviously very long term. Consequently it also takes a unique type of person willing to undertake such a long term and uncertain investment.

While some non-industrial timber growers own tracts of forested land in the hundreds, or even thousands, of acres, most are small landowners with ten, twenty, or fifty acres of trees. These are not wealthy Americans seeking a tax break. Rather, most forest landowners are hard working, middle-class taxpayers. They are farmers, retirees, school teachers, and small town and rural citizens, who love their land and work diligently to manage and make productive the natural resource asset they are privileged to own.

Increasing, stricter environmental regulations have placed limits on the timber acreage that is available for harvest from public lands. At the same time, since the loss of the capital gains differential in 1986, the replant rates on small non-industrial tracts of land

has declined in many parts of the country. The disparity between acres harvested and acres planted continues to grow. Environmental groups, private timberland owners, and the forest products industry all agree that it is critical that our U.S. tax policy be changed to provide greater incentives for reforestation efforts. As a direct result of the loss of the capital gains in the 1986 Act, some timberland owners, particularly in the South, are selling their timberland and investing in something that will provide them with a more certain return. Others are not investing in timber management practices or in reforestation activities, as they once were. While we know that lands can reforest naturally and that trees can grow with little expenditure from their owners, studies have shown that timber will regenerate significantly faster and produce better quality wood if it is managed and reforested properly.

The Archer capital gains bill will provide much needed tax relief. Passing the capital gains deduction in H.R. 9 will provide this country with two very beneficial results - more trees and a better environment. Simply put, allowing tree farmers to keep more of what they produce means they will have more to reinvest in tree production and to spend to ensure proper management of existing timber land.

Mr. Chairman, since the Tax Reform Act of 1986, the Forest Farmers Association has worked to see that a more favorable tax treatment of timber is restored. In the last Congress we supported H.R. 960, the Reforestation Tax Act, which was designed to provide narrow, reasonable tax incentives to encourage more active management of existing private timberlands. The major points of this legislation were:

a) Providing a partial inflation adjustment - When timber is sold, for purposes of determining Section 631 gain, the gain would be reduced by three percent for every year that the timber was held. While this provision would not fully compensate for inflation, it would provide an incentive for those tree farmers who held their investments for a long time.

b) Passive loss rules - The legislation would revise the "material participation" criteria under which tree farmers are required to actively participate for a certain number of hours each year in order to deduct normal operating expenses.

c) Reforestation tax credit - This provision doubles the expenditure limit from $10,000 to $20,000 and indexes the amount for inflation.

d) Reforestation amortization - This provision doubles the limit to $20,000, indexes it to inflation, and reduces the seven-year amortization period to five years.

We have been grateful for the support of a number of Members of Congress for the goals of the Reforestation Tax Act. In particular, I am hopeful that the passive loss provision of the Reforestation Tax Act can be introduced as separate legislation and will be considered by the Ways and Means Committee this year during the tax bill debate. This change in the treatment of passive losses for small landowners is badly needed to ensure that small tree farmers are not penalized for exercising best management practices on their land by being required to carry the expense of these activities for many years until actual harvesting is conducted. Forestry consultants tell me that many small landowners are foregoing important management activities on their timberland because of unfair passive loss tax rules.

Mr. Chairman, I appreciate the opportunity to present the Forest Farmers Association's views at this hearing today. We applaud your efforts to provide capital gains tax relief. We are encouraged that legislation will emerge from this Committee that will provide the necessary incentives to allow non-industrial timberland owners to invest more money in reforestation, management, and maintenance of timberlands so that they can continue to provide this country with an abundant, affordable supply of timber.

Mr. COLLINS. Thank you, sir. It was similar to when I first arrived in Congress in 1993. Representative Montgomery was in the chair that morning, and he asked me, For what purpose did I rise? I said, I would like to address the House for 1 minute, but, Mr. Speaker, like you, I talk kind of slow so it may take me a minute and a half.

I appreciate that slow talk. Mr. Rangel even mentioned it a while ago when you first started up.

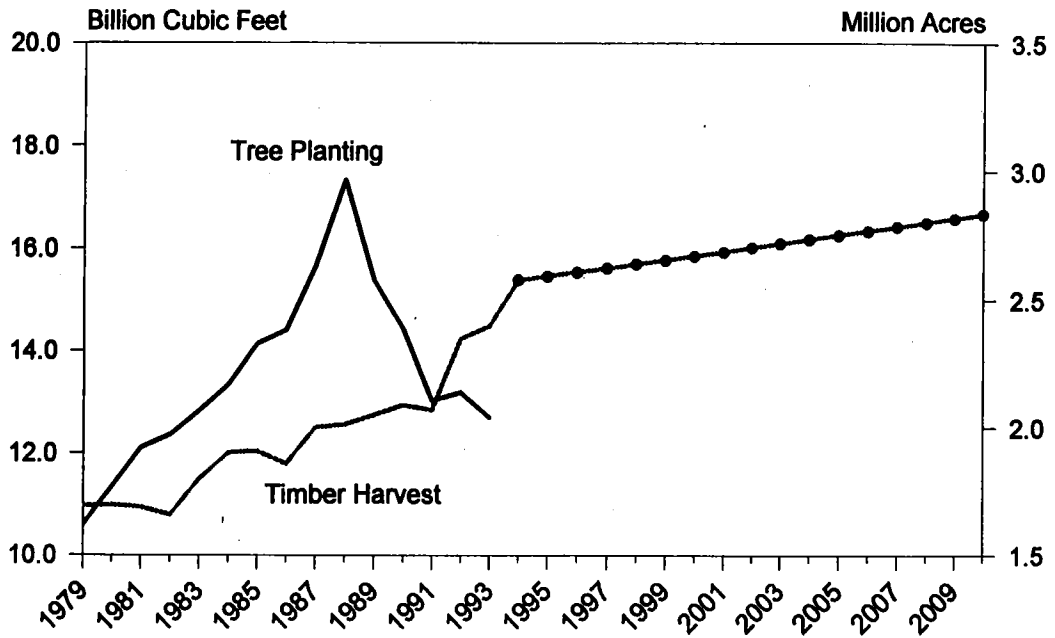
Mr. Stinson, I believe you are absolutely right on target when you say good tax policy and good forestry and good environmental issues are all linked together. That is a very, very good statement, but I have a couple of questions and I am going to yield to Mr. Rangel and then to Mr. Christensen.

Mr. Stuckey, you stated that tree planting in the United States has declined since 1986, the year in which the capital gains tax was increased. Do you have any statistics to really support this statement?

Mr. STUCKEY. Mr. Chairman, I don't have them with me, but we can provide them to the committee, for the record.

[The following was subsequently received:]

Harvest and Tree Planting on Private Lands



Source: USDA Forest Service ; AF&PA

Tree Planting and Direct Seeding on Private Land in the United States (Acres)

	Total Private	USDA Assisted	Total Unassisted
1979	1,618,973	258,802	1,360,171
1980	1,767,776	267,662	1,500,114
1981	1,920,848	264,991	1,655,857
1982	1,971,587	210,388	1,761,199
1983	2,065,458	209,490	1,855,968
1984	2,167,614	185,162	1,982,452
1985	2,326,187	256,088	2,070,099
1986	2,382,043	479,167	1,902,876
1987	2,628,925	976,291	1,652,634
1988	2,964,766	812,656	2,152,110
1989	2,576,886	866,259	1,710,627
1990	2,388,255	697,592	1,690,663
1991	2,105,443	396,072	1,709,371
1992	2,136,617	435,898	1,700,719
1993	2,041,215	467,102	1,574,113

Assisted Acres Include: CRP,FIP,ACP and SIP

Source: USDA Forest Service Annual Tree Planting Reports

Mr. COLLINS. How about any of the other panelists?

Mr. BARTOW SHAW. Mr. Chairman, I have statistics and empirical data supplied by the U.S. Forest Service which show that without question that the tree planting trend has been downward in a dramatic fashion, with the exception of the fact that there was a carryover lag before that downward trend for about 1 year after the 1986 Tax Act was implemented, and that was due primarily to the introduction at that time of the Conservation Reserve Program, which was a one-time marginal cropland set-aside program which encouraged, especially in the Southeast, planting trees. So if you take out the programs where there was assistance, the actual downward trend began and coincided with the Tax Reform Act of 1986.

I have a chart which dramatically shows that, which I would like to introduce in the record. On the vertical axis, there is the timber harvest on private lands which has continued upward, as I stated earlier in my testimony. The pressure on private land harvests is increasing as public land harvesting has decreased.

And on the other vertical axis is the tree planting activity, and it shows the decline rather dramatically. In addition, there are two backup tables which give that information.

This information was derived from U.S. Forest Service statistics. I would like to introduce that.

Mr. COLLINS. With no objection.

[At the time of printing, no information was received.]

Mr. COLLINS. You mentioned the reduction or the growth of harvesting trees is exceeding growth in many areas, and that a lot of the private landowners are harvesting their timber. Is it not true that other taxation, environmental regulations, endangered species, wetlands and all of these are contributing to that fact also?

Mr. BARTOW SHAW. That has had some impact, that is correct.

Mr. COLLINS. Mr. Stuckey, you stated that any capital gains tax reduction should apply to all taxpayers whether corporate or individual. Why is this so important to your industry?

Mr. STUCKEY. Mr. Chairman, as I stated in my testimony, it really is an act of faith when you go out there and you plant a tree and you know it is going to be 30 years at the earliest before you harvest it and probably 12 to 15 years before you have any income on it. You have got your money tied up for that length of time and you have to consider the fact that you have got forest, forest fires, some of the environmental issues. You certainly don't want a redheaded woodpecker to land in your land or part of it to be declared wetlands, but with all of the minefields that you have to go through and with inflation at the end of 30 years, you are hit with a heavy capital gains tax. There is not much of an incentive to plant trees.

Mr. COLLINS. You mentioned, too, that a lot of landowners are actually selling their timberlands or selling their farms with the timber and investing in other areas.

Mr. STUCKEY. That is correct.

Mr. COLLINS. Do we have any statistics other than the commercial or larger companies that show where people are actually investing in planting, buying land for the purpose of tree farming?

Mr. STUCKEY. Your smaller tree farm is not investing—reinvesting his money in his timber, and there again it is not profitable for him. It is not that much of an incentive and, as I said, it does take a unique person.

One of the traits that I have found in the tree farmer is that they really are people that have a love for the land. They are conservationists, and while most of them are not doing it for a profit, they do need a profit to sustain it. But those figures are available, I would assume, from the U.S. Forestry Service that they are, or that the Forest Farmers Association or some of the other associations could make those figures available. Bo, do you have anything?

Mr. BARTOW SHAW. The statistics from the U.S.—and I have those with me also in a form that it includes all States. The statistics—in fact, Mr. Rangel, I had the privilege of appearing before your subcommittee last year on a bill, the Reforestation Tax Act, and the question was asked on the declining acreage and the shortages that might come thereafter and I supplied that as followup the next week to Mr. Payne, and that indicated that the timberland in farm-type timberland was declining.

A true picture of the total nonindustrial land base is difficult to derive, but the closest thing to it was farm-type timberland which would be what Mr. Stuckey is talking about here.

Mr. COLLINS. What percentage of timberland is privately owned noncommercial?

Mr. STUCKEY. I believe it is about 60 percent.

Mr. SIEGEL. Noncommercial is about 57 percent, 57, 58 percent, nonindustrial commercial. Now you put the forest industries in there and then that rises to about 72 percent all private, but the nonindustrial private is about 57, 58 percent.

Mr. STUCKEY. That is close enough for government work.

Mr. COLLINS. That is close enough.

You mentioned earlier that we import a larger amount of lumber products or timber products into this Nation than we export. From what area do we primarily import?

Mr. BARTOW SHAW. Of course, a lot of it comes from Canada but the Scandinavian areas are a large producer of timber products. I do have some statistics here that you might be interested in on their beneficial tax ratios. A lot of investment now is going to Central and South American countries because of the short rotation time, but also because of the favorable tax advantages.

In Brazil, profit on sales of real estate before 1970 are tax exempt, and a 5-percent reduction of the taxable amount is granted for each year the property is held after that date onward. So in timber investment, which is long term, it is an effective, almost, a zero tax.

In Costa Rica, where there is a lot of investment, there is no capital gains tax on individuals or corporations. In New Zealand, there is no capital gains tax as such, and that is another area where there are heavy investments.

For every $1 billion that we import, that is about a $20,000 loss in U.S. jobs; and there is a definite trend. The magnitude has not reached dramatic proportions as yet, but it is continuing very rapidly toward having a significant impact.

Mr. COLLINS. If we are importing a lot of timber products or lumber products from Canada, there must be some advantage somewhere in price structure. What advantage does this Canadian lumber have over us?

Mr. BARTOW SHAW. Well, it is somewhat of a subsidized stumpage situation up there with the publicly controlled lands in Canada. And that has the biggest impact.

Mr. COLLINS. And capital gains such as H.R. 9 would give us some offset.

Mr. BARTOW SHAW. Any time we improve our position in the economics of growing timber in the United States, it is going to have an impact on offsetting the advantage of competing countries.

Mr. COLLINS. Thank you.

Mr. Rangel.

Mr. RANGEL. There is quite a bit of difference between H.R. 9, which is the bill before this committee, and last year's H.R. 960. Which one would be preferred by the timber farmers?

Mr. BARTOW SHAW. I would go ahead and address that. I think without question the capital gains provision is the preferred provision. The Reforestation Tax Act was originally introduced as a response to some of the concerns we have on the capital gains.

Mr. RANGEL. You and a lot of people are claiming we would not have substantial revenue loss with the capital gains provision, and indicate that by lowering the tax, it would encourage people to get more involved and to reinvest, and that would generate activity on the market, that now we get very little taxes because there is very little activity, and by reducing the rate, we would generate more activity and therefore gain more revenue.

If that is true, and in the timber industry now we find people that are looking for different types of investments. And as you said, Mr. Shaw, if there is no capital gains taxes in developing countries, if you lower the tax to make it more profitable to sell, is it possible that you would find that you will be losing investors in U.S. forestry?

Mr. BARTOW SHAW. I think any time you look at this as an investment—and again I hope you understand I am speaking for the AF&PA membership, the corporate membership, and also my experience with nonindustrial landowners as Mr. Stuckey has described, small timberlandowners especially in the Southeast—any kind of investment decision is going to involve a weighing of benefits and risks in returns, and there are risks in these areas. Therefore, any incremental benefit to timber growers in the United States would likely increase their investment and their thoughts of investment. The other part of it is that there is a certain affinity for the land that a lot of these folks have. It would encourage them to invest in these lands that they own where they are not investing now.

I would like to take a minute to read a quote of the U.S. Forest Service and the——

Mr. RANGEL. Let me—because I am going to have to yield my time. Are you saying that most of the people that you are concerned about are farmers that have made investment in their own land rather than those who make speculative investment in order

to receive profits off of their investments? Is that what you are saying?

Mr. BARTOW SHAW. Well, there is a little of both. I am just saying we have a whole spectrum of timberlandowners.

Mr. RANGEL. OK. This is my last question, now. There are some that believe that scoring this capital gains tax cut is going to cause a dramatic revenue shortfall. Others disagree, of course.

Now, in the event that it is very expensive, everyone agrees that they are going to have to make certain that we have a balanced budget and that whatever losses we have in these tax provisions are made up by spending cuts.

Now, the spending cuts don't allow for touching Social Security, interest on our debt, and defense, and Medicare politically goes on and goes off, but no matter how you look at it, substantial cuts will have to be made in other programs, in forestry and agriculture—well, certainly agriculture is one of the big targets anyway, and forestry has no—I have no reason to believe that they will receive any special treatment.

Have you ever thought about whether or not how we pay for these cuts, how your industry would be better off, whether in the tax incentives or in the services and subsidies that are provided?

Mr. STUCKEY. Mr. Rangel, that is a wonderful way of putting it. And I can look at it and view it from your side, too. When income is cut off, you have got a problem balancing the budget, and I understand that better than anyone. And I am not here to defend all of the agricultural—some of the money that is spent in the agricultural area.

I truly believe that some of it could be reduced. But I think what you are looking at here is our country today is in a situation where the tree farmer is not able to make a living under the circumstances. All of these provisions will help, whether it is reforestation, whether it is passive loss, whether it is capital gains. But we cannot afford to not continue to replant our forests. And this is one of the things that the environmentalists and the industry agrees on, is that we cannot continue to have a loss in our reforestation.

Mr. RANGEL. Does that mean that you support the provisions of H.R. 9, and that you just have to take your chances as other people in the cutting arrangements that will be made?

In other words——

Mr. STUCKEY. We support—we support all of it, but——

Mr. RANGEL. Huh?

Mr. STUCKEY. We support H.R. 9, we support the reforestation that was introduced last year.

Mr. RANGEL. This is the taxwriting committee and that is all you should be concerned about.

Mr. STUCKEY. But I can tell you, and history bears this out, that people will be selling off their lands. They are going to look at today, not tomorrow.

Mr. RANGEL. I don't want to argue with you, Mr. Stuckey. All I am saying is this, that you are in front of the taxwriting committee. Everybody wants reduction in taxes. And you know as a former Member, no one likes to give it back to the people, their money, more than politicians and Members of Congress. So that is a done deal.

Now comes the question that whether we believe in it, don't believe it, we are mandated by the majority and by the President to make certain that we don't create a deficit. So that is done, politically certain things are off the table. Forestry is not one of them.

I have no idea how you would make out. Every industry has to make its own case. And I just want to make it clear that what you are saying now is that whatever happens down the line in cutting, that is a different committee, we will make our plea at a different time. But for right now, you want that tax relief.

See, we take the position that we don't know how much tax relief we want until we find out how painful the cuts are going to be, not the majority. Those of us in the minority, we want to cut as much taxes, as the other spending cuts cause us less pain. If it is not my ox that is being gored, let's do what we have to do.

So it is a consideration, and it really doesn't require an answer. But we ought to be alert that when you get from this hand of the government, something is going to be taken back in some other service that government is providing. But it has been a real education.

Good to see you again, Mr. Shaw, and you never let me down, Stuckey, from ball peanuts to save the trees.

Thank you.

Mr. COLLINS [presiding]. Thank you.

Ms. Dunn.

Ms. DUNN. Thank you, Mr. Chairman.

And I will apologize to the panel. This is an interest near and dear to my heart since I have so many timber farms and farmers in my district in Washington State. I want to thank—I want to thank Mr. Christensen for doing the introduction of Mr. Stinson.

And I understand, Mr. Stinson, that you have not been asked a question, so I would first like to give you an opportunity to respond to any questions that have been addressed to the panel. Then I have an additional one for you.

Mr. STINSON. I would like to address the last question we just had here. And I think, you know, another way to look at this, we are talking about an investment in the future. And it is an investment in our forests and it is—you are going to get it paid back.

It may not be right tomorrow, but it is an investment in the future that is, I think, vital to the future generations coming along in this country. And I think we need to look at that really hard. And also the fact that it is going to help everybody, because our forests are very, very important not just for timber production, but for watersheds, wildlife, recreation.

There are many people who use the forests that don't own the forests. So there are some tremendous benefits to our country. And as our population keeps growing, we need more trees. If nothing more, just for oxygen. And so we can't go wrong. It is a win/win situation.

Mr. RANGEL. If the gentlelady would yield.

I agree with you 100 percent.

Ms. DUNN. It is my time, I yield.

Mr. RANGEL. I agree with you 100 percent, want you to know you are not going to have a problem with me. As a matter of fact, I al-

ways use the analogy of investing in young people and schools, because in the long run, you are going to get a return.

Ms. DUNN. Thank you.

And to the entire panel, particularly to you first, Mr. Stinson, since we have had discussions on at least one of these issues, if this capital gains tax cut is enacted, are there other obstacles in the Tax Code that we need to address such as passive loss, for example, that are discouraging to the reforestation industry?

Mr. STINSON. Well, the other tax issue for me that is a big one, is estate tax. And as a small tree farmer and a family held tree farm, one of the things that we look to in the future is how to be able to pass this down to our children. And that is a difficult problem right today. And I think probably that may be the greatest tax problem that most small family held tree farms face today.

Mr. SIEGEL. I would like to say something about the passive loss rules, Ms. Dunn, since you brought it up, and some of the other aspects of timber taxation.

Yes, the passive loss rules and the ability to deduct current expenses are a real problem with the small nonindustrial timberlandowner. Because the passive loss rules that were written by the IRS has, as a result of the 1986 Tax Reform Act, were written in general terms and did not take into consideration the unique aspects of certain types of investment such as timber growing, where more activity may be required on a landowner's part in 1 year and very little in another year, where we have many absentee landowners who, nevertheless, manage their lands very intensively, but are not personally involved, but use consultants, such as Mr. Shaw, to help manage their property.

Therefore, they have a very difficult time in meeting the provisions of the passive loss rules, and the ability, therefore, to deduct currently their expenses associated with their timber properties. In other words, they have to suspend their expenses, which cannot be recovered until timber is sold.

And as we know, that may be many, many years down the road. And that is why many of us in the forestry community would like to see the passive loss rules amended to take into consideration such unique investments such as timber that don't apply to the general terms of the passive loss rules.

Mr. SHAW. If I could take that thought a little bit further, there are several tests on whether you meet the qualifications for these ordinary maintenance costs during the year. One is a 100- to 500-hours test. You have to show that you do qualify.

If you have 500 hours or more, there is a safe harbor—you qualify automatically. If less than 100 hours, you really don't have any opportunity to show that you qualify.

A provision which would eliminate that requirement and put it in the category with the 100 to 500 hours by which you could show that you qualified, would allow a treegrower that has annual expenses such as firebreak plowing, even indirect costs such as property taxes, to deduct those during the time when they may only have periodic income, every 20 or 25 years. So this is an ongoing problem.

Those provisions were in H.R. 11, which passed both Houses of Congress in 1992. Unfortunately, that bill then was vetoed, so it

never made it. But that is a disservice to our treegrowers. And it is a very big problem.

Ms. DUNN. Thank you very much.

Mr. COLLINS. Mr. Christensen.

Mr. CHRISTENSEN. I want to thank the panel for their testimony.

And, Mr. Stinson, I was quite intrigued with your testimony because I thought the cattle business was a tough business. Now I found another business that I don't think I ever want to get into.

Boy, after listening to your testimony, I have to give you a "hats off" for withstanding the insects and the fires and the natural disasters and everything for a long-term investment. And I didn't fully realize the impact of the forestry business.

And not only you, but you, Mr. Stuckey, I know you are also a grower as well. With a long-term investment like that, that is going to take anywhere from 20 to 70 years, depending upon the kind of wood that you are growing, what kind of profit are we looking at here?

If you were to grow, say, 100 acres of trees, what kind of investment do you have in 100 acres of trees and realization of a profit?

Mr. STINSON. Well, an acre of trees in the State of Washington at maturity have a value, varies, but I will give you a spread, $5,000 to $8,000.

Mr. CHRISTENSEN. OK.

Mr. STUCKEY. That wouldn't apply to Georgia. I wish it would.

Mr. STINSON. But they grow a little faster in Georgia. But I guess I think a bigger thing is most of the people who work the land, it is a love of the land that comes first. And growing the trees is very important because it is your livelihood. But if they didn't love the land and really have an interest there, you know, it probably wouldn't come together.

Mr. STUCKEY. And the price does fluctuate. Timber prices now are attractive, particularly in the South. We have had a lot of—a lot of rain.

And I hate to say this, because it is someone else's misfortune, but the price has gone up also because of the spotted owl in the Western States where they couldn't—where the demand is there but they couldn't go in and cut the timber. So they have had to fall back on some Southern timber.

Mr. CHRISTENSEN. OK.

Mr. SHAW. Just to add a little bit more, the anticipated return in the Southeast would be maybe 6 to 8 percent real rate of return, if you are in it for the entire rotation. But you have many, many obstacles. And the illiquidity of it, as was mentioned earlier.

If you invest $250 an acre in planting trees in the Southeast, you immediately have a $100 asset, because that is the market reaction.

So you have got a highly illiquid investment there for 6, 8, 10 years. That contributes a lot to the risk as well as the points mentioned in my testimony. Being from the Hurricane Hugo area, I can attest to the other risks involved there.

Mr. STUCKEY. I mentioned in my testimony, why put your money in land when you can get a long-term bond without the risk? And you are speaking of 6 to 8 percent, and there are some that would say that that is optimistic.

I do get some other value out of it, I enjoy the land, I enjoy the hunting, and that can be very enjoyable. But that kind of risk for a 6 to 8 percent return, I could put it in a bond, in a particular tax-free bond, and sit back and enjoy it.

Plus, I don't run the risk of somebody finding a red cockaded woodpecker on there, and then all of a sudden the investment being worth zero; or someone to come in and say, hey, this is wetlands, you can't come in and harvest your trees.

Mr. CHRISTENSEN. I want to thank the panel. I really appreciate your testimony, especially Mr. Stinson for coming all the way from Washington State.

Thank you, Mr. Chairman.

Mr. COLLINS. Thank you, Mr. Christensen.

There are very few acres of land that you can buy in Georgia, though, for $250 an acre, even though they are setout pines. Is that not true?

Mr. SHAW. Well, my analysis was not including the land value. That was what you would invest in site preparation and planting the trees.

Mr. STUCKEY. You can buy some 250-acre land now.

Mr. SHAW. Yes, you can.

Mr. COLLINS. In certain parts of the State.

Mr. STUCKEY. Sure.

Mr. COLLINS. But is it not true there are really three harvesting periods you are looking at in tree farming, that is, the pulp wood, and then when it gets to be what you call chip and saw, and then on into plywood material or bigger saw timber?

Mr. SHAW. Correct.

Mr. COLLINS. That is where you get your spread from a 15-year investment on up until a 40-, 50-, 60-year investment.

There has been a lot of talk about the fact that tax cuts could result in increased deficits. For the record, we want it to be known that the budget reconciliation that will be coming through very shortly, or very soon, will set the parameters that we will have the opportunity to meet for the tax reductions.

Those cuts are going to be there and those deficits are going to be covered. But is it not further true that a lack of incentive in this area, in this industry, will have a continued loss of timberland which will result in higher costs of building materials, which then will result in higher costs of housing? Is that not a fair statement to make?

Any of you.

Mr. SIEGEL. Sir, I think it is. I don't think there is any doubt that that is true, because of the set-asides on the public lands, the lowering of the timber cutting on public lands, and therefore that puts a lot more pressure for timber, for timber supplies, on private lands.

As we have heard, many of our private owners, particularly the nonindustrial private owners are not reinvesting after they are harvesting. So definitely if the supply shrinks and we are still going to have a housing demand, that definitely will result in higher prices for housing. And I don't think there are that many economists that disagree with that.

Mr. COLLINS. Then tax incentives could keep us a mix of the private landowner, the commercial landowner and the public land.

We thank each of you for being here. We appreciate your testimony. It is very helpful to us.

And the committee will stand adjourned until 10 a.m. tomorrow. Thank you.

[Whereupon, at 3:47 p.m., the hearing was adjourned, to reconvene at 10 a.m., Tuesday, January 31, 1995.]

TAX PROVISIONS IN THE CONTRACT WITH AMERICA DESIGNED TO ENCOURAGE SAVINGS AND INVESTMENT

THURSDAY, JANUARY 26, 1995

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, D.C.

The committee met, pursuant to call, at 10 a.m., in room 1100, Longworth House Office Building, Hon. Bill Archer (chairman of the committee) presiding.

Chairman ARCHER. If our guests will take seats, we can commence today's hearing. Today we continue our hearings on the savings and investment features of the Contract With America. Our focus today will be on the depreciation proposals and on the impact of the Contract on real estate.

The neutral cost recovery proposal in the Contract is intended to address an important issue for business—appropriate depreciation for business property for the creation of jobs. Economists have pointed out that the depreciation rules under the U.S. tax system do not allow businesses to recover fully their costs and place our companies at a competitive disadvantage when compared to companies operating in other countries.

The neutral cost recovery proposal has been put forth as one solution to the problem. I expect that we will hear from witnesses today who will have other possible alternatives. We welcome that input.

The Contract With America will also increase the immediate deductibility of capital items for small businesses, increasing that deductibility from $17,500 to $25,000 per year. This is both a simplification and an additional incentive for small businesses. If it were possible under our budgetary constraints, I would like to increase that amount for expensing even more.

Before moving to our first witnesses, I would like to recognize Mr. Cardin to make an opening statement on behalf of the minority, and as usual any additional opening statements by members of the committee can be put in the record in writing. After Mr. Cardin, we will proceed with our witnesses.

Mr. Cardin.

Mr. CARDIN. Thank you, Mr. Chairman. Mr. Chairman, on my ride in from Baltimore this morning, I was listening to the news and listening to the account of congressional debate yesterday on the floor, and was listening to Henry Hyde talk about the importance of balancing the Federal budget. He reinforced the thought

that I think all of us share, that the most important thing that we can do in order to increase investment in this Nation is to reduce the size of the Federal deficit.

Mr. Chairman, I applaud you for holding these hearings on provisions in the Tax Code in order to encourage additional private sector investment in this Nation. Democrats agree that our Nation lags far behind the industrial nations of the world in our savings ratios and that changes in our Tax Code can help us increase the amount of savings in this Nation, but let me underscore that the most important thing that we can do in order to help investment and savings is to reduce the size of the Federal deficit.

That is why many of us are concerned about how we are going to pay the $720 billion the Treasury has estimated to be the cost of the provisions in the Contract as they relate to the Tax Code. We should know how we are going to pay for these tax cuts before this committee moves forward in recommending these proposals to the full House.

The specific proposals that are before us concern tax changes for investment and savings, many of which enjoy bipartisan support. The 1993 tax bill included targeted capital gains relief, and the 50-percent exclusion, and indexing of capital gains enjoy support by both Democrats and Republicans, although I must point out, as a result of the hearings that have already taken place in this committee, there are certainly questions as to the complexity and the potential for shelters that I think this committee needs to deal with before reporting out such legislation.

I might also point out that the IRAs, individual retirement accounts, have had broad support by both Democrats and Republicans. President Clinton has included provisions concerning IRAs in his recommendations as well as in the Contract. Democrats and Republicans have traditionally supported those proposals.

But today's hearing is concerned with depreciation and the recommendation on the neutral cost recovery system. Perhaps this proposal has some merit in theory, but I don't believe it will work, and I am very interested in listening to the witnesses today explain how this proposal will increase investment and savings in our country and how we are going to pay the $120 billion price tag that the Treasury has estimated that costs the Treasury revenue outside of the budget window during the second 5 years of this proposal, and why taxpayers will choose to give up current savings on depreciation knowing the radical change that this makes in the Tax Code and the unlikelihood that Congress could allow such a provision to remain in place during the entire 10 years that Treasury has made its estimates.

I would also like the witnesses to address on this proposal why we should encourage the creation of tax shelters or how we could avoid tax shelters from being created. Examples have been given to us as to how individuals and companies would make decisions based upon the Tax Code rather than economic considerations because the indexing of the asset, but not of the interest cost, will allow tax shelters once again to be developed as a result of the Tax Code.

So, Mr. Chairman, I would hope that the witnesses in dealing with this proposal will explain first how we are going to pay for it,

and, second, why we should reinstate tax shelters in the code and how we can deal with the complexity issues that have been raised by other witnesses.

Thank you, Mr. Chairman.

[The opening statements follow:]

OPENING STATEMENT OF HON. BENJAMIN L. CARDIN
A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MARYLAND

Thank you, Mr. Chairman. Today's hearing gives the committee an opportunity to address one of the most pressing economic problems facing our country -- the lack of adequate savings, and the resulting lack of capital for investment.

Among the major industrialized countries of the world, the U.S. savings rate lags far behind every country except the United Kingdom. The tax code is not the principal reason for our low savings rate, but we can encourage savings through the tax code, and we should do it.

The tax issues we will consider in this hearing include three major savings and investment proposals. First, we would offer individual and corporate taxpayers a 50% exclusion on capital gains, and would index capital gains for inflation occurring after December 31, 1994.

Democrats have long supported incentives through the tax code to encourage savings and investment. The 1993 tax bill included a targeted capital gains break for long-term investments in small businesses. That provision offered capital gains relief to small companies that have the toughest time raising needed capital.

The fifty percent capital gains exclusion now before our committee is much broader. The fifty percent exclusion will "unlock" assets and encourage new investment in our economy. By reducing the tax burden on investment returns, the exclusion will encourage taxpayers to shift assets from consumption to investment.

The proposal to index capital gains has a basic appeal. We already index many provisions of the tax code, so that tax is based on real rather than nominal, inflation-boosted income. Indexing capital gains will eventually take inflation out of the tax calculation.

But indexing raises some serious problems. It introduces a great level of complexity to the code. Taxpayers will be required to calculate the inflation impact on each individual asset, including, for example, the family car, greatly increasing individual record-keeping requirements.

Another potential problem with indexing is that if we index capital gains without indexing liabilities, we create the potential for tax shelter activity. I hope today's witnesses will address the shelter question, and particularly offer suggestions on how we might limit deductibility of debt financing connected to capital assets.

In addition to the capital gains proposals, we also have before us a plan to expand eligibility for Individual Retirement Accounts. President Clinton and the Republican Contract both have recognized the potential of IRAs to generate new savings,

and, just as important, long-term savings. The long bipartisan history of support for IRAs on this committee is continued in these hearings.

Mr. Chairman, while I believe the capital gains and IRA proposals have merit and deserve support, I cannot say the same for the third leg of the contract's savings and investment package. The so-called "neutral cost recovery system" is a potentially disastrous idea masquerading as a simple, fair investment incentive.

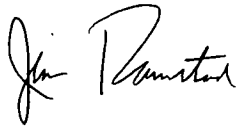
NCRS, or "nickers", as it is known, aims to help solve a real problem for American business. But it is plainly the wrong answer to the right question. The question is, "What can we do to make the depreciation rules more simple and more favorable to investment?" The answer provided by NCRS is to add complexity, make depreciation a multiple choice game, raise the prospect of tax shelter activities, and try to hide $120 billion in lost revenues by pushing it outside the budget window.

The sensible alternative to "nickers" is to clean up the AMT treatment of depreciation. We can solve real problems facing real taxpayers without blowing a huge hole in the deficit. I will shortly introduce legislation to apply regular tax recovery periods to AMT depreciation. AMT relief makes a lot more sense than an untested, theoretical plan that needs a lot more work.

The final point I want to make is that the point of all these provisions is to increase savings. As we all know, the greatest single drag on savings in this country is the federal budget deficit. Each of the savings incentives I have mentioned will, by itself, lower revenues and increase the deficit.

The Treasury Department has calculated the total revenue loss under the tax provisions of the Contract at well in excess of $700 billion over ten years. In fact, it is troubling that several of the provisions of the contract are clearly structured to push revenue losses outside the scorekeeping window.

I hope today's witnesses will include in their comments suggestions on how we should offset the revenue losses that these proposals will generate. And I hope that all my colleagues on this committee will join in insisting that full offsets be identified before we move to final approval of the tax cuts.



STATEMENT OF REPRESENTATIVE JIM RAMSTAD
WAYS AND MEANS COMMITTEE
HEARING ON CONTRACT WITH AMERICA
January 26, 1994

Mr. Chairman, it is a pleasure to have such a distinguished panel of witnesses with us today to discuss neutral cost recovery. I have been extremely impressed with the excellent, real-world witnesses we have had before us to discuss each of the Contract provisions.

Currently, the tax code does not allow businesses to fully recover the cost of investments in depreciable business property. The Contract proposal would increase the depreciation deduction to account for inflation and the time value of money. It would also increase the amount of property that a small business can "expense."

These measures are essential to encouraging the type of investment our nation needs to maintain long-term economic growth. It is truly indefensible that the existing tax code -- with its depreciation schedule that does not allow taxpayers to write off the full cost of their investments -- discourages businesses from reinvesting earnings.

Mr. Chairman, while this seemingly esoteric portion of the Contract gets little attention, it is absolutely critical that we enact it and allow American businesses to continue to grow.

I thank you all very much for being here today and look forward to your testimony.

Chairman ARCHER. Our first witness this morning is the architect of the neutral cost recovery provision as proposed in the Contract With America. We are pleased to have our colleague, Hon. Nick Smith of Michigan before the committee.

As you probably are aware, under the rules of this committee and I think most other committees, we ask you to keep your verbal presentation to 5 minutes or less, and you may submit your entire written statement to be printed in the record without objection.

Nick, we are glad to have you with us, and you may proceed.

STATEMENT OF HON. NICK SMITH, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

Mr. SMITH OF MICHIGAN. Mr. Chairman, members of the committee, thank you very much. With your permission, I will submit for the record my written testimony and respond more specifically to the three concerns that were raised. Also I would like to insert in the record the answer to the question on cost, if that is appropriate, on neutral cost recovery.

Chairman ARCHER. Without objection, so ordered.

Mr. SMITH OF MICHIGAN. Mr. Chairman, I would like to include one other item for the record, and I will talk about it, a chart showing why neutral cost recovery is not a tax shelter, that reviews old ADR, ACRS, GDS, and the proposed system of neutral cost recovery showing specifically that those tax writeoffs under neutral cost recovery are less than any of the previous formations that we put in our Tax Code.

Chairman ARCHER. Without objection.

Mr. SMITH OF MICHIGAN. Let me just give some background and my specific interest. I come from a State, the only State in the Nation that has a total expensing for all business property. So in Michigan we have a value-added tax that allows a full writeoff in the first year for the purchase of all machinery, equipment and facilities.

It has been suggested to me that I should sort of not just increase the expensing to $25,000, but if we could increase that expensing allowance to $250,000 and then have less neutral cost recovery, it would be even a greater advantage to us.

In this country we are facing a situation where our savings are less than most of the other countries of the world, where our investment in machinery and equipment are less than most other industrialized countries, and ultimately and not surprisingly the rate of increase in our productivity is also next to the bottom of the G–7 countries.

We are seeing countries, the Asian tigers, Singapore, Hong Kong, South Korea, and Taiwan, as well as the other industrialized countries, are doing whatever they can to attract capital investment. Economists agree that the countries that are able to attract capital investment are the ones that are going to expand their economies the most.

That is what we are not doing in this country. We saw the Wall Street Journal this morning which said wages are going down. Our standard of living in this country is going down. The question we must ask ourselves is, what can we do in Federal policy to start turning that around.

Right now, ladies and gentlemen of this committee, we penalize businesses that decide they want to invest in the machinery, equipment and facilities that are going to increase their productivity. Does it increase productivity? Being a farmer from Michigan, my analysis would be that if you put a better tool in the hands of the American worker, that worker is going to be able to increase his efficiency, ultimately his productivity, and in the final analysis our competitive position in a very tough world market.

The world market is getting tougher, we have to build the kind of items that people want to buy at a competitive price. The way to do that is to have the kind of tools and equipment necessary.

I introduced this bill last year with about 100 bipartisan cosponsors. This year it has been reintroduced as H.R. 199 and it is part of the Contract With America. It is the only specific job growth proposal in our Contract With America.

I hope the committee will seriously look at it. The Treasury testified the other day that it was going to cost something like $122 billion, an average of $11 billion a year for the next 10 years. Dynamic analysis says to the contrary, it is going to bring in much more revenue than that.

I would suggest, and some of the expert witnesses that are following me will verify this statistically, that even if the economy grows just a very small fraction of what the dynamic model estimates, we will compensate for even the static estimate of costs of this specific proposal.

The other day in Budget Committee, I asked Alan Greenspan, Chairman of the Federal Reserve, what we should do when the static cost of a proposal is significant. His answer was essentially that good policy is good policy, and Congress can't decide what is good for America based simply on a static cost estimate that isn't going to be exact. Mr. Chairman, I appreciate the opportunity to testify, and I would be glad to answer any questions.

Thank you very much.

[The prepared statement and attachment follow:]

NICK SMITH, MEMBER OF CONGRESS
Testimony on Neutral Cost Recovery before the House Ways and Means Committee January 26, 1995

MR. CHAIRMAN...MEMBERS OF THE WAYS AND MEANS COMMITTEE, NEUTRAL COST RECOVERY IS THE ONLY SPECIFIC JOB GROWTH INCENTIVE IN THE CONTRACT WITH AMERICA. CAPITAL GAINS TAX RELIEF WOULD HELP BUSINESSES WHEN THEY SELL MACHINERY, EQUIPMENT AND FACILITIES. NEUTRAL COST RECOVERY IS AN INCENTIVE TO MAKE THESE CAPITAL PURCHASES IN THE FIRST PLACE. LIKE CAPITAL GAINS INDEXATION, NEUTRAL COST RECOVERY INDEXES DEPRECIATION SCHEDULES FOR INFLATION. UNDER OUR TAX CODE, BUSINESSES HAVE TO WAIT 5, 10, 15, OR EVEN 20 YEARS BEFORE DEDUCTING THE PURCHASE PRICE, WHILE INFLATION ERODES THE VALUE OF THE DEDUCTION.

THE U.S. TRAILS ITS INTERNATIONAL COMPETITORS IN PRODUCTIVITY GROWTH. NEUTRAL COST RECOVERY ADDRESSES THIS BY PUTTING MORE EFFICIENT EQUIPMENT AND MACHINERY IN THE HANDS OF OUR WORKERS. THIS IMPROVES PRODUCTIVITY AND ULTIMATELY CREATES JOBS AND INCREASES WAGES FOR AMERICAN WORKERS. SIMPLY PUT, A PERSON WITH BETTER TOOLS PRODUCES MORE EFFICIENTLY AND EARNS MORE MONEY. WE CAN PUT MORE AND BETTER TOOLS IN THE HANDS OF OUR WORKERS BY ESTABLISHING A FAIR TAX POLICY, ONE THAT TAXES THE REAL RETURN ON CAPITAL BY NEUTRALIZING THE LOSS FROM INFLATION AND THE TIME VALUE OF MONEY.

TO ENCOURAGE BUSINESSES TO INVEST IN MACHINERY AND EQUIPMENT, WE NEED TO ALLOW THEM TO DEDUCT THE COSTS OF THESE PURCHASES AS BUSINESS EXPENSES IN THE YEAR OF PURCHASE OR AN EQUIVALENT VALUE AS DEPRECIATION IN LATER YEARS. IN THE SERVICE INDUSTRY SECTOR, WE ALLOW NEARLY ALL PURCHASES TO BE EXPENSED. IN MANUFACTURING AND PRODUCTION INDUSTRIES THAT MOST NEED THE NEW EQUIPMENT AND FACILITIES TO COMPETE IN THE WORLD MARKET, WE DENY THE FULL DEDUCTION.

MR. CHAIRMAN...MEMBERS OF THE COMMITTEE, AS YOU KNOW, THE MARKET FOR CAPITAL IS AN INTERNATIONAL ONE. IN OUR POST COLD WAR ECONOMY, OTHER COUNTRIES ARE DOING EVERYTHING THEY CAN TO ATTRACT CAPITAL INVESTMENT, AND MANY ARE SUCCEEDING. LOOK AT THE GROWTH OF THE NEWLY INDUSTRIALIZED COUNTRIES OF SOUTHEASTERN ASIA: SOUTH KOREA, HONG KONG, TAIWAN, AND SINGAPORE. IN CHINA AS WELL, THE GROWTH RATE HAS BEEN REMARKABLE. CLEARLY, THE U.S. NO LONGER HAS A MONOPOLY ATTRACTING CAPITAL INVESTMENT. IN FACT, OVER THE LAST 20 YEARS, THE UNITED STATES HAS TRAILED MOST OF OUR INDUSTRIALIZED COMPETITORS IN CAPITAL INVESTMENT PER WORKER, IN PART BECAUSE OTHER COUNTRIES HAVE MORE FAVORABLE TAX POLICIES. A STUDY DONE BY THE AMERICAN COUNCIL ON CAPITAL FORMATION, FOUND THAT U.S. CORPORATE TAX DEPRECIATION RULES PUT US AT A STRONG DISADVANTAGE WITH OUR COMPETITORS. OBVIOUSLY, COUNTRIES WITH TAX LAWS THAT ENCOURAGE INVESTMENT GIVE THEMSELVES AN ADVANTAGE IN ATTRACTING CAPITAL.

WE CAN ATTRACT MORE CAPITAL INVESTMENT, INCREASE PRODUCTIVITY, AND EXPAND JOB OPPORTUNITIES SIMPLY BY BEING FAIR TO BUSINESSES WHICH MAKE LONG-TERM INVESTMENTS. NEUTRAL COST RECOVERY, WHICH I SPONSORED IN THE LAST CONGRESS AS H.R. 539 WITH 91 BIPARTISAN COSPONSORS, WAS REINTRODUCED ON THE FIRST DAY OF THIS SESSION AS H.R. 199. THIS PROPOSAL HAS BEEN ENDORSED BY LEADING BUSINESS ORGANIZATIONS: THE U.S. CHAMBER OF COMMERCE, THE NATIONAL FEDERATION OF INDEPENDENT BUSINESS, AND THE NATIONAL BUSINESS OWNERS ASSOCIATION. THESE GROUPS UNDERSTAND THAT OUR CURRENT TAX TREATMENT FOR EQUIPMENT, MACHINERY, AND FACILITIES IS NOT FAIR AND PUTS OUR BUSINESSES AT A COMPETITIVE DISADVANTAGE WITH OTHER COUNTRIES. MOST ECONOMISTS AGREE THAT ENCOURAGING CAPITAL INVESTMENT IS KEY TO ECONOMIC AND JOB EXPANSION.

WE DISCOURAGE CAPITAL INVESTMENT IN THIS COUNTRY BECAUSE WE DON'T ALLOW THESE PURCHASES TO BE CONSIDERED A BUSINESS EXPENSE. TO GIVE A RELATIVELY SIMPLE EXAMPLE, LET'S SAY A BUSINESS BUYS A $10,000 MACHINE WITH AN EXPECTED LIFE OF TEN YEARS. THE BUSINESS CAN DEPRECIATE IT OVER TEN YEARS AT $1,000 PER YEAR UNDER OUR CURRENT TAX LAWS. ASSUMING JUST 3% INFLATION, THE ANNUAL DEDUCTION IS WORTH ONLY $766 BY THE TENTH YEAR, INSTEAD OF THE ORIGINAL $1,000.

UNDER THIS NEUTRAL COST RECOVERY BILL, BUSINESSES WOULD BE ALLOWED TO "EXPENSE" OR "DEDUCT" THE FIRST $25,000 OF CAPITAL INVESTMENT IN THE YEAR OF PURCHASE AND INDEX OTHER DEPRECIATION FOR INFLATION. NEUTRAL COST RECOVERY WOULD BE AN OPTIONAL DEPRECIATION METHOD, SO BUSINESSES COULD STILL CHOOSE TO USE EXISTING FORMS OF DEPRECIATION IF THEY WANTED THE LARGER UP-FRONT DEDUCTION. I WOULD LIKE TO MENTION THAT THE CURRENT 200% DECLINING BALANCE AND THE 150% ARE ARBITRARY METHODS OF DEPRECIATION. THIS, ALONG WITH THE ARBITRARY YEARS OF LIFE ASSIGNED BY THE DEPARTMENT OF TREASURY, RESULT IN SIGNIFICANT TAX ADVANTAGES TO CERTAIN BUSINESSES.

NEUTRAL COST RECOVERY IS NOT ARBITRARY AND ALLOWS ALL BUSINESSES TO DEDUCT THE FULL PRESENT VALUE OF THE PURCHASE REGARDLESS OF THE YEARS OF LIFE. THIS LEGISLATION WOULD USE THE GROSS DOMESTIC PRODUCT DEFLATOR, COMPUTED BY THE COMMERCE DEPARTMENT, TO DETERMINE THE INFLATION INDEX. THOSE BUSINESS PURCHASES NOW ELIGIBLE FOR 200% DECLINING BALANCE WOULD BE ELIGIBLE TO CHOOSE NEUTRAL COST RECOVERY AT 150% DECLINING BALANCE AND WOULD HAVE THE INDEX INCREASED BY A FACTOR OF 1.035 TO REFLECT THE TIME VALUE OF MONEY.

NEUTRAL COST RECOVERY WOULD REDUCE THE COST OF MACHINERY AND FACILITIES, INCREASING ECONOMIC ACTIVITY BY AN ESTIMATED $3.5 TRILLION BY THE YEAR 2000 ACCORDING TO AN INDEPENDENT STUDY BY GARY AND ALDONA ROBBINS. GARY ROBBINS IS A FORMER REVENUE ESTIMATOR FOR THE DEPARTMENT OF TREASURY. EACH MEMBER OF THE COMMITTEE HAS BEEN PROVIDED WITH A COPY OF THIS STUDY. I WOULD REFER MEMBERS OF THE COMMITTEE TO THE CHARTS ON PAGES SEVEN AND TEN OF THE STUDY WHICH SHOW THAT FULL NEUTRAL COST RECOVERY WOULD CREATE AN ESTIMATED 2.7 MILLION NEW JOBS AND INCREASE ANNUAL TAKE HOME PAY BY AROUND $3,300 OVER THE NEXT FIVE YEARS. NEUTRAL COST RECOVERY RESULTS IN EXPANDED BUSINESS AND JOBS BECAUSE IT REDUCES THE COST OF MACHINERY, EQUIPMENT, AND FACILITIES BY AN ESTIMATED 16%.

ON JANUARY 10TH, A REPRESENTATIVE FROM THE ADMINISTRATION SUGGESTED THAT NEUTRAL COST RECOVERY WOULD LEAD TO A REVENUE LOSS AVERAGING $11 BILLION PER YEAR OVER THE NEXT 11 YEARS. THIS ESTIMATE WAS MADE USING A STATIC MODEL. UNDER THE DYNAMIC MODEL USED BY GARY ROBBINS, NEUTRAL COST RECOVERY WOULD INCREASE REVENUES BY APPROXIMATELY 119 BILLION DOLLARS OVER THE NEXT FIVE YEARS. WHILE WE HAVE DECIDED TO CONTINUE THE USE OF STATIC SCORING FOR BUDGET PURPOSES, I WOULD SUGGEST THAT ECONOMISTS AGREE THAT LOWERING THE COST OF MACHINERY, EQUIPMENT, AND FACILITIES BY INDEXING DEPRECIATION FOR INFLATION WILL EXPAND THE ECONOMY AND JOBS. IF THERE IS ONLY TEN PERCENT OF THE ECONOMIC EXPANSION THAT THE DYNAMIC MODEL PREDICTS, REVENUES COMING INTO THE FEDERAL GOVERNMENT WILL MORE THAN OFFSET THE $120 BILLION COST PREDICTED BY TREASURY.

I'D LIKE TO FINISH BY MENTIONING FEDERAL RESERVE BOARD CHAIRMAN ALAN GREENSPAN'S TESTIMONY BEFORE OUR HOUSE BUDGET COMMITTEE TWO WEEKS AGO. HE REMINDED US THAT GOOD POLICY IS GOOD POLICY. I WOULD LIKE TO SUBMIT PART OF HIS STATEMENT FOR THE RECORD. HE SAID THAT IT IS "PROBABLY WISE TO GO FORWARD WITH THOSE (IMPORTANT) POLICIES (THAT HAVE GREAT POTENTIAL) AND TAKE THE SCORING HITS..."

LADIES AND GENTLEMEN OF THE COMMITTEE, AS A MEMBER OF THE BUDGET COMMITTEE, I'M 100% COMMITTED TO CUTTING THE DEFICIT, AND I BELIEVE THAT THIS PROPOSAL WILL HELP, NOT HINDER THAT EFFORT. THIS PROPOSAL WILL BRING IN REVENUE, BOTH IN THE SHORT RUN AND IN THE LONG RUN. EVEN UNDER THE STATIC MODEL, IT WILL BRING IN ADDITIONAL REVENUE OVER THE FIRST SIX YEARS. THERE IS NO QUESTION IN MY MIND THAT BY TIME WE REACH THE SEVENTH YEAR, INCREASED ECONOMIC ACTIVITY WILL HAVE KICKED IN AND PRODUCED MORE THAN ENOUGH NEW REVENUE TO COVER ANY LOSSES.

MR. CHAIRMAN...MEMBERS OF THE COMMITTEE, I WOULD LIKE TO THANK YOU AND THE COMMITTEE FOR YOUR EFFORTS, AND WOULD BE HAPPY TO ANSWER ANY QUESTIONS.

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Neutral Cost Recovery: Investing for Growth, Not Planning for Taxes

Problems with Tax Depreciation

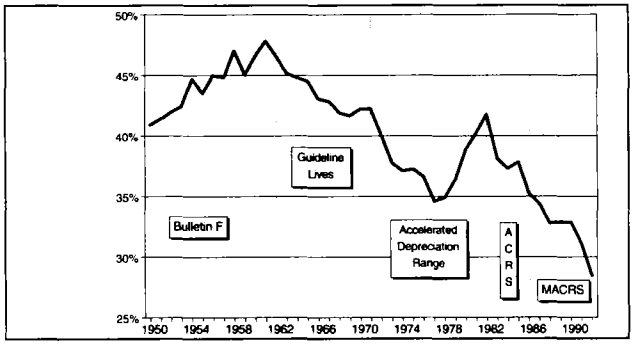
Tax depreciation specifies how much of the original cost of an asset a business can deduct from income in a particular year. (See the Appendix for a discussion of the current depreciation rules.) There are four major ways in which the current tax depreciation system can adversely affect the mix of assets and the level of the U.S. stock of capital.

1. Inherent time bias

Current depreciation schedules are biased against longer-lived assets because future deductions are worth less than current deductions. An investor faced with a choice between a $1 deduction today versus $1 tomorrow would always choose today. At the very least, $1 taken today could be put in the bank and earn interest. Moreover, the erosion in value gets worse the longer the deduction is delayed.

In response to this bias, the mix of U.S. capital has moved toward shorter-lived assets. During the 1950s and early 1960s, structures composed roughly 40 to 50 percent of fixed nonresidential investment. Today, however, structures make up only 28 percent [See Figure 1]. While some of this decline may be due to technological and other reasons, part of it is tied to the tax depreciation system.

Figure 1
Investment in Longer-Lived Assets and Tax Depreciation Schedules



2. Tax life errors

Economic depreciation is the rate at which an asset wears out or becomes obsolete. Recovery of economic depreciation is the largest single cost of most assets. *Tax* depreciation, on the other hand, is an artificial construct which specifies in law the rate at which the original cost of an asset can be deducted from income for tax purposes. Because economic depreciation depends on market conditions and technology, it can never coincide with tax depreciation. Inevitable errors made in determining the appropriate tax lives of assets lead to an inefficient mix of capital and become permanent impediments to growth.

3. Political influence

Tax lives and depreciation schedules are determined through the political process. Government tax analysts usually set "appropriate" tax lives and the Congress generally sets depreciation schedules. The potential for political influence opens the system to abuse.

4. Inflation

Depreciation deductions are not indexed for inflation. This shortcoming magnifies the bias generated by the other three problems.

Table 1 shows how these problems reduce the value of depreciation deductions. In a world with no inflation, failure to adjust for the normal rate of return reduces the value of depreciation deductions by 5.9 percent for a 5-year asset, by 8.4 percent for a 7-year asset and by 44.9 percent for a 39-year asset. To overcome this loss in value, longer-lived assets must earn a considerably higher return over their lifetimes. This higher return is equal to the loss in depreciation value times the tax rate. For example, assuming a tax rate of 33 percent, a 39-year asset would have to earn 13 percent more than a 5-year asset simply due to the lower value of depreciation deductions.

Higher inflation magnifies the loss in value. At a 10 percent inflation rate, the total loss in depreciation deductions ranges from 19.4 percent for a 5-year asset to 80.3 percent for a 39-year asset.

Inflation	5-Year Life	7-Year Life	39-Year Life
0%[1]	5.9%	8.4%	44.9%
3%	10.5%	14.7%	63.2%
5%	13.3%	18.4%	70.4%
10%	19.4%	26.4%	80.3%

Table 1

Loss in Value of Depreciation Write-Offs

[1] *Represents the loss due to failure to adjust for the normal, real aftertax rate of return on capital.*

Neutral Cost Recovery as a Solution

An alternative is to move toward a cost recovery system which assures that all types of capital are treated in exactly the same manner. Expensing has long been an academic model for the perfectly neutral tax system. Expensing allows the business to deduct the entire cost of a new investment immediately. Under current law, small businesses can expense only $17,500 in capital acquisition costs in any year.

Transition problems, however, have always been the basis for rejecting this approach. First, expensing would result in an immediate tax write-off of all investment, completely wiping out most business taxes. The revenue loss would be prohibitive with today's budget deficits. Furthermore, some businesses would not have enough taxable income to use the expanded depreciation deductions, as happened in 1982 when the Accelerated Cost Recovery System (ACRS) was put into place.

H.R. 539, The Investment Tax Incentive Act

Representative Nick Smith (R-MI) has introduced "The Investment Tax Incentive Act" (H.R. 539). The bill would reduce the taxation of capital by reforming the cost recovery system for depreciable assets. Reduced taxes on capital would lower the cost of capital, promote capital formation and spur job creation and economic growth.

Provisions of H.R. 539

H.R. 539 would make federal tax depreciation write-offs for equipment and structures *neutral* with respect to inflation and the time value of money. The specific neutral cost recovery provisions of H.R. 539 are as follows:

- Allow businesses to index depreciation for investments in plant and equipment based on the GDP deflator and an annual rate of return of 3.5 percent.
- Limit the method of depreciation to 150 percent declining balance for indexed investments.
- Provide businesses with the option to continue using current law instead of indexing.
- Effective for investments made after December 31, 1994.
- Eliminate the requirement that taxable income under the Alternative Minimum Tax (AMT) be further increased by an amount equal to 75 percent of the difference between 150 percent declining balance and straight-line depreciation.

The practical impact of neutral cost recovery is to provide owners of capital with the equivalent of a $100 billion tax incentive to invest with no short-term revenue loss.

Although the complicated adjustment under the adjusted current earnings (ACE) provision was repealed in 1993, the bill allows businesses to deduct previously denied allowances on a prorated basis over the next five years.

Neutral Cost Recovery offers a benefit equivalent to expensing to business without the undesirable side effects. Although based on the current schedules of tax lives, it would make two adjustments that would remove all four problems with the present system. (See the Appendix for the proposed schedules.) First, allowable deductions would be indexed for inflation. On average, this adjustment would allow investors to maintain their principal at original values by augmenting write-offs to reflect the higher replacement cost of the same investment solely due to inflation.

The second adjustment would allow an investor to recover a normal 3.5 percent rate of return on invested principal. Adjusting for the time value of money puts the value of future deductions on an equal footing with current deductions. Making one arbitrary schedule the same as any other neutralizes the inherent bias among competing assets, errors in effective tax life measurement and political influence.

A third adjustment assures that the revenue effects of the change will be positive in the near term. The new write-off pattern would be based on a slower method—150 percent declining balance versus current law's 200 percent declining balance—for most assets.

Table 2 compares the depreciation deductions for a $50,000 machine under current law and under neutral cost recovery. Assuming a 5-year asset life and 3 percent inflation, the present value of the $50,000 in depreciation deductions under current law is only $44,762. Under neutral cost recovery, the present value of the $57,820 in write-offs would equal the original cost of the machine. If the machine were incorrectly classified as a 7-year asset, the present value of depreciation deductions under current law would fall to $42,644. Such misclassification would not matter under neutral cost recovery, however, because the present value of the $61,643 in deductions would still be $50,000.

The practical impact of neutral cost recovery is to provide owners of capital with the equivalent of a $100 billion tax incentive to invest with no short-term revenue loss. By stretching out the write-offs, future income and tax benefits would be in balance. It would effectively eliminate taxes on the "normal" return to capital. Business taxable income would not go to zero, however, because taxes would still apply to the returns from intangible assets such as patents, goodwill, trade names, market presence, and so

forth. Further, because the new depreciation system would be limited to new investments, it would not provide a windfall to existing capital. Taxes would continue to be collected on the return to existing assets as long as they remain in service.

Table 2

Depreciation Write-Offs for a $50,000 Machine: Present Law vs. Neutral Cost Recovery

Year	Schedule	Write-off	Inflation Adjustment[1]	Net Present Value[2]
Current Law, 5-Year Life				
1	0.2000	$ 10,000	$ 10,000	$ 10,000
2	0.3200	16,000	15,534	15,009
3	0.1920	9,600	9,049	8,447
4	0.1152	5,760	5,271	4,754
5	0.1152	5,760	5,118	4,460
6	0.0576	2,880	2,484	2,092
Total	1.0000	$ 50,000	$ 47,456	$ 44,762
Neutral Cost Recovery, 6-Year Life				
1	0.1500	$ 7,500	$ 7,.500	$ 7,500
2	0.2550	13,592	13,196	12,750
3	0.1785	10,143	9,561	8,925
4	0.1666	10,092	9,236	8,330
5	0.1666	10,759	9,559	8,330
6	0.0833	5,735	4,947	4,165
Total	1.0000	$ 57,820	$ 53,998	$50,000
Current Law, 7-Year Life				
1	0.1429	$ 7,145	$ 7,145	$ 7,145
2	0.2449	12,245	11,888	11,486
3	0.1749	8,745	8,243	7,695
4	0.1249	6,245	5,715	5,155
5	0.0893	4,465	3,967	3,457
6	0.0892	4,460	3,847	3,239
7	0.0893	4,465	3,739	3,042
8	0.0446	2,230	1,813	1,425
Total	1.0000	$ 50,000	$ 46,358	$ 42,644
Neutral Cost Recovery, 7-Year Life				
1	0.1071	$ 5,355	$ 5,355	$ 5,355
2	0.1913	10, 197	9,900	9,565
3	0.1503	8,541	8,050	7,515
4	0.1225	7,421	6,791	6,125
5	0.1225	7,911	7,029	6,125
6	0.1225	8,433	7,275	6,125
7	0.1225	8,990	7,529	6,125
8	0.0613	4,796	3,900	3,065
Total	1.0000	$ 61,643	$ 55,828	$ 50,000

[1] *Assumes 3% inflation*
[2] *Assumes 3.5% normal rate of return*

Economic and Revenue Effects from H.R. 539

The economic and revenue effects of H.R. 539 were estimated using the Fiscal Associates general equilibrium model of the U.S. economy. Simulating the economic effects of the proposal is done in two stages. First, we used the economic assumptions contained in Clinton administration's February budget to produce a *baseline* forecast of future GDP, employment and investment. Next comes a *dynamic* simulation that forecasts how the economy would behave if H.R. 539 were adopted.

Economic Effects of H.R. 539

H.R. 539 would reduce the economy-wide marginal tax rate on capital by 24 percent and lower the cost of capital by 16 percent [See Figure 2]. Tables 3 and 4 show that by the year 2000:

- Higher investment would increase capital formation in the U.S. by $8.9 trillion [See Figure 3].
- This larger stock of U.S. capital would lead to the creation of 2.7 million new jobs [See Figure 4].

Table 3

Changes in the Economy H.R. 539, Neutral Cost Recovery

**Baseline forecast uses economic assumptions contained in Clinton administration's February budget, which assumes real GDP growth of 2.8%, 2.7%, 2.6%, 2.6% and 2.5% for 1995 through 1999, respectively.*

	Percentage Change from Baseline in:*					
Year	Tax on Capital	Cost of Capital	GDP	Jobs	Capital	Real Growth Rate
1995	-21.6%	-16.1%	1.6%	0.1%	4.2%	1.6%
1996	-22.1%	-16.1%	4.2%	0.5%	11.2%	2.1%
1997	-22.6%	-16.1%	6.7%	0.9%	18.0%	2.2%
1998	-23.0%	-16.1%	8.7%	1.4%	23.3%	2.1%
1999	-23.4%	-16.2%	10.5%	1.9%	27.8%	2.0%
2000	-23.8%	-16.2%	11.4%	2.3%	30.0%	1.8%

Table 4

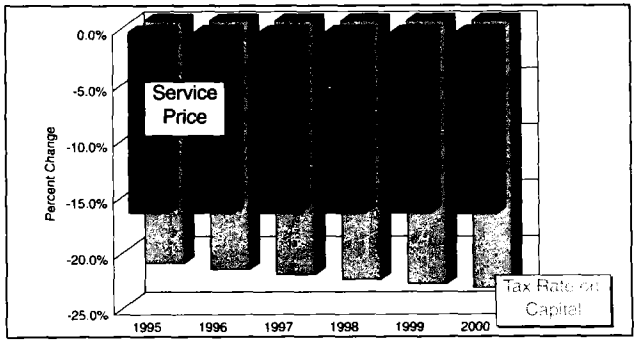
Changes in the Economy H.R. 539, Neutral Cost Recovery

**Baseline forecast uses economic assumptions contained in Clinton administration's February budget, which assumes real GDP growth of 2.8%, 2.7%, 2.6%, 2.6% and 2.5% for 1995 through 1999, respectively*

	Change from Baseline in:*		
Year	GDP ($bil. Nom.)	Jobs (mil.)	Capital ($bil. Nom.)
1995	101.6	0.157	968.7
1996	286.7	0.539	2,697.5
1997	493.4	1.078	4,571.8
1998	687.4	1.675	6,246.0
1999	878.4	2.252	7,847.0
2000	1,022.1	2.717	8,936.6
1995-2000	3,469.7		

Figure 2

Reduction In The Cost Of Capital & The Marginal Tax Rate On Capital



- More capital and labor would yield an extra $3.5 trillion in gross domestic product between 1995 and 2000. By the year 2000, annual GDP would be $1 trillion higher than otherwise.
- This greater economic activity would boost the long-term annual growth rate by 1.8 percentage points [See Figure 5].

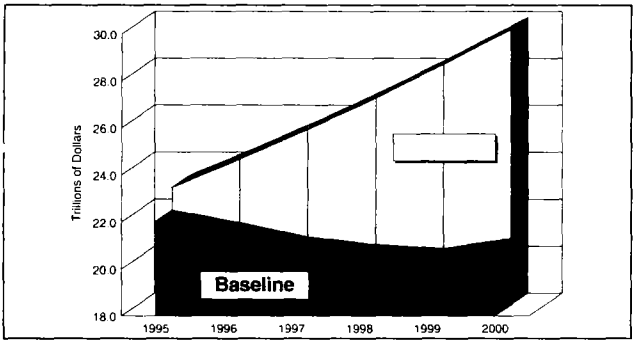


Figure 3
Increase In The Stock Of U.S. Capital

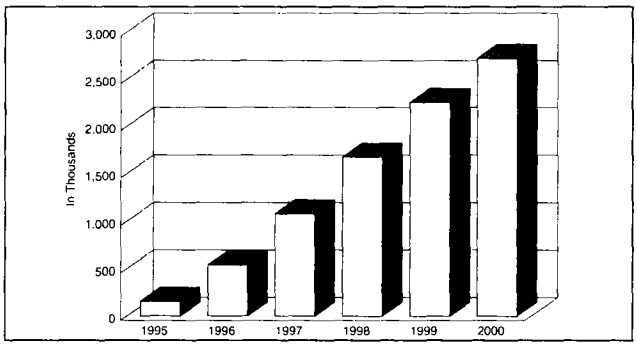


Figure 4
New Jobs From H.R. 539

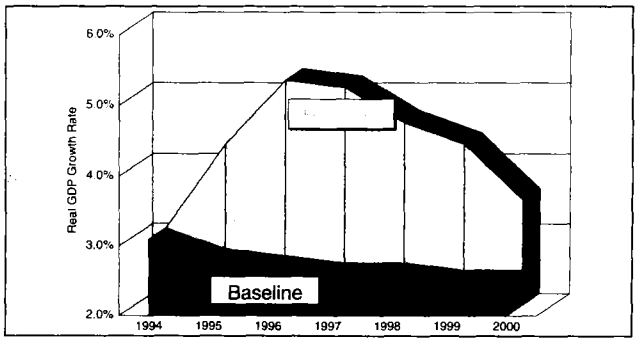


Figure 5
Added Real GDP Growth From HR 539

TaxAction Analysis

Revenue Effects from H.R. 539

Even on a static basis H.R. 539 would pick up revenue during the early years. This is because the switch from the double-declining method to 150-percent declining balance initially reduces depreciation deductions. Higher depreciation deductions in later years due to indexing adjustments start producing static revenue losses by the fifth year.

H.R. 539 would pick up $1.1 billion in federal tax revenues between 1995 and 2000.

By that time, however, added revenues from an additional two percentage points to the long-term U.S. growth path would continue to greatly outweigh any static losses. As Tables 5 and 6 show:

- Even ignoring economic growth effects, H.R. 539 would pick up $1.1 billion in federal tax revenues between 1995 and 2000.
- In addition, higher economic growth would generate an extra $596.1 billion in federal payroll, corporate and personal income, and excise taxes
- As a result, federal revenues would grow by $597.2 billion over 1995 to 2000 [See Figure 6].
- Including higher state and local revenues from added growth means government at all levels would pick up $1 trillion in additional revenue between now and the end of the decade [See Figure 7].

Table 5
Dynamic Revenue Changes
H.R. 539, Neutral Cost Recovery
($bil. nominal)

Year	Federal Soc. Sec. Tax	Federal Corporate Income Tax	Federal Personal Income Tax	Other Federal Taxes	Federal Total	State and Local	Total Government
1995	8.6	0.4	15.8	1.7	26.4	15.9	42.3
1996	24.2	1.1	23.8	4.2	53.3	36.0	89.4
1997	41.7	2.3	33.3	7.0	84.2	58.9	143.1
1998	58.1	3.8	43.6	9.6	115.2	81.1	196.3
1999	74.2	5.6	53.9	12.3	146.0	103.0	249.0
2000	86.3	7.7	62.5	14.3	170.9	120.1	291.0
1995-2000	293.1	20.9	233.0	49.0	596.1	415.0	1,011.0

Table 6
Revenue Changes
H.R. 539, Neutral Cost Recovery
($bil. nominal)

Year	Static Federal Tax Change	Dynamic Federal Tax Change	Net to Federal Government	Net to All Governments
1995	1.0	26.4	27.4	43.5
1996	7.6	53.3	60.9	98.9
1997	9.2	84.2	93.4	154.5
1998	4.4	115.2	119.6	201.8
1999	-5.6	146.0	140.4	242.0
2000	-15.4	170.9	155.5	271.8
1995-2000	1.1	596.1	597.2	1,012.5

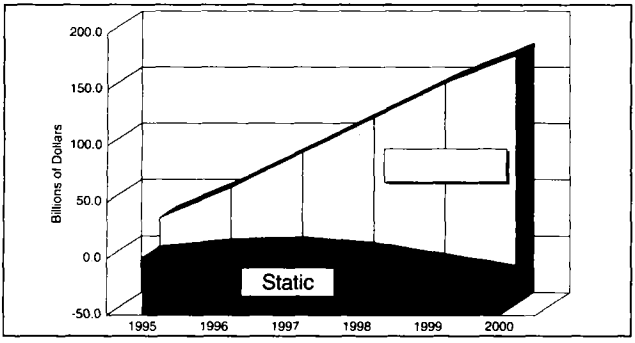


Figure 6
Static vs. Dynamic Revenue Effects from H.R. 539

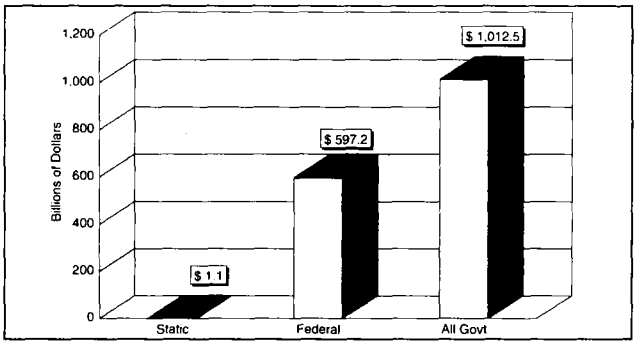


Figure 7
H.R. 539 Cumulative Revenue Effects, 1995-2000

H.R. 539 Would Benefit Workers

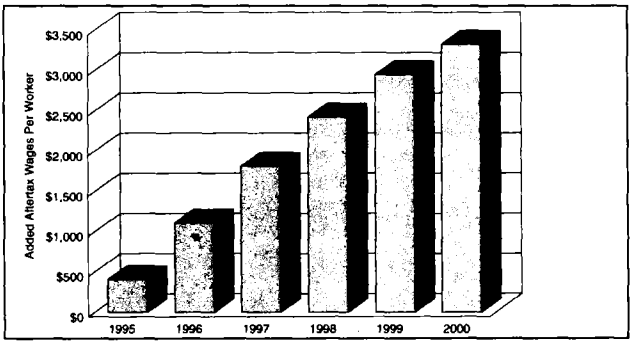
H.R. 539 would add 2.7 million jobs to the economy by the year 2000. Furthermore, the almost $9 trillion expansion in the stock of U.S. capital over the same period would raise the productivity and wages of existing workers. As Table 7 shows, that would amount to an average $4,826 more per worker in annual pretax wages and $3,332 more in take-home pay by the year 2000 [See Figure 8].

Moreover, the gains by workers would be many times more than those received by investors. As Table 8 shows, 68 percent of the $1 trillion addition to GDP in the year 2000 would translate into higher income for workers, government and investors. The bulk — 63 percent — would go to workers as higher take-home pay [See Figure 9]. Federal, state and local governments would receive 39 percent of the increase in higher revenues. Investors would actually take a 2 percent loss due to changing asset values. They would be willing to take short-term losses because they expect to recoup and make profits in the future.

Table 7
Labor Market Effects H.R. 539, Neutral Cost Recovery

Year	Percentage Change in Jobs	Change in Jobs (mil.)	Percentage Change in Aftertax Wage Rate	Change in Aftertax Wage Rate (annual)	Change in Pretax Wage Rate (annual)
1995	0.1%	0.157	1.4%	$ 408	$ 596
1996	0.5%	0.539	3.6%	1,110	1,618
1997	0.9%	1.078	5.6%	1,816	2,641
1998	1.4%	1.675	7.1%	2,425	3,521
1999	1.9%	2.252	8.2%	2,953	4,285
2000	2.3%	2.717	8.8%	3,332	4,826

Figure 8
Increase in Take Home Pay From HR 539



Year	Change in GDP	Change in Capital Consumption Allowances*	Change in National Income	Change in Aftertax Labor Compensation	Change in Government Revenue	Change in Net Aftertax Capital Income**
1995	101.6	34.8	66.8	42.6	43.5	-19.4
1996	286.7	97.6	189.0	120.5	98.9	-30.3
1997	493.4	166.6	326.8	207.9	154.5	-35.6
1998	687.4	229.2	458.3	290.0	201.8	-33.6
1999	878.4	289.8	588.7	370.8	242.0	-24.2
2000	1,022.1	332.0	690.1	432.2	271.8	-13.9
1995-2000	3,469.7	1,150.0	2,319.7	1,464.1	1,012.5	-156.9

Table 8

Composition of Net Changes in Income Flows H.R. 539, Neutral Cost Recovery ($bil. nominal)

**Replacement of capital assets that have worn out or become obsolete.*

***Can be negative because it does not account for changes in asset values. Investors may be willing to accept a*

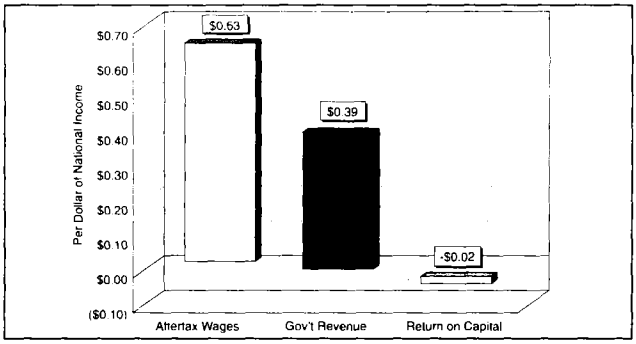


Figure 9

Gains to Labor, Government & Investors From H.R. 539

Conclusion

For policymakers interested in growing the economy and jobs, taking the tax bias out of investment decisions and raising new revenues, Neutral Cost Recovery is a winning combination.

Appendix

Classes of Recovery Property Under MACRS

The Tax Reform Act of 1986 established the Modified Accelerated Cost Recovery System (MACRS) as the basis for depreciating tangible property for tax purposes. The property's "class life" is used in determining the recovery class to which MACRS property belongs. In some cases MACRS arbitrarily assigns certain assets to a specific recovery class regardless of its class life. Property placed in service after May 1993 falls into one of the following MACRS recovery classes;

- 3-year property,
- 5-year property,
- 7-year property,
- 10-year property,
- 15-year property,
- 20-year property,
- 27.5-year residential rental property,
- 39-year nonresidential real property,
- and 50-year railroad grading or tunnel bore.

The 3-year MACRS recovery class includes depreciable personal property with a class life of 4 years or less, race horses over 2 years old when placed in service by the taxpayer and other horses over 12 years old when placed in service by the taxpayer.

The 5-year MACRS recovery class includes depreciable personal property with a class life of more than 4 years but less than 10 years. In addition, the following property is arbitrarily included in this class;

- automobiles or light-general purpose trucks,
- semi-conductor manufacturing equipment,
- computer-based telephone central office switching equipment (excluding PBX equipment),
- qualified technological equipment,
- research and experimentation property,
- equipment used to produce, distribute, or use electrical energy derived from geothermal deposit,
- certain equipment which can convert ocean thermal energy into electrical or other useful energy,
- certain equipment that converts biomass into a useful form of energy,
- and cargo containers.

The 7-year MACRS recovery class includes depreciable personal property with a class life of more than 10 years but less than 16 years and property which does not have a class life and which is not specifically assigned to any other MACRS class. Also, specifically included in this class are railroad tracks.

The 10-year MACRS recovery class includes depreciable personal property with a class life of more than 16 years but less than 20 years. Single purpose agriculture and horticultural structures and any tree or vine-bearing fruit or nuts is in the 10-year category.

The 15-year MACRS recovery class includes depreciable personal property with a class life of more than 20 years but less than 25 years. This category relates primarily to public utilities and includes municipal wastewater treatment plants and telephone distribution plants and comparable equipment used for 2-way exchange of voice and data communications. The category uses 150 percent declining balance.

The 20-year MACRS includes municipal sewers with a class life of 50 years and property with an ADR midpoint of 25 years or more. MACRS provides 150 percent declining balance over 20 years.

The 27.5-year class for business and residential buildings includes residential rental property, mobile homes, elevators, and escalators. Low-income housing falls into this category. MACRS also applies a straight line write-off.

Most nonresidential real property falls into the 39-year class. This includes most structures used by businesses.

Table 9

Current Law General Depreciation Schedules, Half-Year Convention

Year	3-Year	5-Year	7-Year	10-Year	15-Year	20-Year	27.5-Year	39-Year
1	0.3333	0.2000	0.1429	0.1000	0.0500	0.03750	0.01818	0.01282
2	0.4445	0.3200	0.2449	0.1800	0.0950	0.07219	0.03636	0.02564
3	0.1481	0.1920	0.1749	0.1440	0.0855	0.06677	0.03636	0.02564
4	0.0741	0.1152	0.1249	0.1152	0.0770	0.06177	0.03636	0.02564
5		0.1152	0.0893	0.0922	0.0693	0.05713	0.03636	0.02564
6		0.0576	0.0892	0.0737	0.0623	0.05285	0.03636	0.02564
7			0.0893	0.0655	0.0590	0.04888	0.03636	0.02564
8			0.0446	0.0655	0.0590	0.04522	0.03636	0.02564
9				0.0656	0.0591	0.04462	0.03637	0.02564
10				0.0655	0.0590	0.04461	0.03636	0.02564
11				0.0328	0.0591	0.04462	0.03637	0.02564
12					0.0590	0.04461	0.03636	0.02564
13					0.0591	0.04462	0.03637	0.02564
14					0.0590	0.04461	0.03636	0.02564
15					0.0591	0.04462	0.03637	0.02564
16					0.0295	0.04461	0.03636	0.02564
17						0.04462	0.03637	0.02564
18						0.04461	0.03636	0.02564
19						0.04462	0.03637	0.02564
20						0.04461	0.03636	0.02564
21						0.02231	0.03637	0.02564
22							0.03636	0.02564
23							0.03637	0.02564
24							0.03636	0.02564
25							0.03637	0.02564
26							0.03636	0.02564
27							0.03637	0.02564
28							0.03636	0.02564
29								0.02564
30								0.02564
31								0.02564
32								0.02564
33								0.02564
34								0.02564
35								0.02564
36								0.02564
37								0.02564
38								0.02564
39								0.02564
40								0.01282

Table 10

Proposed Basic 150% Declining Balance Before Adjustment

Year	3-Year	5-Year	7-Year	10-Year	15-Year	20-Year	27.5-Year	39-Year
1	0.2500	0.1500	0.1071	0.0750	0.0500	0.03750	0.02727	0.01923
2	0.3750	0.2550	0.1913	0.1388	0.0950	0.07219	0.05306	0.03772
3	0.2500	0.1785	0.1503	0.1179	0.0855	0.06677	0.05016	0.03627
4	0.1250	0.1666	0.1225	0.1002	0.0770	0.06177	0.04743	0.03488
5		0.1666	0.1225	0.0874	0.0693	0.05713	0.04484	0.03353
6		0.0833	0.1225	0.0874	0.0623	0.05285	0.04239	0.03225
7			0.1225	0.0874	0.0590	0.04888	0.04008	0.03100
8			0.0613	0.0874	0.0590	0.04522	0.03790	0.02981
9				0.0874	0.0591	0.04462	0.03583	0.02867
10				0.0874	0.0590	0.04461	0.03387	0.02756
11				0.0437	0.0591	0.04462	0.03262	0.02650
12					0.0590	0.04461	0.03262	0.02548
13					0.0591	0.04462	0.03262	0.02450
14					0.0590	0.04461	0.03262	0.02356
15					0.0591	0.04462	0.03262	0.02310
16					0.0295	0.04461	0.03262	0.02310
17						0.04462	0.03262	0.02310
18						0.04461	0.03262	0.02310
19						0.04462	0.03262	0.02310
20						0.04461	0.03262	0.02310
21						0.02231	0.03262	0.02310
22							0.03262	0.02310
23							0.03262	0.02310
24							0.03262	0.02310
25							0.03262	0.02310
26							0.03262	0.02310
27							0.03262	0.02310
28							0.03263	0.02310
29								0.02310
30								0.02310
31								0.02310
32								0.02310
33								0.02310
34								0.02310
35								0.02310
36								0.02310
37								0.02310
38								0.02310
39								0.02310
40								0.01154

Table 11

Neutral Cost Recovery (H.R. 539) With Constant 3% Inflation

Year	3-Year	5-Year	7-Year	10-Year	15-Year	20-Year	27.5-Year	39-Year
1	0.2500	0.1500	0.1071	0.0750	0.0500	0.0375	0.0273	0.0192
2	0.3998	0.2718	0.2039	0.1480	0.1013	0.0770	0.0566	0.0402
3	0.2841	0.2029	0.1708	0.1340	0.0972	0.0759	0.0570	0.0412
4	0.1514	0.2018	0.1484	0.1214	0.0933	0.0748	0.0575	0.0423
5		0.2152	0.1582	0.1129	0.0895	0.0738	0.0579	0.0433
6		0.1147	0.1687	0.1203	0.0858	0.0728	0.0584	0.0444
7			0.1798	0.1283	0.0866	0.0717	0.0588	0.0455
8			0.0959	0.1368	0.0923	0.0708	0.0593	0.0466
9				0.1458	0.0986	0.0744	0.0598	0.0478
10				0.1554	0.1049	0.0793	0.0602	0.0490
11				0.0828	0.1120	0.0846	0.0618	0.0502
12					0.1192	0.0902	0.0659	0.0515
13					0.1273	0.0961	0.0703	0.0528
14					0.1355	0.1025	0.0749	0.0541
15					0.1447	0.1092	0.0799	0.0566
16					0.0770	0.1164	0.0851	0.0603
17						0.1242	0.0908	0.0643
18						0.1323	0.0968	0.0685
19						0.1411	0.1032	0.0730
20						0.1504	0.1100	0.0779
21						0.0802	0.1172	0.0830
22							0.1250	0.0885
23							0.1332	0.0943
24							0.1420	0.1006
25							0.1514	0.1072
26							0.1614	0.1143
27							0.1721	0.1219
28							0.1835	0.1299
29								0.1385
30								0.1476
31								0.1574
32								0.1678
33								0.1789
34								0.1907
35								0.2033
36								0.2167
37								0.2310
38								0.2463
39								0.2625
40								0.1398

Methodology

The Fiscal Associates Model explicitly incorporates detailed information on tax policy and how it affects the economy, capital investment, output and jobs. Taxes on labor income consist of personal income taxes, payroll taxes and labor's share of indirect business taxes, such as sales and excise taxes. Taxes on capital consist of those levied on assets directly, on the output produced by assets and on the return accruing to owners. The tax treatment for the 20 capital classifications in the Fiscal Associates Tax Model is the average of 5,000 specific assets, weighted by their capital stocks.

We use the service price to measure the cost of capital. The service price of capital relates the components of the investment decision to the supply price of capital. First popularized by Harvard professor Dale Jorgenson, it is based on a multi-period representation of the income and expenses associated with an investment. The expenses associated with an investment are economic depreciation, taxes and the aftertax real rate of return that must be paid to investors.

About the Authors

Gary Robbins is President of Fiscal Associates, a Washington D.C.-based economic consulting firm, and Senior Research Associate of TaxAction Analysis. Mr. Robbins has developed a general equilibrium model of the U.S. economy that specifically incorporates the effects of taxes and government spending. He was Chief of the Applied Econometrics Staff at the U.S. Treasury Department from 1981 to 1982, and Assistant to the Director of the Office of Tax Analysis from 1976 to 1981. Recent publications include IPI Policy Report #124: *Putting Capital Back to Work for America*, and IPI Policy Report #111: *Playing Politics with Government Forecasts*. Mr. Robbins' articles and analysis frequently appear in the financial press. He received his master's degree in Economics from Southern Methodist University.

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About TaxAction Analysis

TaxAction Analysis is the tax policy arm of the Institute for Policy Innovation, a non-profit, non-partisan public policy organization. TaxAction Analysis recognizes that changing tax policy affects incentives to work, save, and invest. These changes in economic behavior are frequently ignored in static government forecasts, resulting in policy decisions that negatively affect economic growth, capital formation, employment, and local, state, and federal revenues. TaxAction Analysis publishes **Economic Scorecard**, a quarterly newsletter, as well as additional commentary on tax policy.

Nothing written here should be construed as necessarily reflecting the views of the Institute for Policy Innovation, or as an attempt to aid or hinder the passage of any bill before Congress.

Chairman ARCHER. Thank you, Mr. Smith. We appreciate your testimony this morning.

Mr. Gibbons.

Mr. GIBBONS. I don't really have a question for you, Mr. Smith. I just want to call to the committee's attention that the Chairman of the Federal Reserve has warned us that we better be careful about what we do, that to the extent that we throw more purchasing power in the hands of the consumer right now, at this particular moment, we are flirting seriously with inflation.

The Chairman of the Federal Reserve testified yesterday, as you know, Mr. Smith, before the Senate and said that we face imminent inflation, that we are at maximum capacity utilization of our farms and factories, we are at full employment on the employment side, that the prices of raw materials are beginning to rocket, go up very fast, and that he has received word that suppliers are planning to increase prices.

It would seem to me that we must be extremely cautious here in this committee and in this Congress about what we do about stimulating that inflation. It would seem to me that the best economic policy we could follow at this time would be to calm down the inflationary trend that we are just entering, and not to throw more purchasing power out there to further inflame the market.

All these tax ideas are wonderful, but I think we have a greater responsibility, and that is to make sure that inflation doesn't get loose in this land again. Now, you can say, oh, you can control that by interest rates. Yeah, interest rate control of inflation works real well for the Republican constituencies, but it works terribly on the Democratic controlled constituency. Democrats are people who borrow money to buy their home and buy their car, and I guess some of them unfortunately even use their credit cards for those things, and Republicans by and large mainly, as I observe them, are people who lend the money, and they have gotten a 30 percent return on their interest rates in the last year.

How much further are we going to go? It seems to me that when you kick off a round of inflation and you control it with interest rates, the people who get screwed are the Democrats and the people who make all the money are the Republicans, and maybe that is a little partisan, but just stop and think about it. Most Democrats are not in the money lending business; most of the moneylenders in my community in the Nation are Republicans, and so they love to control inflation by increasing interest rates, and they take it out of the hide of our Democratic constituency. So I think we are really talking about the wrong subject here today.

Mr. SMITH OF MICHIGAN. Mr. Gibbons, I agree with a great deal of what you say, but one solution probably is to have less Federal Government spending out there driving up the prices of what consumers would otherwise——

Mr. GIBBONS. If we can't pay off this deficit at a time of full employment and full utilization of industrial capacity, that should be our primary goal, not tinkering around the edges of this thing trying to figure out more ways of putting more money in the hands of consumers. That is what most of this tax reduction is all about.

Chairman ARCHER. Mr. Crane.

Mr. CRANE. I congratulate my colleague from Michigan on his testimony. Having had the privilege of visiting with him at his home in the past, and knowing the success he had before coming to Congress in the real world, I salute him for his efforts to try and stimulate investment in plant and equipment with a view to increasing productivity and creating more jobs.

I was intrigued by the testimony of our colleague, Mr. Gibbons, about the difference between Republicans and Democrats. The thing that intrigues me is I think on his side of the aisle they do like to spend, there is no question about that, and they have done it to the point that we are faced with a looming prospect shortly after the turn of the century of a national debt totaling $7 trillion. The fact of the matter is, that money is productively spent only when it is left in the private sector.

Second, the interest rates and so forth that we are going to have to pay to try and keep financing and rolling over that debt are calculated, I think, to destroy the world's last best hope. It is the private sector that provides the resources, and frankly I believed for years that businesses shouldn't be taxed at all because they don't pay taxes. Taxes are a cost of doing business and they have got to be passed on to you and me as consumers with a fair return on investment or you are out of business. So anything that lightens the load for those people engaged in producing goods and services for the benefit of one and all, I applaud, and I salute my colleague again for his initiative here. Keep up the good fight.

Chairman ARCHER. May I ask the members of the committee who wish to inquire to raise their hands. OK.

Mr. Bunning.

Mr. BUNNING. Thank you, Mr. Chairman. I, too, congratulate my colleague, Nick Smith from Michigan, for his constructive ideas on how to make our private sector more productive.

I would like to take just a minute to comment about my good friend, Sam Gibbons', remarks. For 40 years this Federal Government has spent and spent out of control, and if there is any reason to look any further than that, you can look right in this very room, from our predecessors who sat at this very table, and established the tax policies of this government to raise the money to spend ourselves into a $5 trillion national debt.

I can't believe after 40 years of one party rule in the House that now we are trying to get a handle on the Federal deficit. For the first time in my career in the House, it is very short, it is only in its fifth term, we are now, without a discharge petition, openly debating a balanced budget amendment to the Constitution on the floor of the House of Representatives without forcing it out onto the floor and having a balanced budget amendment actually have a chance to pass. We need that kind of fiscal discipline that has not been here for 40 years, and I congratulate you, Nick, because this is one of the ideas that can make our private sector more productive; it can make job creation a lot easier. We will have more people participate and have the Federal Government out of the business of trying to provide and stimulate the economy. It is the private sector's job to do that and not the Federal Government's job; and, I congratulate you on your ideas. I will be very supportive of them

when we talk about them and bring them to a vote in this committee.

Thank you.

Mr. SMITH OF MICHIGAN. Thank you.

Chairman ARCHER. Mr. Levin.

Mr. LEVIN. I wanted to welcome my colleague from Michigan, and I admire your tenacity. You did give me a copy of Dr. Greenspan's testimony on how we estimate these proposals, and I read his later comments as you gave them to me, but I also went back and looked at his earlier testimony, and I simply wanted to say I am sorry Mr. Bunning has left, that I hope we will take his warning, Dr. Greenspan and others, seriously.

I think Mr. Bunning's comments rewrite or try to rewrite history. The 1981 act was not the act of a partisan, a Democratic government. It was an initiative of a Republican President, and I simply want us not to make the same mistakes in the nineties that I think were made on a bipartisan basis in the early eighties, and we will make those mistakes if we ignore warnings about what revenue proposals will cost.

I mean, the Treasury Department estimates that over 10 years your proposal would cost $120 billion at a time when we have a debt that is approximating or coming closer and closer to $5 trillion, and I don't think we can go through a process that imagines away the problem of the debt and the deficit and says let's put on rose colored glasses and assume that these proposals will make money instead of losing, will diminish the deficit instead of increasing it, so I very much again respect your tenacity.

I think the problems of economic growth are very, very serious ones. I favor proposals that stimulate economic growth. As I said yesterday, the issue is not just that of distribution of the tax burden, there are issues of growth. But under the banner of economic growth, we are going to make a serious mistake if we adopt proposals that lead to an increase in the national debt and burgeoning deficits. So I don't know if you want to respond to that, but at some point you and everybody else are going to have to wrestle with estimates that your proposal will dig our hole deeper. And that I think was the basic note sounded by Dr. Greenspan, by Paul Volcker, and virtually everybody else who testified before the Budget Committee that day.

Mr. SMITH OF MICHIGAN. Mr. Chairman, if I may briefly respond, it seems to me there are two questions. One is, do businesses react based on the way we structure our Tax Code? I think the answer is absolutely yes. Businesses often operate to minimize the negative effect of taxes rather than to maximize their efficiency and productivity.

The second question is on cost, and it is a serious question. I'd like to suggest you look at this analysis of the bill by Gary and Aldona Robbins which predicts a dramatic increase in economic activity that will go to $3 trillion by the year 2000, increase the number of jobs for workers by 3 million and increase take-home pay by $3,500.

If only a very small fraction of this actually happens, if we were only to have two-tenths of 1 percent growth in the economy because of this kind of change that stimulates business to invest in prop-

erty, it would more than pay the $121 billion cost estimated by Treasury.

Mr. LEVIN. But just remember we heard that song before in the early eighties, and it turned out to have a lot of sour notes, and I just urge that we learn from the past.

Thank you very much.

Chairman ARCHER. I will announce to the members that I have on my list for inquiry Mr. Zimmer and Mr. Cardin, and at that point, we will move on to our next panel.

Mr. Zimmer.

Mr. ZIMMER. Thank you, Mr. Chairman. I want to commend Mr. Smith for getting this proposal included in the Contract With America. I think it focuses on a very important deficiency in the current Tax Code, but I would like to ask you a specific question.

Is there any reason, Congressman Smith, why you included this fairly complex writeoff system—neutral cost recovery—rather than do what your State of Michigan has done, which is to provide 100 percent expensing immediately, except for the scoring impact?

Mr. SMITH OF MICHIGAN. No reason.

Mr. ZIMMER. So essentially you want to get us as close as you could to 100 percent expensing without knocking the revenue estimates——

Mr. SMITH OF MICHIGAN. Mr. Zimmer, the other partial reason is to allow some flexibility with some companies that would like the option of spreading out some of that cost over several years so beginning companies and startup companies that don't have the revenue to be offset by a first-year depreciation, could take the deduction in later years.

Mr. ZIMMER. In the longest run, beyond 5 or 10 years or any arbitrary cutoff date, do you see the economic impact of your proposal being substantially different from the impact of 100 percent expensing in terms of the impact on economic growth and in terms of the impact on revenues through the dynamic process?

Mr. SMITH OF MICHIGAN. Certainly it would be a greater advantage, and a greater stimulant to expand production in the economy if we did have expensing with some flexibility to spread it out over several years for those companies with low income.

Mr. ZIMMER. Do you have any idea whether using a static model with a very long horizon, a time horizon, the 100 percent expensing would come out essentially the same as the neutral cost recovery?

Mr. SMITH OF MICHIGAN. No, I don't, but Dale Jorgenson, who is going to follow me, and Ernest Christian, Stephen Entin, Thomas Usher, and Andrew Sigler could be more definitive in answering that. If you spread out the static model and said here is what this legislation is going to cost, it would cost more if you spread it out far enough. The static model might even say it is going to cost more than the whole Nation is worth collectively.

The problem is that a static model doesn't take into consideration that a business changes its actions based on tax policy. That's why we should look at our depreciation schedules. We are behind the curve compared with what other countries are doing to their businesses, so I would be delighted if we could go to more expensing.

Mr. ZIMMER. I appreciate your candor on that. I think we shouldn't twist ourselves up in knots simply to fit ourselves into

some kind of preconceived formalistic context that has been set up by the budget process if we in the long run don't achieve any benefit to the taxpayer or the economy by doing so.

Thank you very much.

Mr. SMITH OF MICHIGAN. Thank you.

Chairman ARCHER. Mr. Cardin.

Mr. CARDIN. Thank you, Mr. Chairman. Mr. Smith, thank you for your testimony. I think you have identified a real problem. I just disagree with your solution to the problem.

Depreciation has presented problems for businesses, and I have had many who have come to visit me to talk about concerns that they have, not one supporting the neutral cost recovery, but many suggesting that the AMT problems are the most important issues that we need to deal with.

I will be filing legislation that will use the regular tax recovery periods for AMT for I think that is a better approach than the neutral cost recovery at this time. I am just curious as to your views on the AMT problems as they relate to depreciation and whether you would recommend that we look at that also.

Mr. SMITH OF MICHIGAN. I would ask where we would get the biggest bang for our buck. The manufacturers, the businesses that I have talked to that are somewhat wary of neutral cost recovery, their real concern is this Congress might change the rules midstream, but if we——

Mr. CARDIN. Which I would suggest has happened before, and if in fact Treasury's revenue estimates of $120 billion were to become reality, I think it is likely that Congress would change the rules some time within the next 10 years.

Mr. SMITH OF MICHIGAN. We have never in history, to my knowledge, changed the rules of a depreciation schedule midstream. Once you start on a depreciation schedule, you have always been allowed to follow that schedule.

Mr. CARDIN. We could change rates.

Mr. SMITH OF MICHIGAN. That is certainly a possibility. Let me just briefly reflect on the AMT. Businesses I have talked to feel that we should just reduce tax rates and make it easier for us to stay in business.

It seems to me that if we want to get the biggest bang for our buck, we need to design a tax system that is going to have the kind of results that are going to be good for the American economy. If you agree that encouraging the purchase of new tools, equipment, and facilities is good for the economy and for ultimate productivity, then it seems to me that that is where we want to direct our stimulus. We need to reward what we want to encourage.

Mr. CARDIN. And I applaud you for that. The individuals who will make those judgments, though, are the businesses and the people who run the businesses, and it is just interesting to me that the people that I have talked to in the business community have told me that they would rather us deal with AMT than with the proposal that you have brought forward.

They are the individuals who are going to have to have the confidence to go out there and risk their dollars to buy the investments that we are talking about.

Shouldn't we be listening to what they think is best?

Mr. SMITH OF MICHIGAN. Yes, that's what we're doing. The U.S. Chamber of Commerce, NFIB, and the National Business Owners Association have all endorsed this. I would suspect the majority of the businesses that are members have endorsed this because they think it is important. They don't like being put at a competitive disadvantage with businesses in other countries, but it is certainly something to explore with the business community as they testify.

Mr. CARDIN. Thank you. Thank you, Mr. Chairman.

Chairman ARCHER. Thank you, Mr. Smith.

Mr. SMITH OF MICHIGAN. Mr. Chairman, members, thank you for your consideration.

Chairman ARCHER. If we could ask our next panel to be seated at the witness table.

A general and very warm welcome to each one of you. We are interested in hearing your views primarily on the neutral cost recovery provisions that are in the Contract With America, and our first witness will be Dr. Jorgenson, or Professor Jorgenson, with the Department of Economics at Harvard University.

Mr. Jorgenson, you may proceed. Maybe I should reiterate again for the benefit of all of you that under the rules of the committee, we will ask you to limit your verbal presentation to 5 minutes or less. The lights that are in the center of the witness table will be green, yellow, and red. When the red light comes on, the 5 minutes is up.

I am not going to cut any of you off in the middle of your sentences, but we would appreciate your cooperation. If you have a longer statement in writing, it will be put in the record in its entirety, without objection.

Mr. Jorgenson, you may proceed.

STATEMENT OF DALE W. JORGENSON, FREDERIC EATON ABBE PROFESSOR, DEPARTMENT OF ECONOMICS, HARVARD UNIVERSITY; AND DIRECTOR OF PROGRAM ON TECHNOLOGY AND ECONOMIC POLICY, KENNEDY SCHOOL OF GOVERNMENT

Mr. JORGENSON. Mr. Chairman, ladies and gentlemen of the committee, it is a very great privilege for me to testify before you today on the neutral cost recovery system that you have just heard about from Congressman Smith.

I would like to begin with a summary of my conclusions. As the Chairman just suggested, I am going to avail myself of the opportunity to submit a written version of the testimony that will provide support for these conclusions.

Today we have heard a great deal of discussion of the matter of the Federal deficit, and I think that is a very relevant consideration, but I would like to submit to this committee that the problem of closing the gap between revenues and expenditures is not due to political gridlock and it is not due to ineptitude. It is due to slow economic growth.

If you look at each of the measures that have been adopted by this Congress, and we have had the tax reform decade of the eighties, just past, each one of those provisions was accompanied by forecasts of the type that the Treasury has brought forward and has been the subject of remarks at this hearing.

In every case the economic growth of this economy was inadequate to produce the revenues that were projected, and therefore it is very important for us to focus on the cause of our fiscal problems, namely deficient economic growth. Tax policy, which is of course the major concern of this committee, is the critical instrument for stimulating U.S. economic growth. That is something I think all of us can agree on.

Investment is the most important source of economic growth. Therefore to deal with the core problem that we confront, which is the deficiency in economic growth, we need to focus in future tax reform on measures that are going to strengthen rather than weaken the growth of this economy.

In testimony that I presented to this committee 2 years ago, I supported the position that the Tax Reform Act of 1986, the most recent major tax reform to come out of this Congress, had a very substantial positive impact on U.S. economic growth. That was the result of eliminating a large number of special tax provisions for specific types of assets, resulting in much greater neutrality in the treatment of different kinds of capital income.

As a result, the efficiency of capital allocation within our economy has improved and new opportunities for growth have been created. The benefits of the 1986 Tax Act have steadily increased as the rate of inflation has declined, and I currently estimate these benefits to be in the order of magnitude of $1.25 trillion.

In other words, the benefits are roughly the same order of magnitude as the Federal budget is projected to be by the end of this century.

I would now like to turn to the neutral cost recovery system, which is the subject of these hearings. As Congressman Smith has told you and Mr. Zimmer has emphasized, the neutral cost recovery system is equivalent from the taxpayers' point of view to expensing—immediate expensing of investment expenditures. Therefore, it would further enhance the neutrality of capital income taxation that was substantially advanced in the 1986 Tax Reform Act.

However, to be important as a stimulus to economic growth, it is very important to combine this tax reform with an elimination of deductions such as the deductions to taxpayers who choose to finance investment through debt rather than equity. Otherwise, the Treasury would be put into the position of subsidizing investments by taxpayers.

Therefore I conclude that the way that this committee should look at the neutral cost recovery system is that it is an important element in the transition to a system of taxation which is based on consumption rather than on income, and within that context, it seems to me that it is a proposal that is based on well-tested economic ideas and can serve as an appropriate starting point for the development of tax reform legislation.

Thank you, Mr. Chairman.

[The prepared statement follows:]

CAPITAL COST RECOVERY AND THE AGENDA FOR U.S. TAX REFORM

by

Dale W. Jorgenson

1. *Introduction.*

My name is Dale W. Jorgenson. I am Frederic Eaton Abbe Professor of Economics at Harvard University and Director of Program on Technology and Economic Policy at the Kennedy School of Government. I have written extensively on the topic of capital income taxation, most recently in my Brookings Institution volume, edited with Ralph Landau, TAX REFORM AND THE COST OF CAPITAL: AN INTERNATIONAL COMPARISON, published a little over one year ago. It is a privilege for me to testify to the Committee on Ways and Means today on neutral cost recovery. I will begin by summarizing my conclusions:

Slow economic growth, rather than political gridlock or ineptitude, underlies that failure of attempts by successive Administrations and the Congress to tame the federal deficit. Tax policy for saving and investment is the critical instrument for stimulating U.S. economic growth, since investment is the most important source of growth. To revive our lagging growth rate, future tax reform should focus on strengthening rather than weakening the thrust of the Tax Reform Act of 1986.

The federal tax system imposes a very substantial loss in opportunities for growth on the U.S. economy, but this burden was considerably reduced by the 1986 Tax Act. By eliminating a number of special tax provisions for specific types of assets this landmark legislation resulted in much greater neutrality in the taxation of income from capital. This has substantially increased the efficiency of capital allocation within our economy and created new opportunities of economic growth. The benefits of the 1986 Tax Act have steadily increased as the rate of inflation has declined.

The Neutral Cost Recovery Act of 1995 would provide deductions for depreciation that would further enhance neutrality in capital income taxation. These deductions would be based on the recovery of capital cost over the lifetime of an asset, as under current tax law. However, the deductions would be increased annually to compensate for inflation and allow for a return on capital of three and a half percent per year. From the point of view of the taxpayer these depreciation deductions would be equivalent to an immediate write-off of capital cost or "expensing" of capital expenditures.

In a 1977 study, *Blueprints for Tax Reform*, the U.S. Treasury proposed two alternative approaches to shifting the federal tax base from income to consumption. The first of these is a value added tax, like that employed in Europe and Japan. The second would eliminate investment from the tax base by permitting taxpayers to treat investment expenditures as a business expense. Since investment would be excluded from the tax base, all other deductions from capital income, such as deductions for interest expenses, would also be eliminated.

The Neutral Cost Recovery Act of 1995, like the Treasury proposal of 1977, would eliminate investment from the tax base. To shift the tax base from income to consumption it is essential to eliminate all other deductions from capital income at the same time, including the deduction for interest expenses. Otherwise, the U.S. Treasury would be put in the position of providing subsidies in the form of tax deductions to taxpayers who choose to finance investment through debt rather than equity.

The neutral cost recovery depreciation adjustment should be regarded as one component of a tax system based on consumption rather than income. Shifting the federal tax base from income to consumption would create very important new opportunities for U.S. economic growth. I estimate that the benefits would amount to two trillion dollars. This is the present value of the increase in the future standard of living of U.S. taxpayers that would result from a shift from income to consumption as a base for the federal tax system.

The traditional objection to a consumption tax is that it would be regressive rather than progressive, falling disproportionately on low income taxpayers. Two alternative proposals have been developed for overcoming this objection. the Nunn-Domenici "consumed income" tax proposal and the Armey "flat tax" plan. Under these proposals a system of exemptions for individual taxpayers would be introduced to provide the requisite degree of progressivity in the federal tax system. These proposals are based on well-tested economic ideas and can serve as an appropriate starting point for the development of tax reform legislation.

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2. *The 1986 Tax Reform*

As the tax policy debate revives, it is essential to concentrate on fundamental issues. My paper deals with two of them: First, what did we achieve and fail to achieve with the Tax Reform Act of 1986? Second, how can we create new opportunities for future U.S. economic growth through tax reform? I can summarize my main conclusions succinctly: The U.S. tax system imposes a very substantial loss in efficiency on the economy, but this burden was considerably reduced by the Tax Reform Act of 1986. The benefits of this landmark legislation has steadily increased as the rate of inflation has declined.

My second conclusion is that tax burdens still differ substantially among alternative tax programs, so that very significant opportunities for U.S. economic growth can be created through tax reform. One approach to tax reform would "level the playing field" between business assets and owner-occupied housing by sharply curtailing the tax benefits to housing provided through deductions for mortgage interest and state and local property taxes. A second approach to tax reform would shift the federal tax base from income to consumption by excluding investment from the tax base. Both approaches would substantially enhance the growth of our future standard of living.

I will support my conclusions by first reviewing the achievements of the 1986 tax reform. The economic impact of the 1986 reform was positive and substantial at rates of inflation like those prevailing before the current economic downturn. As the rate of inflation declines toward zero, the benefits grow to the equivalent of more than a whole year of federal spending. This was a major contribution to the future growth of the U.S. economy. However, the 1986 Tax Act did not go far enough in broadening the tax base and eliminating tax preferences. The goal of tax reform should be once again to reduce marginal tax rates at the individual level below thirty percent.

I have presented supporting evidence for my findings about the effect of inflation on the economic impact of tax policy in Table 1, which is taken from my 1990 paper with Kun-Young Yun, published in the *Journal of Political Economy*. In this table we compare the 1986 Tax Act with the pre-existing 1985 Tax Law and two tax reform proposals advanced by the Treasury and the President. Each of these two proposals involved indexing the tax structure for inflation. Table 1 presents estimates of the growth opportunities created or destroyed by inflation and the alternative tax reform packages; all estimates are in billions of 1987 dollars. The benchmark for the comparison is the 1985 Tax Law at a six percent inflation rate.

Let me try to be precise in defining the meaning of the term "growth opportunities". From the economic perspective the objective of government policy, including tax policy, is to enhance the standard of living of U.S. consumers now and in the future. The concept of growth opportunities is a summary of increases in our future standard of living that result from tax policy. This summary measure is simply the present value of these increases in the standard of living to U.S. households. It represents the willingness of the present generation of taxpayers to pay for a change in tax policy that will affect their own standard of living and that of future generations of taxpayers.

As a benchmark for comparison of alternative tax policies, we require that all changes in tax policy are revenue neutral, that is, revenue and expenditure of the government are the same. We adjust tax revenues to maintain the budgetary position of the government sector by means of a purely hypothetical "lump-sum" tax. We consider three alternative methods for adjusting government revenues that involve changes in tax induced distortions. These involve proportional changes in taxes on labor income, sales taxes on investment and consumption goods, and taxes on income from both capital and labor.

Turning to the impact of the 1986 Tax Act, we see that the 1986 tax reform with inflation at the benchmark rate of six percent produces a sizable gain in opportunities for future economic growth. For the distorting revenue adjustments, these gains range from $746.9 billion 1987 dollars to $999.4 billions, or nearly a trillion dollars, equivalent to almost a year's federal spending. The Tax Reform Act of 1986 obviously generated very substantial growth

Table 1.
Growth Opportunities Created by the 1986 Tax Reform
(Billions of 1987 Dollars)

Rate of Inflation	Revenue Adjustment	1985 Tax Law	Treasury Proposal	President's Proposal	1986 Tax Act
0%	Lump Sum Tax	724.0	1489.6	1691.4	1561.8
	Labor Income Tax	478.2	1468.8	1642.4	1565.0
	Sales Tax	400.3	1452.9	1614.6	1558.7
	Individual Income Tax	374.5	1456.1	1619.1	1563.1
6%	Lump Sum Tax	0.0	1907.6	2452.2	448.4
	Labor Income Tax	0.0	1711.4	2170.4	746.9
	Sales Tax	0.0	1600.1	2104.9	901.2
	Individual Income Tax	0.0	1595.8	2007.9	999.4
10%	Lump Sum Tax	-477.1	2060.4	3015.6	-200.8
	Labor Income Tax	-333.7	1791.6	2584.7	267.3
	Sales Tax	-285.2	1623.5	2356.4	517.0
	Individual Income Tax	-221.9	1604.8	2353.1	748.6

Note: In 1987, the national wealth (beginning of the year) was $15,920.2 billion dollars.

opportunities for the U.S. economy. Tax policy makers should recognize the 1986 reform as a giant step in the right direction.

If we compare the Treasury and President's proposals with the 1986 Tax Act at a six percent inflation rate, we find that these proposals would have produced much greater gains in growth opportunities -- more than double those of the 1986 Tax Act for the President's proposal and better than fifty percent more for the Treasury proposal. The obvious question is, why? Fortunately, this complex question has a simple answer: indexing! At a zero inflation rate the two proposals and the actual 1986 tax legislation would have had very similar economic impacts, resulting in gains in growth opportunities of one and a half trillions.

The purpose of the exercises that I have just described is to compare actual tax reform proposals with the Tax Reform Act of 1986. The current tax structure retains many of the features that resulted from the 1986 reform. While the economic impact of the 1986 tax reform was positive and sizable, it is important to underline the conclusion that growth opportunities created by the reform expand considerably as the inflation rate declines. This is due to the fact that provisions for capital income taxation were not indexed for inflation.

I have provided further perspective on the 1986 tax reform in Table 2, giving the economic impact of hypothetical tax reforms that could have been adopted in 1986. Yun and I have considered eight alternatives, using the 1985 Tax Law with a six percent inflation rate as our benchmark. These hypothetical reforms focus on tax distortions induced by differences in the tax treatment of income from corporate, noncorporate, and household sectors, and short-lived and long-lived assets. In the parlance of the 1986 tax debate, these are different ways of "leveling the playing field". As before, we maintain the level of government spending and revenues and adjust tax rates to preserve the balance.

The first hypothetical reform eliminates distortions among assets, but leaves distortions among sectors unaffected. The second removes distortions between corporate and noncorporate business, but does not alter other distortions, while the third extends this treatment to the household sector. The fourth "levels the playing field" among assets in corporate and noncorporate sectors, while the fifth extends this treatment to the household sector as well. The sixth reduces taxation on corporate assets to those of noncorporate assets by "corporate tax integration", as proposed by the Treasury's 1992 report, *Taxing Business Income Once*.

I would like to focus attention on the seventh tax reform proposal presented in Table 2. This is the consumption tax scheme proposed in the Treasury's 1977 *Blueprints for Tax Reform* and now embodied in the Nunn-Domenici "consumed income" tax proposal. Under these proposals the tax base for the federal tax system would be shifted from income to consumption by excluding investment from the tax base. The eighth is a more thorough-going version of this scheme that eliminates sales taxes on investment goods. Either of these two tax reform proposals would create very substantial future growth opportunities for the U.S. economy.

The introduction of consumption tax rules for recovery of the cost of investment expenditures would have doubled the gains in U.S. economic growth that resulted from the 1986 Tax Act. This is the consequence of "leveling the playing field" among all economic sectors -- households, noncorporate businesses, and corporations. At the same time income from all different types of assets -- plant, equipment, inventories, and land -- would be treated symmetrically under the tax law. The tax treatment of income from all the assets employed in the U.S. economy would be completely neutral under a consumption tax, like that embodied in *Blueprints* or the Nunn-Domenici proposal.

The Neutral Cost Recovery Act of 1995 embodies one important component of consumption tax rules, namely, the exclusion of investment from the tax base. However, to achieve the same effect as a full-blown consumption tax, this proposal would have to be combined with other tax reforms, including the exclusion of interest expenses as a deduction from business income. Otherwise, the elimination of investment from the tax base combined with deductions for interest expenses would produce subsidies for taxpayers would choose to finance investments through debt rather than equity.

An important advantage of consumption tax rules is that income from capital employed in the household sector, such as owner-occupied residual housing, would be treated symmetrically with income from capital employed by corporate and noncorporate businesses. An alternative approach to neutral treatment of all forms of capital income would be to try to include income from owner- occupied residential housing in the federal tax base. However, this would require such politically unpalatable measures as reducing or totally eliminating such popular tax deductions as the home mortgage interest deduction or deductions for state and local property taxes on owner-occupied residential property.

Table 2.
Growth Opportunities Created by "Leveling the Playing Field"
(Billions of 1987 dollars)

	1985 Law
1. Within Sector Interasset Distortion	
Lump Sum Tax Adjustment	445.9
Labor Income Tax Adjustment	248.1
Sales Tax Adjustment	168.7
Individual Income Tax Adjustment	70.2
2. Intersector Distortion: C and NC Sectors	
Lump Sum Tax Adjustment	-93.3
Labor Income Tax Adjustment	-416.7
Sales Tax Adjustment	-523.8
Individual Income Tax Adjustment	-715.5
3. Intersector Distortion: All Sectors	
Lump Sum Tax Adjustment	2262.6
Labor Income Tax Adjustment	2156.9
Sales Tax Adjustment	2118.6
Individual Income Tax Adjustment	2067.
4. No Tax Distortion: C and NC Sectors, All Assets	
Lump Sum Tax Adjustment	326.4
Labor Income Tax Adjustment	69.7
Sales Tax Adjustment	-29.1
Individual Income Tax Adjustment	-162.7
5. No Tax Distortion: All Sectors, All Assets	
Lump Sum Tax Adjustment	2663.7
Labor Income Tax Adjustment	2603.9
Sales Tax Adjustment	2572.4
Individual Income Tax Adjustment	2547.2
6. Corporate Tax Integration	
Lump Sum Tax Adjustment	1313.1
Labor Income Tax Adjustment	493.4
Sales Tax Adjustment	238.1
Individual Income Tax Adjustment	-274.5
7. Consumption Tax Rules (Zero Effective Tax Rates)	
Lump Sum Tax Adjustment	3853.9
Labor Income Tax Adjustment	2045.4
Sales Tax Adjustment	1749.3
Individual Income Tax Adjustment	2045.4
8. Consumption Tax Rules (Zero Effective Tax Rates) No Sales Tax on Investment Goods	
Lump Sum Tax Adjustment	4128.1
Labor Income Tax Adjustment	1988.0
Sales Tax Adjustment	1722.1
Individual Income Tax Adjustment	1988.0

3. *Directions for Future Tax Reform.*

I next provide a more precise assessment of opportunities to contribute to the future growth of the U.S. economy through tax reform. For this purpose I will draw on a second paper, "The Excess Burden of U.S. Taxation", that I published with Yun in 1991. In this paper we link tax induced losses in economic efficiency directly to U.S. economic growth. We use a nondistorting tax system as a benchmark in measuring the loss in efficiency from taxation. In this tax system all revenue is raised by purely hypothetical taxes that do not distort private decisions and involve no efficiency loss. By focusing on differences in losses among alternative tax programs, we identify promising avenues for future reform.

Our first conclusion is that the loss in efficiency imposed on the U.S. economy by the current tax system is very large. The efficiency loss is equivalent to eighteen percent of government tax revenue. Each dollar of tax revenue costs the private sector a dollar of foregone investment or consumption and an additional loss in growth opportunities of eighteen cents. We call this estimate the *average excess burden*, defined as the gain in efficiency that would result from replacing the whole U.S. tax system by a nondistorting system. Let me hasten to emphasize that this replacement is purely hypothetical.

The concept of efficiency loss most relevant to tax reform is the *marginal excess burden*. The marginal excess burden of the U.S. tax system is defined in terms of the efficiency loss *per dollar* for the final dollar of revenue raised. The marginal excess burden enables us to quantify one of the most familiar propositions in tax policy analysis. Since efficiency losses rise as tax burdens increase, the marginal cost of raising tax revenue is much greater than the average cost. We estimate that the marginal efficiency loss is 39.1 cents per dollar of revenue, more than double the average loss.

Most important, large differences in marginal excess burdens among different tax programs remain. For example, the marginal cost of raising a dollar through taxes on capital income at the individual level is one dollar and 1.7 cents, while the cost of raising a dollar from labor income taxes is only 37.6 cents. For every dollar of tax revenue transferred from capital income to labor income, the U.S. economy *gains* 64.1 cents in future growth opportunities. This transfer would be revenue neutral, so that it would be in perfect conformity to the Clinton Budget Plan. This provides a clear indication of important potential gains in future U.S. economic growth through tax reform.

My paper with Yun describes the efficiency costs of various parts of the U.S. tax system in greater detail. For this purpose, we analyze the growth of the U.S. economy under reductions of tax rates for the following nine components of the U.S. tax system: (1) the corporate income tax; (2) capital income taxes at the individual level, including taxes levied on noncorporate capital income and taxes on individual capital income originating in the corporate sector; (3) property taxes on corporate, noncorporate, and household assets; (4) capital income taxes at both corporate and individual levels; (5) labor income taxes; (6) capital and labor income taxes; (7) the individual income tax; (8) sales taxes on consumption and investment goods; and (9) all taxes.

Table 3 presents the average and marginal efficiency costs of all components of the U.S. tax system under the Tax Reform Act of 1986. The marginal efficiency costs of the whole U.S. tax system in the ninth panel of Table 3 show that the marginal efficiency cost at rates prevailing under the 1986 tax act was .391 so that the loss in efficiency for each dollar of tax revenue raised was 39.1 cents. However, the average efficiency cost for the whole tax system was .180, so that replacing all taxes by a nondistorting tax would have increased opportunities for economic growth by an average of 18 cents per dollar of tax revenue.

The marginal efficiency cost of sales taxes given in the eighth panel of Table 3 was .262 after the reform, while the cost of property taxes given in the third panel was .176. By contrast, the marginal efficiency cost of all income taxes given in the sixth panel of Table 3 was .497. The efficiency losses were 49.7 cents per dollar of income tax revenue, only 17.6 cents per dollar of property tax revenue, and only 26.2 cents per dollar of sales tax revenue. A substantial increase in efficiency could have been realized by reducing income tax rates and increasing the rates of sales and property taxes. We conclude that the Tax Reform Act of 1986 did not successfully overcome the excessive reliance of the U.S. tax system on income taxes.

The structure of the income tax itself is completely out of balance with marginal efficiency costs of labor income taxes at .376, individual capital income taxes at 1.017, and corporate income taxes at .448. Very substantial gains in efficiency could have been realized by further reductions in marginal tax rates on individual and corporate taxes on capital income, even at the expense of increases in marginal tax rates on labor income. Considerable gains in growth opportunities for the U.S. economy could have resulted from reduced reliance on individual income taxes on capital income and more reliance on corporate income taxes.

An important priority for future tax reform is to lessen the dependence of the U.S. tax system on income taxes. Second, within the income tax there is excessive reliance on taxes on capital income at the individual level. Taxes on capital income at both corporate and individual levels are too burdensome, relative to taxes on labor income. Every dollar transferred to labor income taxes from capital income taxes at the individual level costs the U.S. economy 64.1 cents in lost growth opportunities. Reversing the direction of the 1986 reform by raising marginal rates for "high income" taxpayers in the Budget Enforcement Act of 1990 and the Omnibus Budget Reconciliation Act of 1993 has substantially increased the tax burden on capital income.

4. Conclusion.

My overall conclusion is that changes in tax rates for upper income taxpayers in 1990 and 1993 has nullified many of the growth opportunities for the U.S. economy created by the Tax Reform Act of 1986. It is important to underline this conclusion, since the recent emphasis on "soaking the rich" increases reliance on capital incomes taxes relative to those on labor income. This will be enormously costly in terms of future opportunities for growth of the U.S. economy. Future tax reforms should strengthen rather than weaken the basic thrust of the 1986 Tax Act in enhancing the neutrality of capital income taxation.

The Neutral Cost Recovery Act of 1995 is an important contribution to the coming debate over tax reform. This Act would introduce provisions for recovery of capital costs that are equivalent to the expensing of investment expenditures required under consumption tax rules. However, neutral cost recovery must be combined with other tax reforms, such as the elimination of deductions for interest expenses, in order to enhance neutrality of the federal tax system. Achieving neutrality in the taxation of income from all assets in the U.S. economy is the most important goal for future tax reform.

Changing the federal tax base from income to consumption is an idea whose time has come. This change will create very important new opportunities for growth in the standard of living of all Americans. The traditional objections to consumption as a base for taxation on grounds of regressiveness have been successfully addressed in the Nunn-Domenici "consumed income" and the Armey "flat tax" reform proposals. A neutral system for cost recovery is embodied in both of these proposals as well as the Neutral Cost Recovery Act of 1995. These proposals are based on well tested economic ideas and can serve as the starting point for the development of tax reform legislation.

Table 3.
Efficiency Costs of U.S. Tax Revenues After the Tax Reform Act of 1986

Tax Bases		Reduction in Tax Rates (%)										
		5	10	20	30	40	50	60	70	80	90	100
1. Corporate Income	MEC	.448	.435	.418	.397	.379	.363	.348	.334	.322	.310	.301
	AEC	.448	.442	.431	.421	.412	.404	.397	.391	.384	.379	.374
2. Ind. Cap. Income	MEC	1.017	.989	.951	.904	.853	.812	.767	.727	.688	.650	.613
	AEC	1.017	1.003	.977	.953	.928	.906	.884	.863	.842	.822	.803
3. Property Value	MEC	.176	.174	.171	.168	.164	.160	.157	.153	.149	.145	.142
	AEC	.176	.175	.173	.171	.169	.168	.166	.164	.162	.160	.158
4. All Cap. Income	MEC	.675	.650	.616	.573	.533	.498	.466	.435	.407	.382	.359
	AEC	.675	.663	.640	.619	.600	.582	.566	.551	.537	.524	.512
5. Labor Income	MEC	.376	.358	.333	.303	.276	.253	.237	.216	.201	.190	.183
	AEC	.376	.367	.350	.334	.320	.307	.296	.285	.275	.266	.259
6. 1+2+5 = 4+5	MEC	.497	.462	.414	.355	.301	.254	.212	.175	.142	.114	.091
	AEC	.497	.480	.448	.418	.391	.366	.343	.323	.304	.287	.271
7. Ind. Income	MEC	.520	.490	.449	.396	.349	.305	.265	.229	.196	.167	.140
	AEC	.520	.505	.477	.451	.426	.403	.381	.361	.342	.325	.308
8. Sales value	MEC	.262	.259	.254	.249	.242	.236	.230	.224	.218	.211	.205
	AEC	.262	.261	.257	.254	.251	.248	.245	.242	.239	.236	.232
9. All Tax Bases	MEC	.391	.356	.308	.249	.197	.151	.113	.082	.063	.048	.040
	AEC	.391	.374	.342	.312	.285	.260	.238	.220	.204	.190	.180

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Chairman ARCHER. Thank you, Mr. Jorgenson.

Our second witness is Ernest Christian, who a couple of years back was with the Department of the Treasury, and who is now chief counsel for the Center for Strategic Tax Reform. We welcome your testimony. You may proceed.

STATEMENT OF ERNEST S. CHRISTIAN, CHIEF COUNSEL, CENTER FOR STRATEGIC TAX REFORM

Mr. CHRISTIAN. Mr. Chairman, Mr. Gibbons, members of the committee, I attach special significance to the combination of the neutral capital cost recovery system, the American dream savings account, and the capital gains tax reform.

Together these proposals embody important principles of tax policy that serve the national interest. It is that interest and those principles that are vital. The details can be handled one way or another. I recommend to you a statement attributed to Dwight Eisenhower in 1956. He said, "I have but one yardstick by which I measure all major decisions, and that yardstick is, is it good for America."

The philosophical and analytical principles of NCRS and the American dream savings account are good for America. NCRS and ADS are based on the correct analytical principle that income should be taxed once, not twice. Either tax the income that is saved and invested and do not tax the return, or deduct the amount invested and tax the return, but do not tax both the investment and the return.

Although NCRS is not, in my opinion, a full substitute for first-year expensing, it does implicitly recognize that expensing the cost of business capital investment is correct, both as a matter of tax analytics and rational economic policy. Although the American dream savings account is not a full substitute for a full up front deduction for all personal savings, it recognizes that a deduction for saving is the correct rule under a tax system that seeks to tax all income once and the same and not to penalize those who choose to save part of their income for their own and the Nation's benefit.

NCRS, ADS, and capital gains tax reform reflect many of the worthy precepts of neutrality and income measurement that underlie most of the major proposals for totally restructuring the American tax system. As one who has devoted a good portion of his professional career in the Treasury Department and in private life to fundamental restructuring, I applaud the recognition of these precepts.

The present Internal Revenue Code is not good for America. Total restructuring is needed. NCRS and other provisions in the Contract are, in my view, steps toward that goal. Many people anticipate that a total restructuring will soon occur. Many of the reservations about NCRS that you may hear from witnesses probably reflect that expectation.

NCRS is being compared to an ideal standard. Compared to present law, NCRS is meritorious and deserves serious consideration. NCRS is, however, not perfect. Because NCRS postpones present deductions in exchange for larger deductions in the future, it is complex. For the same reason, it may involve an element of uncertainty and risk from a business' standpoint. It results in a

pattern of near term revenue gains and larger future revenue losses that may complicate the transition to the kind of total tax restructuring that I understand will soon be on the agenda and that I hope will soon be enacted into law.

If a near-term transitional alternative is sought, one alternative is to accelerate depreciation under present law and to modify the so-called alternative minimum tax accordingly. In the near term this would reduce, but not eliminate, the tax bias against capital investment. That would be good for America.

This near-term relief would also aid the transition to first-year expensing under a total restructuring in the future that is also good for America. On the other hand, compared to present law, NCRS over a long term is also good for America. Thus, the choice is between one or more good things, not a choice between bad and good.

That concludes my oral statement, Mr. Chairman. I thank the committee for its attention.

[The prepared statement follows:]

STATEMENT OF
ERNEST S. CHRISTIAN
CHIEF COUNSEL, CENTER FOR STRATEGIC TAX REFORM
BEFORE THE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

JANUARY 26, 1995

RE: NEUTRAL COST RECOVERY SYSTEM

In General

In the context of addressing the Neutral Cost Recovery System,[1] I shall also refer to two related tax provisions in the Contract With America now before the Committee -- the capital gains tax reform[2] and the American Dream Savings Account.[3]

I attach special, even historic, significance to the combination of these proposals. They embody important principles of tax policy that serve the national interest.

In making your decision on the details of NCRS and the related provisions, I recommend to you a statement attributed to Dwight Eisenhower in 1956.

> "I have but one yardstick by which I measure all major decisions -- and that yardstick is: Is it good for America?"

Present law penalizes the savings and investment that make labor more productive and provide better jobs and higher livings standards for all Americans. That economic engine is the ultimate source of everyone's income and well-being. To impair that productive process is not good for America; nor is it necessary.

NCRS would reduce, by some measures even eliminate, the tax bias against business capital investment in the future. Other provisions in H. R. 9 and H. R. 6 would reduce but not eliminate the tax penalty on Americans' abilities to save for their own and the nation's future. That is good for America.

It is also good for America that NCRS and other provisions in the Contract reflect many of the same worthy precepts of tax neutrality, correct income measurement, efficiency, and unabashed national self-interest that underlie most of the major proposals for fundamental restructuring of the American tax system that we hear so much about. As one who has devoted a good portion of his professional career, in the Treasury Department and in private life, to fundamental tax restructuring, I applaud the recognition of these precepts. We are moving in the right direction.

Although it goes about it in an indirect and complex way, NCRS implicitly recognizes that expensing the cost of business capital investment is the correct result, both as a matter of tax analytics and rational economic policy.

Both NCRS and the ADS personal savings proposal are based on the correct premise: tax income once but not twice. When a dollar of income is deferred through savings and investment, either do not tax the dollar when invested and tax the return of principal and the earnings on principal when later received, or tax the dollar invested and do not tax the earnings, but do not tax both the dollar and the earnings on the dollar.

True expensing of business capital investment, where the dollar is deducted at the outset, is the ideal. It is the approach taken in Congressman Armey's

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1/ H. R. 9, Title II, Job Creation and Wage Enhancement Act of 1995.
2/ H. R. 9, Title I, Job Creation and Wage Enhancement Act of 1995.
3/ H. R. 6, Sec. 4, American Dream Restoration Act.

restructuring proposal and in the restructuring proposal by Senators Domenici and Nunn that has been widely discussed.

NCRS and the ADS personal saving proposal reflect the next best alternative. ADS, for example, is similar to a back-loaded IRA. No deduction is allowed for deposits in the account but the withdrawal of principal and earnings on principal are excluded from tax.

In broad outline, NCRS is the same. A partial deduction is allowed at the outset. Additional and enlarged deductions are allowed later in order to exclude from additional tax a sufficient amount of future returns of principal and earnings on principal to equate to a single tax on a discounted present value basis.

Some may be surprised that I feel it necessary to give such emphasis to one tax instead of two taxes. But remember, a fundamental premise of the present Internal Revenue Code is to tax both the dollar of income that is saved and invested and to tax the earnings on that investment. That is bad for America. The need and opportunity to correct this long-standing failing of present law is what makes NCRS of vital importance.

Detailed Comments on NCRS

Both friends and foes of NCRS may point out deficiencies. Criticisms by proponents of improved capital cost recovery may, however, be muted because they recognize the overriding importance of the principles of NCRS and the great step forward in U.S. tax policy these principles represent.

On the other hand, it is important to correctly understand NCRS. What it is, what it is not, and why. It is also necessary to put NCRS in context.

A. *NCRS Is Not Perfect*

NCRS is not perfect. It is not a full substitute for first-year expensing. It does not eliminate the need to move forward promptly toward the goal of a total restructuring of the American tax system which I hope will be the next item on the Committee's agenda. In some ways, the deficiencies of NCRS highlight the urgent need for a total restructuring of the American tax system. Many of its imperfections are the result of an attempt to fit an improved capital cost recovery system into the faulty structure of present law.

Such imperfections as exist must be put in perspective. Compared to present law, NCRS is a meritorious system. If the only choice were between NCRS and present law, NCRS ought to be enacted. It is primarily when NCRS is compared to the ideal of first-year expensing that we tend to focus on imperfections.

1. *Cash Flow*. From the perspective of a business making capital investments, NCRS produces a less good up-front cash flow result than first-year expensing. Businesses that invest in capital equipment will in the first year and for several years thereafter be allowed to deduct smaller portions of the cost -- smaller even compared to present law. In effect, they will trade up-front deductions for larger deductions in the future. In effect, they are prepaying additional tax -- or lending the Treasury money -- which additional tax will be repaid with interest through enlarged deductions in the future.

2. *Indexing and Deductions in Excess of Cost*. Because NCRS does not allow the full cost of a capital investment to be deducted in the year paid, the deferred deductions must be indexed (increased) to reflect inflation. If the full cost were immediately expensed, no indexing would be necessary. Also because deductions for cost are postponed until the future, the amount of those postponed deductions must be increased beyond the initial cost of the property in order that their value to the business -- taking into account the time value of money -- will be equal to the value of deducting the cost of the property in the earlier year when the investment was made.

3. *Putting Complexity in Perspective.* Postponing deductions and then indexing and allowing enlarged postponed deductions adds significant complexity. The complexity of NCRS must, however, be put in perspective.

Should complexity be given greater weight when NCRS attempts to *reduce* the tax burden on capital investment than has been the case in the past when the law was amended to *increase* the burden on capital investment? For example, enormous complexity was created in 1986 when deprecation allowances were *reduced* through a combination of the present Modified Accelerated Cost Recovery System (MACRS) and the so-called Alternative Minimum Tax.

The complexity of NCRS must also be weighed against the importance of the principles involved and against the long-term benefits to economic growth and higher living standards that are logically associated with relieving the present tax bias against savings and investment the United States.

B. *NCRS in Overall Context*

NCRS is being proposed in the context of high federal deficits and a serious attempt to reduce and ultimately eliminate deficits in significant part through expenditure reductions; while at the same time enacting important tax relief.

As part of that tax relief, NCRS has a unique characteristic -- it actually *increases* tax revenues over the next four to five years by roughly $20 billion according to some estimates.

Here, again, we see the important premise of one tax instead of two as well as the important difference between the two possible approaches: (i) either allow an up-front deduction for savings and investment and later tax the return, including the return of principal, or (ii) do not allow an up-front deduction for savings and investment but do not later tax the return.

By, in effect, opting primarily for the latter approach through the mechanism of postponed deductions, NCRS is a valuable approach in the context of the near-term budget accounting equation. In that context, it is a way of currently enacting and putting in place an improved capital cost recovery system without any current-year revenue cost.

Such a result does not, however, arise by magic or alchemy. It arises from changing the timing of deductions -- less depreciation deductions now and more later. This timing change has consequences.

From a federal budget accounting standpoint, NCRS will result in very large future deductions and very large revenue costs after the first four to five years. These future revenue losses -- measured off the base of present law -- may impede efforts to achieve a balanced budget by the year 2002.

In contrast, actual expensing or some current step toward actual expensing -- such as increasing currently allowable depreciation deductions -- would have a current revenue cost, say for the next four years, but thereafter would not create the large over-hang of future deductions and revenue losses in years five through ten that arise under NCRS.

C. *Looking to the Future*

The future-oriented structure of NCRS and its future-oriented consequences raise additional considerations.

1. *A Good System in the Future.* On the positive side, after a few years of continuing capital investment with more and more property under NCRS, and as postponed deductions start to be realized in large amounts, NCRS will produce significant positive cashflow results for businesses.

2. *Changes in Tax Law.* Many businesses are, however, aware that the tax laws often change. Frequent change has particularly been the case in the past with depreciation and capital cost recovery. How reliable are the postponed deductions that NCRS inherently generates and upon which its efficacy and rationale depend?

Those who raise this issue are not necessarily saying that future Congresses will renege. Instead, they may be anticipating positive and desirable tax law changes in the future -- such as lower tax rates.

How could a lower business tax rate in the future be a case for concern from a business' perspective? The answer, I suggest, is mixed. One should be careful not to get carried away with criticisms of NCRS which may be based on the following proposition: A business will have given up present law deductions against a 35% corporate tax rate in exchange for future and enlarged deductions against a future tax rate that may be less than 35%. I understand the mathematics that the future deductions will, if the future tax rate is less, be worth less, but that does not necessarily mean that a business will be less well off than would be the case had NCRS not been enacted and present law continued.

3. *Fundamental Tax Restructuring*. I hope that a likely future event will be a fundamental restructuring of the American tax system. In one way or another, most such proposals contemplate first-year expensing of capital investment and contemplate lower tax rates as well. Some might be concerned that the existence of NCRS would make the transition to actual expensing more difficult. This is an issue to be fully explored and thought through.

My own answer, as an advocate of fundamental tax restructuring, is not so pessimistic.

There are two kinds of transition issues. One is the philosophical or tax policy transition of going from present law to full and direct expensing as is inherent in most restructuring proposals. That philosophical transition is made easier by NCRS. NCRS will in principle have crossed the Rubicon, so to speak.

The mechanical transition is more uncertain. It's ease or difficulty, including revenue considerations, partly depends on how quickly the transition occurred. If restructuring proceeds quickly after enactment of NCRS, the mechanical transition would be fairly easy. If it occurred three to five years later after a large amount of deductions had been postponed and were starting to become available, these deductions in conjunction with first-year deductions under a newly enacted expensing system could present a revenue problem.

D. *Alternatives to NCRS.* If alternatives are desired and are to be considered, and if fundamental restructuring is likely, I would suggest consideration of the following:

- Increase depreciation allowances under MACRS (the present depreciation system) to make them coincide as closely as possible to the depreciation allowances under the pre-1986 ACRS system as can be afforded in light of revenue constraints and the need for deficit reduction.

- Repeal or modify the so-called Alternative Minimum Tax so that it no longer penalizes companies for making needed capital investments.

Like NCRS, these changes would be good tax policy and be good for America. They also would be a down-payment on full expensing from a budgeting standpoint and, in that respect, ease the transition to fundamental restructuring.

The most important matter is to preserve the vital principle of NCRS -- that expensing or its equivalent is the correct analytical and policy result. We should not to lose the momentum toward enacting into law that and other principles of good tax policy that are in reality important strategic steps for America in the competitive world marketplace of today.

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Chairman ARCHER. Thank you, Mr. Christian. I think you finished even before the yellow light went off. We are grateful for that.

Our next witness is Stephen Entin, resident scholar, Institute for Research on the Economics of Taxation. Mr. Entin, we would be pleased to hear your testimony. You may proceed.

STATEMENT OF STEPHEN J. ENTIN, RESIDENT SCHOLAR, INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

Mr. ENTIN. Thank you, Mr. Archer. My name is Steve Entin from the Institute for Research on the Economics of Taxation.

It is a pleasure to be here to talk to you about neutral cost recovery today. I was working at Treasury when the concept was first thought up, and it is nice to see that it has gotten somewhere in the last 12 years.

Just yesterday in the Wall Street Journal there was an article entitled, "Census Bureau Confirms Eroding Wages." This has been the subject of some concern for many years. It factored in the last two presidential elections, and I think it is time to do something about it.

One of the things we could do about it is give workers more and better equipment to work with and get businesses busy hiring and training them again to muster a work force to use the new capital. Unfortunately, the Tax Code is an obstacle. Investment writeoffs must be stretched out over many years, and consequently, the present value of the writeoffs is less than the investments cost. This is very peculiar. Revenues are not profit until they exceed the cost of producing the product or service. Businesses get to deduct all their wage costs, they get to deduct all their fuel costs, all their raw materials costs, and all their shipping costs. Why are they restricted to writing off only 75 to 95 percent of the real cost of their equipment and less than half the real cost of their factory buildings, offices, shops, and rental housing units?

By making businesses stretch out their writeoffs of plant and equipment, the current tax treatment of capital starts counting revenues as profits before the businesses really earned a cent. Taxes are sometimes due when no real profit has been earned. Investments in general have to earn more than otherwise to counter this tax bias, and trillions of dollars of otherwise attractive and valuable capital formation is lost.

The biggest losers are the workers whose productivity, wages, and job opportunities are curtailed. Government loses, too, as tax revenue is forgone on the lost GDP. Expensing is the straightforward cure, but it has an adverse impact during the budget window and it runs afoul of the PAY–GO provisions.

NCRS gets around that problem. It would provide all of the investment incentives of expensing for equipment immediately while raising revenue during the budget period. Equipment purchased in 1995 would benefit fully and the economic benefits of increased capital formation would begin right away.

NCRS would produce a significant reduction in the cost of capital, which would necessarily lead to a significant increase in the capital stock, higher productivity, and higher wages. GDP would ultimately be several percentage points higher. Annual growth

rates might be increased anywhere from 0.5 to 1.5 percent a year for several years.

It would take only a small fraction of that projected growth, about one-tenth of 1 percent to two-tenths of 1 percent a year, accumulating to a bit over 1 percent higher GDP after about 10 years, to offset the static revenue cost of NCRS as projected by the Treasury. No reasonable forecast would show any growth less than that.

Furthermore, the additional growth of wages and employment would reduce the need for Federal income support payments. Both on the revenue side and on the outlay side, the deficit would be improved.

Regrettably, the committee has curtailed the NCRS adjustment for long-life equipment and structures to deal with Treasury's static revenue loss projection beyond the budget period. I think you should consider the additional economic growth and corresponding revenue reflow that NCRS would generate and restore the full NCRS treatment for all assets.

I also recommended on page 4 of my testimony that the committee consider, not only applying NCRS treatment to the AMT, but also adjusting the AMT asset lives to equal those of the ordinary tax system. I believe that the revenue reflow would justify both steps. I think they are entirely consistent and both are very valuable.

Criticisms of the NCRS proposal in recent Treasury testimony are unfounded. There are no tax shelters here. Treasury is twisting the term to mean any departure from the current biased system in which savings and investment are doubly or triply taxed. Viewed from the perspective of a neutral tax system in which savings and investment are treated evenhandedly relative to consumption, NCRS is the correct approach and anything less is a bias against investment.

To recap: NCRS can correct the underdepreciation of capital within the framework of the current budget rules and can get the economy moving forward now. The resulting growth will make it that much easier to trim government deficits as more jobs at better wages reduce the need for Federal income support payments. NCRS is a win-win proposal that is deserving of prompt passage. Why wait?

Thank you.

[The prepared statement follows:]

HEARING ON NEUTRAL COST RECOVERY AND EXPENSING OF INVESTMENT

Statement of Stephen J. Entin, Resident Scholar
Institute for Research on the Economics of Taxation (IRET)

before the
Committee on Ways and Means
January 26, 1995

Mr. Chairman and members of the Committee, thank you for the opportunity to present my views on the neutral cost recovery system (NCRS) proposed in H.R. 9.

The provision at issue — the only business-specific growth incentive in the "Contract With America" — relates to the write-off of depreciable assets. Under current law, businesses are allowed an immediate write-off (expensing) of only a small amount ($17,500) of the cost of plant, equipment, structures, and certain other assets. They must stretch out the remainder of the write-offs over many years, and, because the total amount of the write-offs is limited to the original outlay for the property, the present value of the write-off is less than the property's cost. The present value is reduced by the opportunity cost of money and by inflation, and this reduction is greater the longer is the life of the property and the higher is the rate of inflation. As a result, a real cost of production is understated, and the businesses' taxable incomes exceed their real incomes. Investment, productivity, wages, and employment suffer.

Under current law, purchases of equipment are written-off over periods of time ranging from 3 to 20 years. Most residential structures are written-off over a 27.5 year period. Commercial and industrial structures are written-off over a 39 year period. Stretching out the write-off period reduces the present value of the deductions due to lost interest and inflation. The result is that the business deducts an amount that is less in present value than the amount paid for the property. The under-depreciation overstates taxable income, resulting in a higher-than-statutory tax rate on the real earnings of the asset. The table illustrates the difference in the value of the deductions between expensing and one of the set of depreciation schedules commonly used in current law. For example, the real present value of deductions for the 7 year asset at 3% inflation is only 84.6% of the cost of the asset. The present value falls short of the amount paid for the property by $15.40 on a $100 piece of equipment, costing the firm an extra $5.39 in tax in present value terms, assuming a 35% corporate tax rate. The longer the asset life and the higher the rate of inflation, the greater is the loss in present value. At current rates of inflation, the present value of write-offs for structures is less than half of the cost of the property (not shown in the table).

Present Value of Current Law Capital Consumption Allowances per Dollar of Investment Compared to Expensing (First-year Write-off).

Asset lives:		3 yrs	5 yrs	7 yrs	10 yrs	15 yrs	20 yrs
Present value of first-year write-off of $1 of investment		$1.00	$1.00	$1.00	$1.00	$1.00	$1.00
Present value of current law write-off of $1 if inflation rate is:	0%	$0.964	$0.937	$0.912	$0.877	$0.796	$0.742
	3%	$0.935	$0.888	$0.846	$0.789	$0.667	$0.592
	5%	$0.917	$0.859	$0.807	$0.739	$0.599	$0.519

Assumes a 3.5 percent real discount rate, assets purchased in first quarter of the year.

The most straightforward way of correcting under-depreciation is to permit expensing of the investment — deduction of the amount paid for the property in the year in which the property is purchased. H.R. 9 takes a useful but small step in that direction by increasing the allowable amount of expensing from $17,500 to $25,000. Going directly to expensing for all write-offs,

however, would involve a large cost to the Treasury in the short run, and would run afoul of the PAYGO provisions of the budget law.

A cheaper near-term alternative is to spread the depreciation deductions over time but to allow deductions in amounts such that their present value equals the amount paid for the property. Such schedules constitute a "neutral cost recovery system" (NCRS). Under neutral cost recovery, businesses (corporate and non-corporate) would be allowed to adjust their depreciation write-offs annually by a normal real discount rate of, say, 3.5% plus the rate of inflation. This adjustment would approximate the normal real return on investment, and create write-offs equal in present value to expensing. It would allow businesses to recover their full real costs, the economically correct approach. NCRS would give a substantial boost to investment and wages.

One of the best features of NCRS is that it provides all of the investment incentives of expensing immediately while being consistent with the PAYGO provisions in the budget law. Equipment purchased in 1995 would benefit fully, and the economic benefits of increased capital formation would begin right away.[1] Nonetheless, because the provision requires businesses electing to use NCRS for short lived assets to employ the 150% declining balance method of depreciation (before NCRS adjustment) instead of the 200% declining balance method allowed under current law, the provision would raise revenue during the budget period.

H.R. 9 provides that the election of NCRS would be optional. Firms that would prefer to retain the slightly higher near term deductions and lower total write-offs of current law would be allowed to do so. NCRS will not harm any business, and will benefit most.

Investment tax credits (ITC) could also be used to offset all or part of the shortfall in value of normal depreciation allowances, though they are generally only an approximation of the shortfall. One drawback of the ITC is that the credit rates would have to be adjusted by statute as the inflation rate changed in order for the capital recovery system to remain neutral. Another drawback, in the current budget climate, is the large up-front cost to the Treasury. NCRS avoids both of these problems.

Growth and Budget Effects

A recent paper by Gary and Aldona Robbins[2] calculates that NCRS, as originally proposed, would have produced a 16% reduction, on average, in the pretax internal rate of return needed for an investment to be worthwhile. The modified version, trimming the adjustment for long lived assets, would be less effective in this respect. Additional capital would be accumulated until the rate of return fell to this new, lower value. It takes a great deal of additional capital to depress returns. Consequently, I would expect NCRS to produce an increase in the capital stock, over time, of perhaps 20 percent or more above levels that would otherwise occur. The higher capital stock and the resulting higher employment and productivity would boost the ultimate level of GDP by several percentage points over 5 to 10 years. Annual growth rates might easily be anywhere from 0.5 to 1.5 percentage points higher than otherwise during that period.

It would only take a fraction of that growth to make NCRS revenue neutral. Additional annual growth of only about 0.1% to 0.2%, cumulating to a bit over a 1 percent increase in the permanent level of GDP after 10 years, would offset the static revenue cost of NCRS. No reasonable estimate of the economic effect of a major reduction in the tax on capital could fail to predict several times that result.

NCRS should be adopted because it is the right thing to do. It reduces the anti-saving, anti-investment bias in the tax code, and raises incomes and employment. Nonetheless, the Congress does have legitimate concerns about the budget. Fortunately, NCRS is one of a small group of tax reforms that will almost certainly help rather than hinder deficit reduction. Not only would revenue increase, but the additional growth of wages and employment would reduce the need for federal income support payments.

Consistent with Neutral Tax Systems

A neutral tax system would not discriminate against saving and investment. The income tax, by taxing both income that is saved and the returns on that income, taxes income used for

saving and investment more heavily than it taxes income used for consumption.[3] Dissatisfaction with this bias, and a determination to create a more neutral tax system, lie at the heart of all the major tax restructuring proposals that have been studied in think tanks, academia, and the Treasury, or submitted as legislation (such as Domenici-Nunn, the Armey flat tax, Danforth-Boren, and various VAT and national sales tax proposals). Some resemble income taxes, in which saving and investment are deducted from taxable income. Others impose a tax on goods and services that constitute final consumption, either at the retail level or during the production process.

Within the general framework of a neutral, consumption-based or saving-exempt income tax, there are two general approaches to creating neutrality. One is to exempt interest, dividends, capital gains, and other returns on capital from tax. This is akin to the tax treatment accorded state and local tax exempt bonds. The other method of achieving neutrality is akin to the tax deductible IRA. It involves allowing a deduction for income that is saved or invested, while taxing all the returns.

In such a system, all saving by individuals should get either "municipal bond" treatment or deductible IRA treatment (without the limits on contributions and holding periods attached to current IRAs, 401(k) plans, 403 (b) plans, SEPs, and Keough plans).[4]

In the case of direct investment in plant, equipment, structures, inventory, and R&D, the neutral treatment is "expensing", writing off the investment in the year it is purchased instead of depreciating it over many years. NCRS, which is equivalent to expensing in present value, is consistent with this neutral concept of taxation, and may be viewed as a step in the direction of a restructured, neutral tax system.

An additional source of bias in the tax code is the taxation of income at the corporate level and again at the shareholder level. This additional "double tax" applies to corporate income that is taxed and then distributed as dividends to shareholders, and to after tax corporate earnings retained for reinvestment, which increase the value of the company and are taxed again as capital gains when the shares are sold. Ideally, the corporate and individual income taxes should be combined or "integrated" (which means passing through corporate earnings and deduction to the shareholders as is done with subchapter S corporations and partnerships). Short of that, tax relief for dividends paid and for capital gains is in order. A final layer of tax on capital is imposed by federal and state transfer taxes, which should be eliminated.

Difficulties with the Committee Proposal

It is regrettable that the Committee has curtailed the NCRS adjustment for equipment with tax lives of 15 and 20 years and for residential, commercial, and industrial structures with tax lives of 27.5 or 39 years. The Committee proposal grants them only the inflation adjustment and not the 3.5% normal real return accorded other depreciable assets. Also, inventory outlays and R&D, which are equally deserving of NCRS treatment, are not covered.

The important principal behind NCRS is that businesses should be allowed a full write-off for all their costs of production, and that anything less overstates real business earnings. Once it is decided that it is all right to ignore a portion of the costs of production in calculating income for tax purposes, where does it end? Should businesses be allowed to deduct only 92% of their wage costs, or only 50% of their research expenses? The only deduction that is not entirely arbitrary is 100%, and that is also the only way to correctly value income and to maintain neutral treatment of income used for consumption and income used for saving and investment.

The Committee should consider the additional economic growth and corresponding revenue reflow that NCRS will generate and should restore full NCRS treatment of long lived equipment and structures, and should cover inventory investment and spending on R&D. If the Committee is too uncertain of the economic effects to proceed with a full adjustment immediately, it should at least affirm the principal of full adjustment by legislating a phase-in of the real 3.5% return in the current bill. For example, structures built in 1995 could receive inflation plus a 0.1% real adjustment; those built in 1996, inflation plus 0.2%; and so on until the full 3.5% real adjustment is achieved for structures placed in service 35 years from now. The phase-in would be slow enough to present little static revenue loss near term, and to avoid any tendency for investors to defer construction from one year to the next to achieve better tax

treatment. The drawback to the phase-in, of course, is that the economy will not immediately experience the added growth that full NCRS treatment would provide.

H.R. 9 provides the same NCRS adjustment of the depreciation allowances under the alternative minimum tax as it does to the depreciation allowances under the ordinary income tax. This is proper and necessary to prevent additional businesses from becoming subject to the AMT, and to allow businesses that are subject to the AMT to recover their full costs of investment. It would be even better, however, to go an extra step and utilize the same asset lives in the AMT as under the ordinary income tax, in effect using the same capital recovery rules in the two systems. Under both systems, depreciation write-offs are to be made equal in present value to the cost of the property. It makes no sense to have two different sets of NCRS-adjusted depreciation tax schedules to achieve the same result, and to have two different tax systems that treat businesses differently according to whether their investment levels are high or low.

Unfounded Criticisms of the Proposal

Leslie B. Samuels, Assistant Secretary for Tax Policy, Department of the Treasury, raised a number of objections regarding NCRS in his testimony before this Committee on January 10, 1995. Most of his complaints are unfounded. I agree with only one assertion. He states that the provision of full NCRS treatment — inflation plus 3.5% — to assets with tax lives of 10 years or less, with longer lived assets receiving only the inflation adjustment, is discriminatory. This is correct. The solution, however, is to provide long-lived equipment and structures with full NCRS adjustment, not to deny the improved tax treatment to all assets by scrapping the entire NCRS proposal. Even as the proposal stands, long lived assets and structures would be treated better under NCRS than under current law. Given that they are currently treated much more harshly, relative to expensing, than short lived assets, the improvement granted to long lived assets, though incomplete, is nonetheless as significant as that given to short lived assets.

Samuels also expresses concern that businesses will engage in too much investment simply to offset other income with NCRS deductions. This is a distorted view. Rapidly growing, rapidly investing businesses might be unable fully to utilize their capital consumption allowances under NCRS unless they have sufficient other income against which to take their full write-offs. Such businesses would experience a penalty, the loss of a portion of the value of write-offs that had to be deferred. The presence of other income corrects what would otherwise be an unwarranted disincentive.

Samuels acknowledges that NCRS provides the same present value of deductions that would be allowed under (neutral) consumption based tax systems, but he mis-describes this as "reducing the effective tax rate on the income for new investment to zero (as under a consumption-based tax)." Samuels confuses "returns" with "income". In theory, in a competitive market, the present value of the returns on capital are driven down to levels that just cover the cost of the capital, and the tax saved by expensing the capital would just equal the tax on the returns, in present value. Thus, the returns are taxed, but do not yield a net tax to the government unless the returns exceed the cost of the asset. This is as it should be, for unless the returns exceed the cost, there is no net real income. If the returns exceed the cost, there is net income, and it yields a net tax. Income, properly defined, is taxed at the statutory rate.

A recent Wall Street Journal article[5] compared the results of neutral cost recovery with the accelerated cost recovery system plus ITC provisions of the Economic Recovery Tax Act of 1981, which eliminated the tax liability of some large businesses and supposedly produced negative tax rates. The ITC and the rapid write-offs in the 1981 Act may have resulted in a present value of write-offs in excess of full cost at low rates of inflation for some kinds of property. By contrast, neutral cost recovery, which automatically adjusts for changing inflation, cannot produce excessive write-offs or negative tax rates. And if, in some cases and time periods, an accurate accounting of the real investment outlays of a business would produce no taxable income, then that is the result the tax code ought to allow.

Other critics of NCRS have claimed, incorrectly, that there is a subsidy or "negative tax rate" applied to debt financed assets in current law, and that NCRS would worsen it. For example, a recent CRS paper[6] laments that, in the case of debt-financed investment under current law, businesses receive a write-off of an investment (which NCRS would enhance) plus a deduction for the interest paid on the funds borrowed to buy the asset. The tax lost to the

interest deduction is called a subsidy to the business. This analysis ignores the fact that the interest paid by the borrower becomes taxable income to its lender. The tax paid on the interest by the lender is a rough "wash" for the tax saved on the interest by the borrower.[7] In the case of debt-financed investment, the lender and the borrower are de-facto "partners" in the investment, and receive the same combined tax treatment as investment financed within a partnership. This evenhanded tax treatment of investment regardless of the form of the business arrangement involved is a basic tax principal.[8] It is easy to make an activity appear to be subsidized if half the tax paid on the activity is omitted from the analysis. The truth is, if the business were not allowed a deduction for the interest, that amount would be taxed twice, once on the borrower's tax form, and again on the lender's. The combined tax treatment of the investment is correct under neutral cost recovery (hence its name).

Conclusion

Revenues aren't profits until they exceed the costs of producing the product or service. By making businesses stretch out their write-offs of plant, equipment, and structures, the current tax treatment of capital starts counting revenues as profits before the business has really earned a cent. Taxes are sometimes due when no real profit has been earned. Investments in general have to earn more than otherwise to counter this tax bias, and trillions of dollars of otherwise attractive and valuable capital formation is lost. The biggest losers are the workers whose productivity, wages, and job opportunities would be increased if the lost capital had been created. Government loses too, as tax revenue is foregone on the lost GDP. NCRS can correct the under-depreciation of capital within the framework of the current budget rules, and can get the economy moving forward now. The resulting growth will make it that much easier to trim government deficits, as more jobs at better wages reduce the need for federal income support payments. NCRS is a win-win proposal that is deserving of prompt passage.

Endnotes

1. Other approaches for moving to expensing that have only small near term outlays would delay the economic gains for years or decades. For example, it would be possible to phase in expensing over time, but the budget and economic consequences would be less favorable in the near term. One could allow businesses to expense 5% of their investment in 1995, 10% in 1996, and so on until 100% expensing is reached in 2014. This would cost some money during the budget window. Worse, the incentive to increase investment and capital formation would build slowly, with the result that there would be little economic improvement from the provision in the next several years. Indeed, the phase-in would create incentives to defer investment unless the phase-in rate were very slow.

2. "Neutral Cost Recovery: Investing for Growth, Not Planning for Taxes", Institute for Policy Innovation, Lewisville, TX, August, 1994.

3. Suppose that, in the absence of taxes, one could buy $100 of consumption goods or a $100 bond paying 4% interest, or $4 a year. Now impose a 20% income tax. One would have to earn $125, and give up $25 in tax, to have $100 of after-tax income to consume. The cost of $100 of consumption in terms of pre-tax income has risen 25%. To get a $4 interest stream, after taxes, one would have to earn $5 in interest, pre-tax. To earn $5 in interest, one would have to buy a $125 bond. To buy a $125 bond, one would have to earn $156.25 and pay $31.25 in tax. The cost of the after-tax interest stream has gone up 56.25%, more than twice the increase in the cost of consumption.

Put another way, in the absence of the income tax, each dollar of interest would, in effect, cost the saver $25 in current consumption ($100/$4). After the income tax, it would take $156.25 to buy $4 in interest or $125 of consumption. Each dollar of interest would cost $31.25 in foregone consumption ($125/$4), 25% more than in the no-tax situation.

There are two ways to restore neutrality. One is to exempt interest from tax. One would then have to earn $125 to buy a $100 bond, earning $4 with no further tax. This is akin to the tax treatment accorded state and local tax exempt bonds. The other method is to allow a deduction for income that is saved, while taxing the returns. One would have to earn $125 to buy a $125 bond, earning $5 in interest pre-tax, and, after paying $1 in tax on the interest, have $4 left. This is akin to the deductible IRA.

For a fuller discussion of the basic income tax bias against saving and investment, see:

Bradford, David F., et al, Blueprints for Basic Tax Reform, Second Edition, revised, Arlington, VA, Tax Analysts, 1984.

Schuyler, Michael A., Consumption Taxes: Promises & Problems, Washington, DC, Institute for Research on the Economics of Taxation, 1984.

Tax Reform for Fairness, Simplicity, and Growth, Vol. 3, Value-Added Tax, Department of the Treasury, Washington, DC, 1984.

Ture, Norman B. and Stephen J. Entin, Save, America, Washington, DC, Institute for Research on the Economics of Taxation, 1989.

Ture, Norman B. and B. Kenneth Sanden, The Effects of Tax Policy on Capital Formation, New York, Financial Executives Research Foundation, 1977.

4. At the very least, all these plans should be liberalized. The best measure would be the Breaux-McCrery universal IRA legislation (S.159 and H.R.328) that would create unlimited tax deferred individual investment accounts for all saving, with no restrictions on the amount of saving that could be deducted, no penalty tax on withdrawal at any age, and no forced distribution at any age. The Contract with America recommends a "back-ended IRA". While worthwhile in concept, a back-ended IRA could be crippled by the implicit taxation of otherwise tax free withdrawals created by the current method of taxation of social security benefits. See my testimony on reform of benefit taxation, Ways and Means Committee hearing, January 19, 1995.

5. Lucinda Harper, "GOP Pushing Big Corporate Tax Break In the Form of Depreciation Changes", Wall Street Journal, December 5, 1994, p.A2.

6. David L. Brumbaugh and Jane G. Gravelle, "The Neutral Cost Recovery System and the House Republican Contract", CRS Report for Congress, 95-75 E, Congressional Research Service of the Library of Congress, Washington, DC, Jan. 5, 1995.

7. There would be no tax paid by the lender if the lender were a tax exempt entity (charity, state government, church, etc., but that is due to the tax exempt status of such entities. Their income is tax free regardless of source, whether it be a contribution from a wage earner or interest on a savings account, federal bond, or corporate bond. The tax exempt status of charities has nothing to do with the correctness of NCRS or the treatment of debt finance at the business level under current law for taxable businesses and individuals.

8. The evenhandedness is violated, of course, by the "double-taxation" of corporate income at the business and shareholder level. Volumes of tax analysis have been written urging Congress to correct that error by providing dividend and capital gains relief, or complete integration of the corporate and individual income taxes. It is abundantly clear that it is corporate income that is incorrectly taxed, and that debt financed investment is receiving more correct treatment.

Chairman ARCHER. Thank you, Mr. Entin.

Our next witness is Thomas Usher, chairman of the American Iron & Steel Institute and president of USX Corp. Mr. Usher, we are pleased to have you with us. You may proceed.

STATEMENT OF THOMAS J. USHER, CHAIRMAN, AMERICAN IRON & STEEL INSTITUTE, AND PRESIDENT AND CHIEF OPERATING OFFICER, USX CORP.

Mr. USHER. Thank you, Mr. Chairman. My name is Tom Usher. I am president and chief operating officer of USX Corp. I am here today in my capacity as chairman of the American Iron & Steel Institute.

On behalf of the 34 U.S.-based member companies of AISI, I thank you for the opportunity to testify regarding certain provisions in the Contract With America. Our written statement lays out the steel industry's capital formation problems, including our technical suggestions on how to improve our tax laws.

Today, since I am not a tax lawyer, I am going to highlight our recommendations and discuss why changes are needed from the viewpoint of an American businessman. AISI fully supports the Contract With America's objective of lowering the cost of capital so that job-creating businesses can more easily invest in new plant and equipment.

Our cost of capital problems are caused because many of our steel companies remain mired in the alternative minimum tax on a seemingly permanent basis. The AMT reduces our cash flow and hinders our ability to pursue projects that will reduce costs, increase productivity, and preserve high-paying manufacturing jobs for Americans.

While our strong preference would be the outright repeal of the AMT or the consideration of fundamental tax restructuring, the Contract With America's objective of lowering the cost of capital for regular and AMT taxpayers is something that does get our attention. Conceptually the neutral cost recovery system is a step in the right direction.

NCRS should increase the present value of depreciation deductions for both regular and AMT taxpayers. However, even with NCRS benefits, taxpayers in an AMT position would continue to be discriminated against when compared to regular taxpayers.

A simplified version of NCRS, coupled with meaningful AMT reform, could go a long way to make the cost of capital for American steel producers competitive internationally. My one technical suggestion concerning NCRS is that it should be simplified.

We have only so much horsepower and we should be spending it to make steel, not projecting quarterly increases in the GNP implicit price deflator. Why not have Congress fix the depreciation tables in advance by projecting an average inflation rate?

Fixed depreciation percentage would reduce complexity and make long-range facility planning more certain. At the very least, indexing should be done annually instead of quarterly. In addition to NCRS, or if NCRS is not pursued, AMT reform should be a top priority and should be based on three principles.

First, accumulated AMT credits and other credits should be allowed to partially offset AMT liabilities. Second, investment recov-

ery periods under the AMT should be the same as those under the regular tax. What economic sense does it make for our industry to have a 7-year recovery period for regular tax purposes and a 15-year period for AMT purposes? This change alone would give many AMT taxpayers nearly the same benefits as NCRS and would be much simpler.

Third, expenditures for nonproductive assets, such as pollution control equipment, should be expensed or at least not subject to the lengthy AMT depreciation schedules.

Why do American steel companies and other capital-intensive industries need these changes to lower the cost of capital? One need look no further than last week's news reports. The U.S. 1994 projected trade deficit for goods is expected to be the largest ever. Some may argue that the trade deficit is so high because U.S. manufacturers can't keep up with the growing U.S. demand for products. Why? Isn't it possible that our tax policies have discouraged U.S. capital investment, contributing to lost jobs and plant closings, and what about the factories that were never built because of our noncompetitive cost of capital?

Today the U.S. steel industry is recognized as having world class costs and world class quality. However, we are the only major economy in the world that is required to import a significant amount of steel due to the lack of domestic capacity. If we had added to our capital base, the trade deficit would be lower and America would have more good-paying manufacturing jobs. These were the jobs that made the American factory worker the envy of workers around the world. These were jobs with good health care, with wages that enabled a person to own a house, own a car, and educate their children. In short, quality jobs with a quality of life.

Americans need these jobs and Americans want these jobs. Sure we have created new jobs, but many of them are minimum wage jobs or low-paying jobs in the service area—fast food, restaurants, and shopping centers. More than two of these jobs are needed to provide a family with a standard of living than one manufacturing job provided years ago.

In conclusion, we congratulate the Members of the 104th Congress for recognizing that our current tax system penalizes new investment in plant and equipment. The concepts in NCRS combined with meaningful AMT reform are needed to improve our cost of capital and to preserve quality manufacturing jobs for Americans.

Thank you.

[The prepared statement follows:]

STATEMENT OF THOMAS J. USHER
PRESIDENT AND CHIEF OPERATING OFFICER OF
THE USX CORPORATION AND
CHAIRMAN OF THE AMERICAN IRON AND STEEL INSTITUTE (AISI)
ON BEHALF OF AISI'S U.S. MEMBER COMPANIES
BEFORE THE HOUSE WAYS AND MEANS COMMITTEE
JANUARY 26, 1995

This statement is on behalf of the 34 U.S. member companies of the American Iron and Steel Institute, who together account for more than two-thirds of annual raw steel production in the United States.

Mr. Chairman, AISI's U.S. members are grateful to you and this Committee for calling hearings on the tax provisions in the *Contract with America* designed to encourage greater savings and investment. In particular, we are pleased that staff has asked that this panel focus on the proposed Neutral Cost Recovery System (NCRS) in the *Contract* and the ways in which Congress can best address what continues to be a critical problem for U.S. manufacturers -- namely, **the grossly inadequate capital cost recovery system in the United States, especially as it affects Alternative Minimum Tax (AMT) payers.**

In general, AISI supports a fiscal policy that recognizes the need to reduce and hopefully eliminate the federal deficit over time, control surging health care costs, promote jobs and economic growth, and accelerate investments aimed at rebuilding U.S. infrastructure. As a top priority, Congress should enhance the competitiveness of U.S.manufacturing. It should ensure that the burden of taxation is as broad-based as possible so that it does not fall disproportionately on U.S. manufacturing, the nation's key source of good jobs. And it should study the potential advantages of a replacement tax system, because our existing business tax code is harming U.S. competitiveness.

Given these concerns, we would like in this statement to address not only the proposed NCRS, but the critical importance of further, significant AMT reform; the need to avoid new anti-competitive taxes; and the need to look seriously at fundamental tax restructuring through an entirely new approach.

NCRS: A Good Step in the Right Direction

With respect to NCRS, we applaud Congressman Nick Smith (R-MI) for developing this concept as a way of encouraging new investment by U.S. companies in productive plant and equipment. Its introduction as Title II in HR 9 (the Job Creation and Wage Enhancement Act) is a good step in the right direction, and we look forward to working with this Committee to ensure that the final bill achieves its goals in the vital area of capital cost recovery.

Our analysis of the proposed NCRS is driven by one overriding factor: the reality that many U.S. steel companies remain mired in the AMT on a seemingly permanent basis -- and the AMT has a 15-year (world's worst) capital cost recovery system. Thus, the chief reason AISI supports the NCRS proposal is that it markedly improves the net present value of depreciation under the AMT. **Additional, substantial AMT reform is one of the most important things the 104th Congress can do to keep the U.S. economic recovery going.**

With respect to NCRS specifically, we have the following observations:

- First, AISI absolutely supports the NCRS' four main goals of improving the capital cost recovery system, lowering the cost of capital, removing the distortions in the existing business tax system, and approaching the economic equivalent of expensing.

- Second, we strongly support the decision to extend NCRS benefits to AMT payers, because depreciation under the AMT's excessively slow recovery period is particularly subject to erosion by inflation.

- Third – because the AMT continues to be the single greatest distortion in the current system, the biggest disincentive to investment, and about as far as one can get from the ideal of expensing – the incentive to invest in productive plant and equipment that the NCRS provides will not be fully realized without additional AMT reform.

- Fourth, as NCRS is proposed, because 15-year AMT recovery periods will stay in place and continue to be more than double what they are under the Modified Accelerated Cost Recovery System (MACRS) of the regular corporate tax (seven years), depreciation for AMT payers will remain discriminatory and less beneficial than it is for regular taxpayers.

- Fifth, with respect to recent testimony by Assistant Treasury Secretary Leslie B. Samuels, we strongly agree that incentives should be focused on investments that improve productivity, but take issue with the idea that NCRS will enable permanent AMT payers to "zero out" their tax liability.

- Sixth, we would like to work with Congress to ensure the best possible provision and, in that regard, concerns have been raised about the proposed NCRS, including that: (i) it slows down depreciation for regular taxpayers in the early years; (ii) its benefits in later years could be reduced by a future Congress; (iii) NCRS does not fully meet its own objective to provide a present value of future deductions that is equivalent to the value of current expensing; and (iv) it represents a complicated new depreciation method that would add yet another layer of complexity to an already complex U.S. business tax system. At a minimum, to reduce complexity, NCRS indexing should be done annually, not quarterly. This could slightly reduce NCRS benefits, but would be a practical trade-off.

In view of these concerns, we think Congress should also continue to explore alternative, and possibly simpler and more direct, ways of achieving the worthy goals that this proposal embodies. One concept worth considering is simply to move to a system of straight expensing, possibly over a 5-10-year phase-in period. Yet another approach, which we strongly endorse, is to **focus in H.R. 9 much more directly on the anti-competitive nature of the AMT. If the goal is to effect tax code changes that promote investment in productive equipment and manufacturing competitiveness, Congress' highest priority should be additional, substantial AMT reform**.

AMT: The Need for Additional, Substantial Reform

The AMT originally was intended to ensure that all profitable U.S. corporations pay at least some fair share of tax each year. As you know, Mr. Chairman, that goal has been turned on its head. The changes to the AMT in the 1986 Tax Reform Act (TRA) have had the unintended effect of placing steel and other low-profit, capital-intensive companies in a near-permanent AMT status, with taxes being payable even in years where economic losses are incurred. As a result, the AMT is having a serious, adverse impact on U.S. capital cost recovery and a highly distortive effect on U.S. investment flows.

Unfortunately, the AMT reform contained in the 1993 budget bill – the elimination of the AMT's adjusted current earnings ("ACE") adjustment – does not solve the problem for steel and other investors in long-lived assets, including many of steel's key customers. Among other things, the 1993 reform still leaves intact the AMT's slower depreciation methods (150 percent declining balance)

and long recovery periods (15 years) -- periods identical to those Congress abandoned in 1981 as being outdated and inadequate due to inflation and technological advances.

The AMT's discriminatory depreciation methods and excessively slow recovery periods have had especially harmful effects on the U.S. steel industry. That's because the AMT is most damaging to (i) companies that must invest heavily and continuously in productive equipment, (ii) companies in cyclical industries, and (iii) companies that are marginally profitable because they make products subject to intense domestic and international competition. That sounds like a classic definition that fits much of the U.S. steel industry. Thus, a good way to understand why the AMT is such a problem and why additional reform is so urgently needed is to look closely at the case of steel.

Since 1980, thanks in large part to massive self-help efforts and over $35 billion in investment in new steel plant and equipment, the United States steel industry has dramatically improved its competitive position. In spite of suffering major economic losses for a number of years, we aggressively restructured and modernized. As a result, today labor productivity in our industry exceeds that of even Germany and Japan, and we're the low-cost supplier of quality steel products to the U.S. market. That's the good news, because a strong and healthy steel industry is critical to the U.S. industrial and defense base.

The bad news is that we did all this in the face of an anti-competitive tax system and at enormous cost. We would have made even greater capital investments and competitive gains had it not been for the AMT, which forced steel companies to pay effective tax rates well in excess of the regular corporate rate and raised our cost of capital by as much as 20 percent.

The main problem continues to be the AMT's extreme bias against capital investment. This anti-competitive tax treats accelerated depreciation as an "adjustment" or "preference item " (an increase in income) that must be added back into the AMT calculation -- even when profits are low or non-existent and the economy is in recession. Insofar as U.S. steel companies have no choice but to invest heavily and continuously -- in good times and bad -- it is this "add-back" that increases taxable income, and thus forces many low-profit, capital-intensive steel companies into long term, if not permanent, AMT status.

Since passage of the TRA and its harmful AMT amendments, steel companies with significant reported losses (for both financial and regular tax purposes) have been forced to pay AMT and to defer any tax benefits associated with losses until regular taxes exceed the AMT, which may be never. Adding insult to injury, as steel companies have remained stuck in the AMT -- due to its perverse depreciation provisions -- they have been unable to use their accumulated minimum tax credits ("AMT credits"), which accrue in the years when the AMT exceeds regular tax liability.

The AMT credit, which can only be used when a taxpayer gets out of the AMT, was designed to ensure that, over time, no company would pay more tax than it would if it were in the regular tax. Most steel companies, however, have not been able to use the AMT credit against regular tax liability in subsequent years, as provided under current law. As a result, the AMT in effect has become <u>the</u> regular tax for most steel companies. That's because the buildup of deferred depreciation add-backs keeps us constantly in the AMT and thus unable to use our "pre-payments" to the government in a meaningful time frame. Meanwhile, the government has the advantage of our funds, interest-free, for many years.

As research done for the American Council for Capital Formation (ACCF) has shown, capital-intensive companies, like steel, that must continue to modernize immediately before or during an economic downturn, are penalized the most because of their buildup of deferred depreciation. What happens is

that, when steel company incomes decline, the AMT forces us to pay higher effective tax rates that reduce cash flow at a time when cash flow is already weakened by low or non-existent profits. In addition, even if we were to choose to stop our capital improvement programs during periods of recession -- which is not a realistic possibility -- we would still pay more tax in a given year because the AMT's depreciation add-backs relate to prior years' capital spending.

Some steel companies, for example, have had years recently where they experienced large financial losses and losses for regular tax purposes, yet paid significant AMT amounts. Once again, the "problem" was the high level of capital investments -- and AMT depreciation preferences -- arising out of earlier years. Once again, loss-making companies were forced to pay a tax that acts more like a maximum tax. And once again, AMT credits could not be used.

With respect to the future, many steel companies are likely to remain stuck in the AMT for the remainder of this century and beyond. The reason may sound ridiculous but, as things stand now, we will have to stay in the AMT simply because we will need to continue high levels of investment to modernize our facilities and comply with Clean Air Act regulations.

It is critical, therefore, that Congress start to look at the U.S. business tax system as the steel industry now views the marketplace -- in a global context. According to a September 1991 analysis done by Arthur Anderson for ACCF, "when comparing the United States under the AMT with other countries, the United States ranks consistently at or near the bottom in terms of the present value of depreciation deductions and with respect to nominal capital cost recovery allowances, implying a disincentive to capital formation." This study concludes that , after five years, a U.S. steel company under the AMT recovers only 30 percent on its investment in plant and equipment, compared to 60 percent in Japan, 90 percent in Korea, and 100 percent in Brazil. We do not think the modest AMT reform of 1993 would change these conclusions.

Capital costs and capital formation remain critical concerns to our industry. In spite of the progress made in recent years, U.S. steel producers still face numerous competitive challenges, including (i) foreign companies that rely on government subsidies, dumping, closed markets and cartel behavior, (ii) large new costs to comply with U.S. environmental rules, and (iii) high pension and health care legacy costs. Under these circumstances, the last thing we need is an anti-competitive tax that penalizes investment, raises the cost of capital, and impairs capital formation.

The AMT is hitting the wrong people for the wrong reasons. It was enacted to ensure that no corporation with substantial economic income could deliberately structure its finances to avoid tax liability. Instead, it is placing capital-intensive, low-profit U.S. steel companies at a severe competitive disadvantage -- not only against non-AMT paying domestic producers of competing materials but against foreign competitors, who pay no income tax when they have no profits and whose depreciation is not subject to an AMT.

Congress knows the problems. The AMT is imposing a tremendous administrative burden, because it requires numerous depreciation and inventory calculations. It is inherently inequitable, because it is providing vastly different tax treatment to similar investments made by similar taxpayers. It is acting as a competitive drag on U.S. manufacturing. It is penalizing in particular those companies that invest the most in relation to their profits. It is impeding new investment by many companies, because the AMT's depreciation add-back is applied retroactively. And by denying the use of pre-paid regular tax -- i.e., AMT credits -- at all, or within a meaningful time frame, the value of these credits is rendered worthless. It is time for additional, substantial AMT reform.

AMT Reform: What Congress Should Do

Mr. Chairman, it is clearly our view that further, significant AMT reform should be your highest tax policy priority at this time. Therefore, should Congress choose not to adopt the proposed NCRS, we would ask that you carefully consider our recommendations on ways in which the AMT can be changed to achieve some of the same goals as NCRS.

With respect to AMT reform, we ask you to consider the following principles -- that: capital cost recovery provisions should promote, not impair, manufacturing investment and competitiveness; recovery under the AMT should be no longer than under the regular tax; AMT credits should be made available to companies that find themselves in the AMT; the regular corporate income tax should be the dominant tax regime for all taxpayers over an extended period of time; and under no circumstances should expenditures for non-productive pollution control and abatement equipment be subject to the AMT.

Given these principles, we urge that Congress do three things:

- **First, make the AMT's anti-competitive capital cost recovery period consistent with that of the regular corporate tax for investments in long-lived assets.** This would help mitigate the discrimination -- and the penalty -- that the AMT now imposes on investment. Such a change would be less complex to administer than the proposed NCRS and, viewed from a cash flow perspective, many AMT payers might prefer the certainty of a shorter recovery period to potential NCRS benefits. If Congress still wants to maintain an AMT penalty, it would be more than sufficient to limit it to a slower write-off method (150 percent declining balance for AMT versus 200 percent declining balance for regular tax).

- **Second, change the way the AMT credit operates to make it usable for industries such as steel.** The AMT was never intended to tax capital investment at a higher rate than the regular tax on a permanent basis. But this is exactly what happens when AMT payers are denied use of the credit. Since many AMT payers will not have enough regular taxable income to utilize their AMT credits fully in a meaningful time frame, a mechanism should be established to allow partial utilization of credits against AMT liability. In the past, AMT-paying companies have supported legislation to permit taxpayers with certain unused minimum tax credits to offset up to 90 percent of the total of current year regular and net minimum tax liabilities. This would monetize these credits and thus decrease the cost of capital. It would also stimulate economic growth by liberating funds for additional capital investment.

- **Third, exclude investments in environmental equipment from the AMT's depreciation add-back calculations.** Such investments inevitably reduce the money available for modernization projects to improve productivity and competitiveness. That is why there are good reasons to consider the immediate expensing of non-productive pollution control and abatement equipment. At the very least, such expenditures should be excluded from the AMT's restrictive depreciation calculations.

New Anti-Competitive Taxes: What Congress Should Avoid

Turning to another issue of long-standing concern to steel, AISI is especially pleased that the *Contract* takes a strong stand against new anti-competitive taxes. In the 1993 debate over the proposed BTU tax, we think one key message was that the United States must avoid imposing a layer of new costs on U.S. producers of domestic and exported goods -- cost increases that are not borne by imports and foreign competitors.

New energy taxes are of obvious concern to the steel industry, because steel remains America's largest industrial user of energy, accounting for about three percent of all of the energy consumed annually in the United States. Purchases of energy account for roughly 20 percent of the cost of manufacturing a ton of steel. And most of this energy -- including electricity -- is derived from carbon fuels such as coal, natural gas and oil, which remain essential inputs in the steelmaking process.

Steel has been doing its part to help create a cleaner environment that uses less energy; the Institute's U.S. members have achieved a reduction of over 40 percent in energy consumption per ton of steel shipped since 1975. Our main concern is that new energy taxes in the U.S. not impose a solution to national -- and global -- energy and environmental problems that would make U.S. manufacturers less competitive. For example, the direct and indirect effects of the proposed BTU tax -- even with the suggested exemptions -- would have added at least several hundred million dollars to steel's annual operating costs.

Western Europe has taken steps -- including industrial user exemptions -- to ensure that its manufacturers are not harmed by efforts to promote a cleaner environment and energy conservation. Still, U.S. proposals continue to surface that would cost jobs and impose unilateral burdens on manufacturers in the United States.

Examples of recent suggestions for new anti-competitive taxes include proposals for (i) a 125% increase in the inland waterways fuel tax, (ii) a new hard rock minerals tax, (iii) a 200% lead tax, and (iv) a higher tax on vessels and cargo which, as part of maritime reform legislation, actually passed the House in 1994. All of these would have had serious adverse impacts on the United States steel industry. With your help, none will become law this year.

The System Is Broken: The Need to Study Fundamental Tax Restructuring

Of course, not all taxes are anti-competitive, and that brings us to a final issue of concern -- the prospects for systemic reform. Mr. Chairman, you said recently that you have "just about given up hope" that the present income tax system can be reformed. As AMT payers, we strongly agree with you that the present tax system is broken and that the issue of crafting an entirely new approach as a replacement to the current system deserves further study.

Most of AISI's focus over the past several years has been on studying the pros and cons of a substitute "border-adjustable" tax (BAT) -- a tax applied equally to domestic production and imports, but not to exports.

Our chief interest has been on the international competitiveness aspects of a BAT. The United States is virtually the only major economy in the world that does not use some form of GATT-legal BAT on business activities in its territory. In Western Europe, Japan and other markets, U.S. exporters and the products they sell face a BAT upon entry. But in the U.S. market, foreign companies are not required to pay a BAT on the goods they sell here -- and they get a rebate of their own government's BAT when their products leave as exports.

Take the North American Free Trade Agreement (NAFTA) as another example. While NAFTA will eventually eliminate duties on intra-NAFTA exports of steel and other products, U.S. exports will continue to be charged a seven percent goods and services tax upon entry into Canada and a 15 percent value-added tax (VAT) upon entry into Mexico. At the same time, these taxes will continue to be rebated for Canadian and Mexican exports to the United States.

These examples show that there are good reasons to think that, if properly constructed, fundamental tax reform through a substitute BAT could

lower the cost of capital, simplify the U.S. business tax code, improve U.S. competitiveness, promote U.S. exports, and provide additional revenue (from imports) for deficit reduction and other important national goals. In addition, BAT proponents say that this could all be done without raising taxes for U.S. businesses or causing significant price hikes for U.S. consumers. In other words, they believe that a BAT need not have the adverse impacts of a European Union-type VAT, which is applied at every stage of production as well as to the end-user.

At the same time, some important concerns have been raised about fundamental tax reform through a BAT, especially as regards transition rules. To be acceptable, therefore, fundamental tax reform must conform to certain key principles. Among other things, it should: (i) replace current and proposed taxes on U.S. companies, so that there is no net tax increase on U.S. businesses; (ii) provide for immediate expensing of new plant and equipment purchases; (iii) be simple and relatively easy to administer; (iv) be border-adjustable; and (v) insist on good transition rules that would allow U.S. businesses to maintain tax assets or credits (e.g., net operating loss carryforwards and AMT credits) that they have accumulated under the current system.

Mr. Chairman, as you proceed to study the pros and cons of an entirely new approach to our existing business tax system, AISI stands ready to help in any way we can.

Conclusions

To summarize:

- AISI supports the NCRS proposal in the *Contract with America* designed to encourage new investment by U.S. companies; it's a good step in the right direction, because it markedly improves depreciation under the AMT, the world's slowest capital cost recovery system.

- AISI places the highest tax policy priority on additional, substantial AMT reform; this is one the most important things Congress can do to keep the U.S. economic recovery going.

- Should Congress choose not to adopt NCRS, we suggest strongly that it reform the AMT by (i) conforming its recovery period to that of the regular tax, (ii) making AMT credits usable, and (iii) excluding environmental investments from the AMT.

- With respect to other issues of concern to the steel industry, we are grateful that the *Contract* opposes imposition of new anti-competitive taxes (e.g., energy taxes), and agree with the Chairman that the issue of fundamental tax restructuring deserves further study.

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We thank the Committee for this opportunity to present the views of AISI's U.S. member companies on tax policy issues of growing importance to the United States steel industry.

Chairman ARCHER. Thank you, Mr. Usher.

Our next witness is Andrew Sigler, CEO of Champion International.

Welcome.

STATEMENT OF ANDREW C. SIGLER, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, CHAMPION INTERNATIONAL CORP., STAMFORD, CONN., ON BEHALF OF THE AMERICAN FOREST & PAPER ASSOCIATION

Mr. SIGLER. Thank you, Mr. Chairman. And thank you for giving us this opportunity today.

I represent the American Paper & Forest Association and Champion. I will attempt to make my comments principally from the position of Champion. I have to say, that the first thing I would do is second the testimony of Tom.

One of the things that I think is important to remember when I listen to the comments of others here this morning, when you are talking about business, you tend to lump us together and we are all very different. We are a capital-intensive cyclical business, as is steel. We spend an enormous amount of money to gain the ability to sell one ton of paper. We produce a basic world commodity, and our profitability will always flow up and down with cyclical swings of the U.S. economy, and for both of our industries, the world economy.

Our tool is capital spending. We have to spend to make money. It is not a matter of stopping spending, because technology changes. We spend an immense amount of money to keep and maintain the equipment that we have.

We spend the money on new technology to make us more competitive. We spend an immense amount of money on new technology, to meet the requirements that we have on the environmental side. So it is not a matter of saying we will spend or we will not spend. That is the tool we use. And we think the way that tool is treated by the tax laws makes it very difficult for us compared to a lot of other businesses.

I will use 1986, because I want to make a comment about AMT, myself. Since 1986, we have spent more than $6 billion. In that time, we have created approximately 4,000 new jobs. These are high-paying, highly skilled, highly trained people. We have created jobs in regions with the construction and ongoing performance of the facilities that we built. It is a great economic plus for the small businesses that supply us at all stages.

I speak in support of the proposed neutral cost recovery legislation, on the basis that anything that can help us in the recovery of our capital is a positive thing.

I would like to speak a little bit more to the recovery side than the cost side. I don't believe that we make decisions on $1 and $2 billion mills based upon a fluctuation in the tax rate, et cetera.

We make investing when we have the available cash, and the speed of recovery of our capital is a lot more important, personal opinion, than the cost of our capital. But we tend to lump them together and we have talked more about cost than we have about recovery of investment. Certainly, this bill addresses both.

We have the same concern that has been expressed before, about the lack of confidence that these proposed cost recovery rules will stand up over an extended period of time. They certainly haven't in the past.

I want to make a specific comment, and I don't want to repeat what Tom has said, but the 1986 enactment of AMT has created a very difficult thing for our company. We have been on AMT for the last 6 years.

I don't know that we will ever get off it. That means that the recovery of our capital is pushed out to the furthest point, which is probably, in our case, 13 to 14 years. AMT forced us to pay taxes when we were losing money. We were only making money if you assumed that depreciation is income, as the AMT does. So we could not take advantage of even current law incentives for investment, nor could the vast majority of the paper industry, because of AMT.

So we like to talk about the theory of improved cost recovery, and I think the proposal is different and it makes a lot of sense, but it is academic to us, because AMT lays out there. And until some adjustments are made in AMT treatment of depreciation, we will not be able to take advantage of anything that you might do under the regular tax.

Thank you very much.

[The prepared statement and attachment follow:]

STATEMENT ON "CONTRACT WITH AMERICA"

ANDREW C. SIGLER
CHAIRMAN & CHIEF EXECUTIVE OFFICER
CHAMPION INTERNATIONAL CORPORATION

BEFORE THE

HOUSE COMMITTEE ON WAYS AND MEANS

JANUARY 26, 1995

Mr. Chairman and Members of the Committee, I appreciate very much your invitation to be here today to discuss the opportunities facing this nation for continued economic growth and job creation through increased investment in productive plant and equipment. I commend you for including this issue as one of your first 100-day agenda items. I am speaking to you today, not only as a representative of my company, but on behalf of the American Forest and Paper Association[1]. You will not find a stronger supporter nor a better example of the role of investment in creating good, high-paying manufacturing jobs than the industry represented by this association.

I have been the CEO of a major forest products company for some 20 years now and have seen many changes in tax policy designed to motivate one type of behavior or another over the years. I can tell you from experience that the tax code does make a difference. It can either encourage or discourage new investment. Today, I believe the tax code discourages new investment, particularly because of the broad scope of the corporate Alternative Minimum Tax (AMT).

The pulp and paper segment of the industry is one of the most capital intensive[2] and internationally competitive industries in the world. We have invested more than $130 billion in new pulp and paper production and pollution prevention equipment since 1980. This amount accounts for about ten cents of every sales dollar from paper products, the highest reinvestment rate of any U.S. manufacturing industry.

This industry is also a great example of the positive effect of investment on productivity. As a result of our investment, productivity has improved dramatically, costs are down and this industry is a strong global competitor. That doesn't mean, however, that we can become complacent. Industry technology is rapidly changing, world-wide competitors are proliferating, and proposed government regulations require new environmental technologies to be adopted.

Because of the requirements of global competition, technological advances and environmental protection, the industry must continuously reinvest large amounts of capital, yet the current tax code discourages that investment in a number of ways. Compared to our international trading partners, the U.S. tax

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[1]The American Forest and Paper Association (AF&PA) is the national trade association representing producers of paper, pulp, paperboard and wood products, as well as the growers and harvesters of this nation's forest resources. The industry has over $200 billion annual sales, employs 1.6 million workers, has an annual payroll of $49 billion, and is among the top ten employers in 46 states. Forest products represent more than seven percent of U.S. manufacturing output.

[2] Each employee in the pulp and paper business is supported by $123,000 of plant and equipment.

code is significantly less favorable for investment.[3] The enactment in 1986 of AMT, plus the loss of the investment tax credit and capital gains rate differential, and the lengthening of recovery periods under regular tax depreciation have all raised the cost of capital and reduced the funds available for investment in job creating assets. This trend of recent tax changes must be reversed to provide more favorable and predictable treatment of investment.

The forest products industry strongly supports the goals of the "Contract with America" and its proposed Neutral Cost Recovery System (NCRS). We have long advocated more favorable cost recovery rules and commend the Committee for seeking tax changes to increase productivity and economic growth. We believe that in the long-run increased investment is the best way to improve the standard of living for all Americans.

Pulp and paper manufacturing assets are relatively long-lived, with recovery periods under the regular tax of seven years and 13 years under the AMT. Since it takes so long to recover the cost of investment for tax purposes, there is significant loss in the value of depreciation deductions due to inflation and the time value of money. We believe that NCRS, if enacted and left unchanged for years to come, would prove quite beneficial in two ways. (See attached table.)

First, NCRS would take a significant step toward removing the AMT penalty from future investment and could be an important step toward ensuring that investments in similar assets are treated in a like manner regardless of the profitability of the taxpayer. Second, it would allow us to more aggressively replace old and outdated equipment, meet capital demands for environmental spending, and would enable this industry to be internationally competitive well into the next century. The benefits of being competitive ultimately flow to American workers through development of new job skills that make them more valuable and lead to increased wages.

Our primary hope, however, is that you will make improvements to the cost recovery system that will be sustainable over a long period of time. The frequent changes in the tax law only create uncertainty in planning for new investment and ultimately make the tax code less effective in motivating positive behavior. We recall all too clearly and all too painfully, the roll back of investment incentives in 1986 and the retroactive impact of AMT which changed the economics of many investments in the 1980s after they had already been made.

If budgetary or political constraints require your Committee to fine-tune or possibly even consider alternatives to NCRS, I hope you will at a minimum try to make improvements to what I believe is the most detrimental aspect of the current tax law with respect to investment – the anti-capital bias of the Alternative Minimum Tax.

Much of the forest products industry is subject to AMT simply because of the amount of investment required to be competitive. In fact, my company has been paying AMT since 1987, when it was first effective. The combination of high investment and cyclical profits has meant that the $4.7 billion of investment in plant and equipment that Champion has undertaken since 1987 has been severely penalized by AMT.

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[3] Special Report, "The Impact of the Alternative Minimum Tax on Investment and Economic Growth," Table 2, American Council for Capital Formation, Washington DC, November 1990.

Under the AMT, our assets are subject to the worst capital cost recovery system among our major international trading partners. In fact, the AMT directly increases the cost of capital for pulp and paper manufacturing assets by some 10 percent over what it would be under the regular tax system.[4] This is due in large part to the extended recovery periods under AMT, which are about twice as long as that used for regular tax purposes.

The AMT is particularly pernicious because a company is hit hardest when it can least afford it. AMT increases taxes when profits decline and cash flow is constrained. Yet most capital intensive companies cannot simply stop investing because profits have temporarily fallen. The investment must be completed in order to generate income in the future. As a result, companies can pay the AMT penalty on investment even when they may actually be losing money.

When the economy improves and a company's profitability returns, its AMT problems are not necessarily over. Often, the company does not have enough regular taxable income in the short-term to fully offset the large amounts of AMT credits that have been generated in bad economic times. This is particularly the case for the forest products industry. At some point during the past five years, almost every forest products company was in an AMT position.

When the law was originally written, Congress did not intend for companies to incur a permanent tax increase as a result of AMT, so they created a credit for the difference between AMT and regular tax liability. This credit can only be used to offset future regular tax liability. The problem with this credit, however, is that many companies have accumulated so many credits that they will not be able to use them in a meaningful time frame. When they can finally use them, the credits will be of little value due to inflation and the lost alternative use of the money. Consequently, many companies are providing the U.S. government with an indefinite interest-free loan.

The proposed NCRS does in fact provide improved depreciation for both regular and AMT firms and, therefore, the forest products industry supports its enactment. The proposal does not, however, completely eliminate the AMT penalty on investment. There will still be a significant cash flow difference between AMT and regular tax depreciation because of the extended length of the recovery period under the AMT.

Should your Committee decide to make changes to NCRS or consider alternative proposals to encourage investment, we would recommend that priority be given to reform of the AMT. One possibility would be to conform AMT recovery periods to those under the regular tax.

Additionally, and perhaps more long-term, we hope the Committee will consider solutions to other AMT problems such as the inability of taxpayers to fully utilize AMT credits in a meaningful time frame.

I appreciate the opportunity to comment on the employment and investment aspects of the "Contract with America" and I applaud you for taking this first step toward putting our nation on a path toward sustained economic growth and new job creation.

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[4] Special Report, "The Impact of the Alternative Minimum Tax on Investment and Economic Growth," Table 1, American Council for Capital Formation, November 1994.

TABLE A

Effect of NCRS on Pulp and Paper Manufacturing Assets

7 year -- Regular Tax Depreciation
13 year -- AMT Depreciation
per $100 of investment

Year	Regular Tax Amount	AMT Amount
1	10.71	5.77
2	20.45	11.62
3	17.18	11.00
4	14.97	10.40
5	16.00	9.83
6	17.10	9.48
7	18.28	10.13
8	9.77	10.82
9		11.58
10		12.37
11		13.23
12		14.12
13		15.11
14		8.06
Total	124.46	153.52
Discount rate*	7.46%	7.46%
Present Value of costs recovered	94.51	93.53

*November 1994 Long-Term Govt. Bond Rate

Chairman ARCHER. Thank you, Mr. Sigler.

Our last witness of this panel is Donald Schapiro, partner with Chadbourne & Parke in New York.

Mr. Schapiro, we are delighted to have you with us.

Welcome.

STATEMENT OF DONALD SCHAPIRO, PARTNER, CHADBOURNE & PARKE, NEW YORK, N.Y.

Mr. SCHAPIRO. Thank you, Mr. Chairman and members of the committee. I appreciate the opportunity to testify before this hearing.

I am a practicing lawyer in New York City and I am appearing here today in my individual capacity as a person who is familiar with the tax law. I work with it every day and I have done that for a long, long time.

My testimony is directed to what may be the unpopular technical subject of the technical aspects of this bill. It is not directed to the economic issue of lowering the cost of capital. I would like to talk with you about and share with you some views I have about the language of the bill, how it works and what it does as a matter of sound tax policy.

I would ask you to bear with me and to refer to my testimony. There are some tables there which I would like to talk about because you cannot really understand this unless you look at numbers, or at least I cannot. So I would like to ask to you look at numbers. It is not talking about budgets, it is just talking about numbers and depreciation, the way businesspeople would see it out there.

Let me start out by saying that the proposed system would give taxpayers extra depreciation deductions for tangible property placed in service after December 31, 1994. These extra deductions would not reduce the cost basis of property and would not be subject to recapture.

They are really very much like tax credits. And to understand what the bill does, technically, one must understand what a tax credit does. And—my prepared testimony tries as best it can to explain that.

Now, I am going to use the phrase "NCR bonus depreciation" to refer to these extra deductions which come and which don't reduce basis. Now, there are two kinds of these bonuses in the bill. One is automatic and applies only to property having a cost recovery period of 10 years or less. That is the 1.035 inflater.

The other kind applies to all property, including that benefited by the 1.035 inflater, and is indexed to inflation.

I would ask you to now bear with me. It is really only 2 minutes or so that I would ask you to do that, to turn to the tables in my testimony—so that at least I can demonstrate how this works.

Now, on exhibit 2, on page 5, the first column is years. The second, third, and fourth columns, (a), (b), and (c), show inflation rates which is just really a mathematical thing on a calculator. And it shows that $1 invested at 3.5 percent would grow, for example, in 39 years to $3.70. That is table (a). Or at 5 percent, to $6.39 or at 7 percent to $13.08.

Let me now ask you to look at line 10 of that table, year 10. That says that a dollar invested at 3.5 percent inflation rate would grow to $1.36 and $1.55 and $1.84. The NCR inflation bonus is 36 percent of the depreciation taken in the 10th year, at a 3.5 percent assumed rate of inflation; 55 percent, at a 5 percent assumed rate of inflation and 84 percent at a 7 percent assumed rate of inflation. That is the added bonus measured by the otherwise allowable depreciation.

Now, if you look at 15 years down the line in columns (d), (e), and (f). you see that at a 3.5 percent rate of inflation it is 62, 98 and 158 percent going across. If you combine the two, both the automatic and the other, that is combined in the table below. And for 10 years, you would get an additional bonus depreciation of 85 percent at one assumed rate of inflation, 110 percent at another and 150 percent at another. Which means that is the extra deduction.

Now, the tax value of these extra deductions is set out on the following page, and you can trace it through.

Let me just say, as a matter of technical tax policy, the committee should consider that under a system like this, with increasing amounts of depreciation deductions as property ages, the taxpayer would have an incentive to keep old property. Unlike the investment tax credit, this does not encourage new investment. It encourages keeping old, worn-out stuff because if you throw it out, you lose these bonuses. This is like a wine cellar, the older the wine, the better, because it keeps generating these extra bonuses.

The second thing to keep in mind is the fact that debt is not indexed, which is a point previously made, and that produces unfairness. The rest of the comments I have are in my prepared statement.

[The prepared statement and attachments follow:]

Testimony of Donald Schapiro, New York, NY
January 26, 1995

My name is Donald Schapiro. I am a partner of the law firm of Chadbourne & Parke in New York City, and a visiting lecturer in law at Yale Law School. I am appearing today in my individual capacity as a person familiar with the tax law.

Section 2001 of H.R. 9, (the "Bill") would amend the depreciation deduction provisions for property placed in service after December 31, 1994.

(1) It would substitute the 150% declining balance method for the 200% declining balance method for tangible property having a recovery period of ten years or less. Property otherwise depreciated at 150% declining balance or under straight-line depreciation would retain the existing method of depreciation.

(2) As an offset to the detriment to taxpayers from the switch from the 200% to 150% declining balance method, the amount allowable under the 150% method in each year for property so switched would be increased by an exponential factor of 1.035 which is shown in column (a) of Exhibit 2 attached. The effect of this change is illustrated in line 3 of Exhibit 1 attached.

(3) In addition to the increase in depreciation deduction based on the 1.035 factor described in (2) above, there would be an increase in annual depreciation deductions, as increased by the 1.035 factor where applicable, to reflect an indexing for inflation. This inflation indexing increase would apply irrespective of the recovery period of the property. Thus, it would apply to property covered by the 1.035 factor as well as property with a longer life, including real estate. The effect of this change would depend on the rate of future inflation and the period of depreciation. Exhibit 2 attached shows how the increased deduction would be calculated assuming annual inflation indexing of 3.5%, 5% and 7%, without taking into account the 1.035 factor. Exhibit 3 attached combines the 1.035 factor with various assumed rates of inflation indexing.

(4) I will refer to the combined extra depreciation allowed under the 1.035 formula and the inflation indexing as the "NCR Bonus" (*i.e.*, bonus depreciation under the neutral cost recovery system). Where a separation between the elements is relevant, I will distinguish between the 1.035 factor NCR Bonus and the inflation indexing NCR Bonus. The NCR Bonus does not reduce the basis of the property; nor does it increase the amount subject to recapture at ordinary income tax rates. Thus, while the NCR Bonus is referred to as a "deduction," it has the characteristics of a tax credit, calculated by multiplying each year's NCR Bonus by the taxpayer's federal tax rate.

(5) The existing federal tax system does not contain an equivalent type of "deduction-credit" concept, and so far as I am aware there has never been such a concept in the federal tax system. There are a number of problems which should be considered in this connection, including the following:

(a) As property ages, taxpayers would have an incentive to allow it to remain in service, because the NCR Bonus will be available each year the property is kept in service, and will grow with inflation. For example, assume property with a remaining cost recovery period of five years is being depreciated on a straight line basis at the rate of $100 a year before the NCR Bonus. If the property were abandoned, there would be a deduction of $500. On the other hand if the property is continued in service, there will be five years of NCR Bonuses available in addition to the $500 deduction.

(b) There could be an administrative problem for the Revenue Service in determining when property has been removed from service and the NCR Bonus ceases.

(c) The NCR Bonus is available for debt financed property and for leased property. Where leased property is debt financed, the NCR Bonus can amount to an inflation hedge for lessors. Assume, for example, property having a recovery period of 20 years is mainly debt financed and net leased to a user for an annual rental equal to the debt service. In such a case, the higher the rate of inflation, the higher the NCR Bonus each year to the lessor, even though the lender is bearing the risk of inflation. Possibilities such as this suggest that tax sheltering may be increased as a result of the Bill.

(d) It will presumably be necessary for all taxpayers to accumulate additions to the cost of an asset in annual segments, because each year's additions to cost will presumably start their own NCR Bonus calculations. The required computations are likely to be complex and may be difficult to audit.

(e) The NCR Bonus system is likely to influence the manner in which assets are bought and sold. Thus, where an older NCR-qualified asset is held in corporate form, a transfer by a stock sale would be much more advantageous, because the NCR Bonus entitlement would not be lost. This sort of transferability could generate tax shelter activity. The Committee may wish to consider whether a provision like section 382, which is designed to discourage traffic in tax losses, might be appropriate.

(f) Taxpayers will place great stress on avoiding loss of NCR Bonus due to terminations of partnerships and other transfers of property. A similar problem arose on the recapture of investment credits, but the recapture was for only seven years at decreasing amounts, and did not apply to real estate.

(g) The anti-churning rules referred to in sub-section (k)(6) are not reprinted in the present Internal Revenue Code. These rules were not designed for NCR Bonuses. They are not wholly clear, and only proposed Treasury Regulations have been published under them. I strongly recommend that these rules be carefully reviewed, enacted as part of the current code, and illustrated with a detailed committee report. They are the first line of defense against transactions which are not intended to be covered, and should be examined with care and clearly explained. Further, rules should be provided as to which types of transfers will allow the transferee to step into the shoes of the transferor as to retaining entitlement to NCR Bonuses.

(6) The Ways and Means Committee may wish to consider whether the NCR Bonus should be modified where property is debt financed and whether special attention should be paid to the passive loss rules, traffic in corporations holding old NCR Bonus property, and other tax sheltering opportunities. Potential administrative difficulties of determining when property has been removed from service might also be reviewed.

(7) The Committee might wish to review Exhibits 1, 2, 3 and 4 attached to determine whether the benefits of the NCR Bonus should be changed. For example, Exhibit 4(a) shows that real estate with a 39 year recovery period will generate aggregate tax savings over the 39 period due to the NCR Bonuses of 67.4% of its original cost assuming a 5% rate of inflation and 1.316 times its original cost assuming a 7% rate of inflation. Exhibit 4(b) shows that 10 year recovery property depreciated at 150% declining balance will generate aggregate tax savings over the 10 year period due to the combined NCR Bonuses of 15.2% of its original cost assuming a 5% rate of inflation and 19.9% of its original cost assuming a 7% rate of inflation.

Table showing effect of 1.035 factor only on property with recovery periods of 3,5 and 10 years. The calculations assume a cost of $1,000

Line	3-Year Recovery Period	Year 1	2	3	4	5	6	7	8	9	10	Total
1.	200% declining balance depn	667	222	111								1,000
2.	150% declining balance depn	500	250	250								1,000
3.	1.035 factor NCR Bonus[1]		9	18								27
4.	Cumulative 200% declining balance	667	889	1000								-
5.	Cumulative 150% declining balance	500	750	1000								-
6.	Excess of line 4 over line 5	167	139	-								-
7.	**Aggregate extra tax paid at 35% at start of current year for full year**		58.45	48.65								-
8.	**Value line 3 at 35%**		3.15	6.3								9.45
9.	35% tax gross-up (line 8 x 1.54)		4.85	9.7								14.55
10.	**Line 9 as a % of line 7**		8.3%	20%								-

[1] Total neutral cash recovery depreciation adjusted for the 1.035 factor is the amount in line 2 multiplied by the factor shown in Exhibit 2 for a 3.5% inflation rate. Line 3 in each table is the excess of this total over line 2.

Line	5-Year Recovery Period	Year 1	2	3	4	5	6	7	8	9	10	Total
1.	200% declining balance	400	240	144	108	108						1,000
2.	150% declining balance	300	210	163	163	164						1,000
3.	NCR Bonus		6.7	11.6	17.8	24.2						60.3
4.	Cumulative 200% declining balance	400	640	784	892	1000						-
5.	Cumulative 150% declining balance	300	510	673	836	1000						-
6.	Excess of line 4 over line 5	100	130	111	56	-						-
7.	**Aggregate extra tax paid at 35% at start of current year for full year**		35	44.5	38.8	19.6						-
8.	**Value line 3 at 35%**		2.34	4.06	6.23	8.47						21.1
9.	35% tax gross-up (line 8 x 1.54)		3.6	6.25	9.6	13.0						32.45
10.	**Line 9 as a % of line 7**		10.3	13.7	24.7	66.3						-

Line	10-Year Recovery Period	Year 1	2	3	4	5	6	7	8	9	10	Total
1.	200% declining balance	200	160	128	102	82	66	65	66	65	66	1,000
2.	150% declining balance	150	128	109	92	87	87	87	87	87	86	1,000
3.	NCR Bonus		4.5	7.7	10.0	12.9	16.4	19.9	23.8	27.6	31.6	155.4
4.	Cumulative 200% declining balance	200	360	488	590	672	738	803	869	934	1000	-
5.	Cumulative 150% declining balance	150	278	387	479	566	653	740	827	914	1000	-
6.	Excess of line 4 over line 5	50	82	101	111	106	85	63	42	20	0	-
7.	**Aggregate extra tax paid at 35% at start of current year for full year**	-	17.5	28.7	35.3	38.9	37.1	29.8	22	14.7	7	-
8.	**Value line 3 at 35%**	-	1.6	2.7	3.5	4.5	5.7	7.0	8.3	9.7	11.1	54.1
9.	35% tax gross-up (line 8 x 1.54)	-	2.4	4.2	5.4	6.9	8.8	10.8	12.8	14.9	17.1	83.3
10.	**Line 9 as a % of line 7**	-	13.7	14.6	15.3	17.7	23.8	36.2	58.2	101	244	-

Table showing annual amount to which $1 would grow at various assumed rates of inflation (columns (a),(b) and (c)); and the annual inflation indexing NCR Bonus amount as a percentage of the depreciation deduction without the NCR Bonus (columns (d), (e) and (f))

	Amount to which $1 would grow at various assumed rates of inflation			Inflation indexing NCR Bonus as a percentage of depreciation deduction without any NCR Bonus		
	(a)	(b)	(c)	(d)	(e)	(f)
	Rate of Inflation			Rate of Inflation		
Year	3.5%	5.0%	7.0%	3.5%	5.0%	7.0%
1	0	0	0	0%	0%	0%
2	1.035	1.05	1.07	3.5	5	7
3	1.07	1.10	1.14	7	10	14
4	1.11	1.16	1.23	11	16	23
5	1.15	1.22	1.31	15	22	31
6	1.19	1.28	1.40	19	28	40
7	1.23	1.34	1.50	23	34	50
8	1.27	1.41	1.61	27	41	61
9	1.32	1.48	1.72	32	48	72
10	1.36	1.55	1.84	36	55	84
11	1.41	1.63	1.97	41	63	97
12	1.46	1.71	2.10	46	71	110
13	1.51	1.80	2.25	51	80	125
14	1.56	1.89	2.41	56	89	141
15	1.62	1.98	2.58	62	98	158
20	1.92	2.53	3.62	92	153	262
25	2.28	3.22	5.07	128	222	407
30	2.71	4.12	7.11	171	312	611
39	3.70	6.39	13.08	270	539	1208

Table showing the amount of NCR Bonus Depreciation as a percentage of depreciation deduction without NCR Bonus, combining the 1.035 NCR Bonus and the inflation indexing NCR Bonus assuming various rates of inflation

Year	1.035 NCR Bonus Amount	1.035 NCR Bonus Amount combined with inflation indexing NCR Bonus at assumed rates of inflation shown		
	(a)	(b)	(c)	(d)
		3.5%	5.0%	7.0%
1	0%	0%	0%	0%
2	3.5	7.1	8.7	10.7
3	7	14.4	12.4	14.5
4	11	23.2	28.8	36.5
5	15	32.3	40.3	50.7
6	19	41.6	52.0	66.6
7	23	51.3	64.8	84.5
8	27	61.3	79.1	104.4
9	32	74.2	95.4	127.0
10	36	85.0	110.8	150.2

Table showing aggregate inflation indexed NCR Bonus and tax value at 35% tax rate assuming a $1,000 asset is depreciated straight line over years shown with various assumed inflation rates

Recovery Period In Years	Assumed Inflation Rates					
	3.5%		5%		7%	
	NCR Bonus	Tax Value	NCR Bonus	Tax Value	NCR Bonus	Tax Value
27.5	591	207	988	346	1709	598
39	1070	374	1926	674	3760	1316

Table showing tax value of 1.035 NCR Bonus combined with inflation indexing NCR Bonus at assumed rates of inflation for an asset of $1,000 with a 10-year recovery period

	1	2	3	4	5	6	7	8	9	10	Total
1. Annual 150% declining balance amount	150	128	109	92	87	87	87	87	87	86	1,000
3.5% Inflation											
2. Combined NCR Bonus Percentage, exhibit 3, column (b)	—	7.1	14.4	23.2	32.3	41.6	51.3	61.3	74.6	85	
3. Line 2 times line 1	—	9.0	15.7	21.3	28.1	36.2	44.6	53.3	64.9	73.1	
4. **Tax value of NCR Bonus (35% of line 3)**	—	3.2	5.5	7.5	9.8	12.7	15.6	18.7	22.7	25.6	**121.3**
5.0% Inflation											
5. Combined NCR Bonus percentage, exhibit 3, column (c)	—	8.7	12.4	28.8	40.3	52.0	64.8	79.1	95.4	110.8	
6. Line 5 times line 1	—	11.1	13.5	26.5	35.1	45.2	56.4	68.8	83.0	95.3	
7. **Tax value of NCR Bonus (35% of line 6)**	—	3.9	4.7	9.3	12.3	15.8	19.7	24.1	29.0	33.4	**152.2**
7.0% Inflation											
8. Combined NCR Bonus percentage, exhibit 3, column (d)	—	10.7	14.5	36.5	50.7	66.6	84.5	104.4	127.0	150.2	
9. Line 8 times line 1	—	13.7	15.8	33.6	44.1	57.9	73.5	90.8	110.5	129.2	
10. **Tax value of NCR Bonus (35% of line 9)**	—	4.8	5.5	11.8	15.4	20.3	25.7	31.8	38.7	45.2	**199.2**

Chairman ARCHER. Thank you, Mr. Schapiro.

Let me alert the committee that we are nearing a vote on the floor on the Barton constitutional amendment, so when the bells ring, we will continue for about 5 minutes with our inquiry and then we will break to go vote. We will return after the vote. I hope that our witnesses will bear with us and stay with us for the completion of the inquiry period.

There are many, many things I would like to ask you, but I think I am going to defer to the members of my committee at this point. I am going to recognize and yield to Mr. Bunning for the first inquiry.

Mr. BUNNING. Thank you, Mr. Chairman.

Mr. Usher, I would like to ask you some specifics. You mention AMT increases your cost of capital. Do you ever take AMT into consideration when deciding whether you should or should not make a capital expenditure?

Mr. USHER. We do. When we look at any type of investment, we have to be able to recover this cost, or it doesn't make sense for us to do it. And we have a list of things we would like to do that is a lot longer than the money we have. So quite often, we find ourselves deferring projects because they just don't provide a sufficient return to us.

However, if we had relaxation of the AMT, where we would be able to have capital expenditures depreciated, for example, over the same life as the regular corporate tax, there are investments that we probably would make that we currently don't make.

Mr. BUNNING. Mr. Sigler, why does the forest product industry seem more susceptible to the problems with the alternative minimum tax than some others?

Mr. SIGLER. Probably—first of all, we are very capital-intensive. In other words, it costs us more money to put in a pulpmill or paper machine for what revenue we would get as compared to other manufacturers. We are the largest in the world. We produce a basic world commodity and our prices swing up and down with the economy.

Our prices are almost auction prices. So we can end up with very large depreciation deductions in relation to our income, especially during a recession. Let's take the last 5 years where Champion spent $5 to $6 billion. We ended up with large AMT payments even though we broke even or incurred losses under normal financial accounting standards.

So AMT kicks in and the way it works, we add back as income what is called a depreciation preference item and then pay tax on it at a 20 percent rate. Grossly oversimplifying, but for us that is a cash out at a time when we can least afford it. Maybe we drive the prices up and down a little more violently, but it is those things that work together.

Mr. BUNNING. In your testimony, you suggested two changes in AMT, shorter recovery periods and a faster use of the AMT credit.

Mr. SIGLER. Well, you know——

Mr. BUNNING. Which one would you like first.

Mr. SIGLER. We would like expensing. And if you really get down to us, we think that those of us who are essentially in business to build things and use money, we think we should be able to expense

the same as others do their advertising and research and development budgets.

Short of that, my personal feeling is we ought to get rid of the AMT. It makes no sense. It was brought in to address a leasing problem in 1986 that doesn't exist today. Congress never intended for the AMT to trap companies and keep them permanently paying a higher rate of tax than under the regular tax, yet that is what it does today.

Short of that, I support recovering the investment faster. It takes us about twice as long to recover our investment than under the regular tax. I agree with Tom's comment we look at how fast we can recover cash in an investment and so I think improved AMT depreciation by shorter recovery periods would have the greatest effect on new investment.

Mr. BUNNING. Mr. Entin—this will end my questioning—when Assistant Secretary of Treasury Samuels was here, he argued that the neutral cost recovery might lead us to new tax shelters. Please respond to that for us, if you would.

Mr. ENTIN. Treasury always likes to match income and depreciation recapture, and tries to balance these things off over the life of a project. But very often when a firm has a new project or new product coming out, it doesn't achieve sales and revenues until some time later, but it takes some deductions immediately.

Treasury has gotten to the point where they say any time you have a deduction now that is bigger than your current earnings on your project, that is a tax shelter. That is nonsense. The term used to mean that somehow the writeoffs for a project over the life of the project were bigger than the cost of the project. And you could get something like that back in the bad old days when you had nonrecourse loans and you really did not have that much money at risk or back in the days when the investment tax credit might have been so big that it overcompensated for the underdepreciation in the depreciation schedules and you were giving companies back more than they were investing.

But to say that because in the short run a particular product might not have gotten into the market yet, and meanwhile you are depreciating some of the equipment, that there is a tax shelter, is outrageous. That is not what a tax shelter means. You have to look at the whole life of the project. Neutral cost recovery only allows a business to write off the full present value of the cost. It doesn't allow it to write off more than that.

There have been some concerned comments by the Treasury about interest and the lack of adjustment of interest and debt for inflation. There were comments here today. I think that is a mistake. The tax treatment that we give the purchase of a piece of equipment and then the earnings of that equipment is the tax treatment that applies to the actual economic activity of the firm. How the financing is done is something quite separate. A firm should be allowed to deduct the interest that it pays to the lender because the lender is being taxed on the interest. The two are a wash, and the debt financing is treated for tax purposes the same as internal financing. There is no shelter there. There is no distortion there. If we went all the way to a full-blown consumption tax like Nunn-Domenici or Mr. Armey's bill or Mr. Archer's approach,

one would not have to worry about the interaction between the borrower and the saver. For example, in the Nunn-Domenici bill, the saver would get a deduction for his savings and pay tax on the interest, and then the borrower would not need to be given a deduction.

But if you were not to give the saver his deduction for his expenses, or you were not going to exempt the saver from having to pay tax on the interest, then to tax the interest at the saver's side and the flow of capital at the business side is to double tax that income.

So this complaint is something which simply suggests that Treasury might be telling you either A, "We don't like the bill and we are coming up with excuses," or B, "You really ought to go the whole distance and solve this saver-borrower problem in addition to the depreciation problem."

Well, I don't think they want you to go full-blown reform. I think they are just making an excuse. In a full-blown system you would address the saver's problem, but it doesn't mean that you cannot handle the businesses' depreciation problem in the meantime. That is independent and should go forward.

Chairman ARCHER. The gentleman's time has expired.

Mr. Gibbons will be our last inquiry.

Mr. GIBBONS. Wouldn't it be simpler, better for all of you—as long as we cling to this old income tax system—if we just simply went to an expensing system on purchases of assets?

Mr. JORGENSON. I would like to respond to that.

I think that is exactly right. And I think that is precisely why it is very important for this committee to look at the neutral cost recovery system as essentially one element of a transition to a consumption tax.

Now, the key things you, and as Chairman Archer and others have pointed out in this committee many, many times, is the transition problem of going from an income tax system to a consumption tax system. The problems that are involved are formidable, as you just heard. And I think that is something that needs to be addressed. But I think the way to look at the neutral cost recovery system is that it is potentially one element in that transition to a consumption-based system.

Mr. GIBBONS. You would rather have expensing than any of the gimmicks we come up with here though, wouldn't you?

Mr. JORGENSON. Well, expensing involves a tremendous revenue loss, Mr. Gibbons. We have to address issues of the budget agreement and the deficit that have been brought before this committee. And in the process of the transition, those issues are going to have to be addressed. But in the long run, if you think about where the Tax Code ought to end up, yes, we ought to end up at expensing and we ought to take the other steps to eliminate tax deductibility of interest and the other things that have been discussed here to produce a completely neutral Tax Code. That should be our objective in the long run.

Mr. GIBBONS. Thank you.

Chairman ARCHER. Thank you gentlemen.

We will recess now to vote and we will come back as soon as possible. If you will indulge us and remain, we would appreciate it.

[Recess.]

Mr. BUNNING [presiding]. Our guests will take their seats, please.

Mr. Houghton will inquire.

Mr. HOUGHTON. Thank you.

I thank you gentlemen for being with us. I am sorry for the interruption, but I guess you understand the reasons.

I would like to ask a question to anybody, but particularly to Mr. Usher and Mr. Sigler.

I happen to agree with you on the alternative minimum tax. We have got to do something about this and I appreciate your comments. I would like to talk about the main focus of this hearing which is the neutral cost recovery.

Neutral cost recovery is really expensing on a present value basis. And the problem is this: That it is backloaded so you get a lesser depreciation today and a greater one later on. And also probably in the process you don't trust it. I mean, the government will get the benefit earlier on, and yet when the pinch comes, this thing will change.

So that is one problem. Now another problem, of course, is if you don't change that, and if you do keep it in place, you almost cannot do this thing alone. It is so generous, there is so much money, as a matter of fact, you probably could get into the same pit we got into before, where people were borrowing to put up buildings or to buy equipment which they didn't need because the advantage was so great. It is a huge impact.

So, the answer to that might be—and I am sure there will be great howls here—to eliminate the deductibility of interest. So you are really between a rock and a hard place here, and I would like your comments on it.

Mr. USHER. Well, I recognize the problems that you have mentioned. And what I would say is that, while certainly a lot of the concepts in the NCRS are appealing to us, we find ourselves—and I think this is unique to a lot of manufacturing businesses that are very capital-intensive, cyclical, and that must compete in a world market—the problem we have is that the technology in our business changes quickly.

We need to continue to invest. And in the steel industry, for example, we are going through a whole phase of new technology. We are either going to invest in this or we are going to be left behind, and the steel needs of this country are going to be supplied by Japan, Korea, Italy, or whatever. We need to have a system that allows us to quickly recover that capital.

Now, probably from our perspective, the easiest way to accomplish that would be to just reduce the AMT life down to the same as for regular taxpayers—7 years instead of 15 years. It would be relatively simple and allow us to continue to invest in this business.

Absent that, we are going to see, I think, a continually eroding manufacturing base in this country. And I strongly feel that, while there is a great move to go to high technology, the manufacturing base in the United States is important. In addition, these high-tech producers sell to us. They can only sell so many home computers. They have to sell to us.

So I think from our perspective, we recognize the problems with NCRS. We think Congress' appreciation that businesses, such as ours, need to recover their capital costs quicker is important. I guess our preference however, would be toward proposals that would allow us to reform the AMT. Most of the members of AISI are in a permanent AMT position. They are not going to get out of it and that is really where I think the emphasis needs to be directed.

Mr. HOUGHTON. Maybe rather than going through all of these contortions, it would be a better idea simply to take an expensing approach?

Mr. USHER. I certainly wouldn't argue with that.

Mr. HOUGHTON. How do you feel about it, Mr. Sigler?

Mr. SIGLER. Well, expensing is what we would really like. And I think that probably the fault we have is we come down here and we try to take into consideration what can be done and the things that are really yours to decide. I speak from a position of a company that has capital as its basic raw material. It is not development, it is not advertising, it is not people. It is capital. Expensing is the ultimate way of getting your money back and being able to use it again. We run our businesses off of cash flow.

And so I agree with Tom. If you look at what is the thing that bothers us most now, it is AMT. A lot of dollars that we could reinvest to create new jobs are tied up at the Treasury in excess taxes we are paying due to AMT. It is a lot of dollars.

Mr. USHER. We would also favor expensing. It is the practicality of it. So many other costs are expensed, it makes sense to expense these type of costs also.

Mr. HOUGHTON. Are there other comments that other members of the panel would like to make on this?

Mr. ENTIN. Expensing has the up front cost. At Treasury, you are going to get the same howling about interest and about tax shelters in a far more virulent form if you try expensing on them. That is not really the issue. Both of those complaints by Treasury are invalid.

Remember, the problems back in the sixties and the eighties came from an ITC that was too generous or nonrecourse loan problem. It did not come from the accelerated depreciation itself.

Mr. HOUGHTON. Thank you.

My time is up, thank you very much.

Mr. BUNNING. Mr. Zimmer will inquire.

Mr. ZIMMER. Thank you.

Professor Jorgenson, you said for purposes of equity and symmetry it would be appropriate, if we expensed the cost of equipment or went to net neutral cost recovery, for the interest costs of the taxpayer to be nondeductible. Have you looked into the practicalities of achieving that and how you link specific interest payments to a specific purchase and a specific piece of equipment? Is it possible?

Mr. JORGENSON. Mr. Zimmer, as I suggested, I think that the neutral cost recovery idea is a very good one, but it really has to be viewed in the context of the whole Tax Code, and in particular, it has to do with the issue that you just raised. And it seems to me that the only way to do that is through a comprehensive reform

aimed at shifting the base away from income toward expenditure. And within that context, obviously, eliminating interest deductibility would be an important element.

There are two proposals that are going to be before this Congress. One, the Armey flat tax proposal which was discussed in the last Congress. The other, the Nunn-Domenici proposal which has also been discussed, and both of them move in this direction and involve eliminating the deductibility of interest. So I am not proposing that one ought to look at neutral cost recovery and the elimination of interest expenses in isolation from the rest of the Tax Code. I think that you really have to look at this as part of a comprehensive reform.

Mr. ZIMMER. Logically speaking, you would have to go to the next step and say that the lender won't recognize any income.

Mr. JORGENSON. Right. As you realize, many of the lenders in this economy are people who are in a tax-protected position—people who essentially don't pay tax or they pay a modest amount of tax. Otherwise, it doesn't pay to clip coupons on bonds. So many of the securities that we think of as debt, in the sense that is used in the Tax Code, are securities held by lenders who are themselves not taxable. That is what creates the opportunities that we have been discussing for tax shelter and why an approach in isolation would not be a satisfactory one, in my view.

Mr. ZIMMER. Mr. Entin.

Mr. ENTIN. If you went all the way to consumption-based tax treatment, as for example in Mr. Armey's bill, the individual would not get a deduction for his saving, but he would not be taxed on his interest.

If you get rid of the deduction for interest at the corporate level or business level without simultaneously adopting something like the Armey approach to exempt interest at the lender level, you would be double taxing the interest in much the same way we double tax dividends.

The current treatment is correct if the lender is taxable. The borrower's interest deduction and the taxation of the lender's interest should both come off at once, or the interest deduction should remain until we go that extra route and eliminate the taxation of saving at the lender's level.

The only time you run into trouble is when you are borrowing from a charity or some other tax-exempt entity. But that distortion is not due to the way we treat business borrowing or the way we treat purchases of supplies and equipment. It is due to the fact that Congress said that charities shall be tax exempt. And they are exempt on their income whatever the source. If a wage earner takes wages out of his paycheck and gives it to the charity and takes the charitable deduction, the charity doesn't have to pay taxes on that income. Or the charity's income may be interest on a savings account or a government bond or a corporate bond. You shouldn't be altering the tax treatment of businesses because you have given a certain group of individuals in the economy tax-exempt status on any income they might get.

Mr. ZIMMER. We are running out of time, but I would like to put a flat question to all the members of the panel, once again comparing up front expensing to neutral cost recovery.

Do you see significant differences between the two proposals in terms of their macroeconomic effect and in terms of their long-term effect on Federal revenue disregarding any particular budget window?

Mr. CHRISTIAN. Mr. Zimmer, I think that expensing would be the preferred alternative. I think that is generally agreed. People think it is not impractical—that it is not practical. But let me make a point that it is merely a timing change.

NCRS gains revenue in the first 3 to 4 years as you know. It then loses a very large amount of revenue later on. Now, conversely, if you went to expensing for equipment placed in service in 1995 and thereafter, that would create significant—I don't know the number, but significant revenue losses for a number of years. Perhaps five. Don't hold me to that exactly. But expensing turns around very quickly relative to present law and starts producing, relative to present law, gains in the outyears.

And you have to think about that and it is very interesting in the context of trying to reach a balanced budget by the year 2005. You might find that expensing beginning in 1995 could fit better into that pattern than NCRS does, because the goal is a balanced budget in the year 2002, not a balanced budget in 1998 or 1997.

Mr. BUNNING. Mr. Cardin.

Mr. CARDIN. Thank you, Mr. Chairman.

Let me again thank the panelists. I think this discussion has been extremely useful and helpful. There appears to be certain agreement among all of you that the preferred route would be to expense. But we all know that as a practical matter is not what we can accomplish in this cycle, that we are not—we don't have the revenues on our scorekeeping and it is not practical.

Mr. Houghton raised some very interesting points about the neutral cost recovery system, and the potential costs to the Treasury. Mr. Shapiro has pointed out, I think, very well, that based upon what happens with inflation, we could have some very serious problems of freezing assets that are relatively old. And that could cause a problem.

But let me just raise what I think is the most serious problem, practical problem with the neutral cost recovery, and that is we are going to argue as to the costs. We are going to argue as to the economic assumptions.

There are going to be those who say that it will produce all types of economic benefits and, therefore, we should use dynamic scoring and not look at these outyear costs. There are going to be others who disagree with that and we are going to spend more time arguing over the economic assumptions and there is going to be a lack of confidence that we know what we are doing. And I would suggest that it is just not going to move forward.

On the other hand, dealing with the alternative minimum tax, we know what we are talking about. We know what impact it is going to have. We know what revenues it will in the short term cost the U.S. Treasury, and we can at least work off the same song sheet on AMT.

Now, we could maybe disagree as to whether this is an interim step or a final step, or whether we are moving toward expensing. But I would hope that, as we did in 1993, in making some progress

on the depreciation base, that we could try to develop priorities to make progress in this go-round. And it seems to me that the most practical, pragmatic approach is for us to deal with AMT first, rather than trying to argue over the economic assumptions of the neutral cost recovery system, which at best most businesses see as an interim step toward expensing.

I would appreciate your thoughts about it. It seems to me that we could come together on AMT, although I don't think we can on this neutral cost recovery, though that is just my observation. Does anyone wish to comment?

Mr. JORGENSON. Mr. Cardin, I think this committee really ought to proceed on each of these tax proposals within a framework in which the overall impact is neutral so far as the government budget is concerned. That was the approach that was taken in 1986.

I think that proved to be a very, very fruitful tack. That was an approach that led to what I believe to be the greatest achievement, as I said a couple of years ago, of this committee in this century, the 1986 Tax Act.

And I think that, therefore, pursuing your line of reasoning, rather than get involved in a lot of detailed discussion about dynamic and static scoring and that sort of thing, one ought to consider in this committee's proposals in an overall framework of revenue neutrality. If someone is coming up with a revenue loss of something that you have discussed or that the Treasury has put before us, one really ought to consider that in the face of other changes that are going to produce revenue gains.

Mr. CARDIN. I appreciate that. Of course, the $120 billion over the 10-year period that the Treasury has come up with for the neutral cost recovery, is an amount that it is going to be extremely difficult for any of us to agree to fill that void.

Mr. USHER. If you could do one thing in the near term, I think that lowering the tax life for the AMT taxpayer down to the normal taxpayer life would probably be as significant a change as you could make to help, and this would help an awful lot of basic manufacturing companies in this country.

Mr. SIGLER. I find it very stimulating to talk about all these cost recovery options, but from a practical point of view, the only thing that governs most of my life, is AMT. And it is the one thing I would consider negative to the company and to the economy.

Mr. ENTIN. It would be correcting an abuse that hits the AMT people harder than other people are hit by the current tax law. You wouldn't be doing anything to help the people that currently are not being hit by the AMT. Concerns about the inadequacy of static revenue estimation apply equally to AMT and to neutral cost recovery. Adopting NCRS and fixing the AMT both have outyear revenue effects that would appear less alarming with dynamic revenue estimation. Look at the outyear revenue effects. Within 10 years, Federal revenues will be, roughly, $2.4 trillion. Treasury is estimating that neutral cost recovery would cost $28 billion in the tenth year, which is 1 percent of revenue. If we get 1 percent additional growth of GDP out of this proposal, it ought to pay for itself.

Mr. CARDIN. If we correct AMT, we are going to have more unity in working toward expensing.

Mr. BUNNING. Ms. Dunn will inquire.

Ms. DUNN. Thank you very much, Mr. Chairman. I am sorry for the interruption.

Gentlemen, apparently Mr. Sigler, the questions I would have proposed to you having to do with the forest products industry and the particularly onerous effect on that industry of the AMT have been asked. I will simply look to the record for that and won't ask you to be repetitive, but I do want to ask you to apply some things to the creation of jobs in a State like my State, Washington State. How would improvements in depreciation under the AMT affect jobs?

Mr. SIGLER. I think you have to look at the company's general strength, cash flow determines what you have the capability of doing. If you can recoup the cost of an investment, for cash now, then new investments can be made. Cash flow is really what governs the ability to put in a sawmill or two or to make the large capital expenditures to improve a pulpmill or put in a new bleach plant. Those are the kinds of investments that create high-wage jobs, and provide economic growth and they are made based upon your ability to do it—cash flow.

When our costs are not recovered for 13 years, our decision to make new investment is much more dependent on the availability of cash flow than on what the total dollar cost may ultimately be. Because when you are in our kind of crazy business where the prices go up and down 100 percent each way, you don't make a capital investment that is going to take you 5 years to bring on line on, based whether it is 14.6 RDCI or 15.3. You make a lot of judgments and the most basic judgment is, can I pay for it? Cash. Not financial accounting, but availability of cash.

Ms. DUNN. Thank you, Mr. Chairman.

Mr. BUNNING. Mr. Hancock will inquire.

Mr. HANCOCK. Thank you, Mr. Chairman. I don't have any questions.

Mr. BUNNING. Mr. Rangel will inquire.

No questions?

Mr. Jacobs.

Mr. JACOBS. Mr. Chairman, the good news is I have no questions. The bad news is that Mr. Ford asked me to read two questions, and I agreed to do so. So, you cannot win for losing.

In summary, I think—now, let's see, Mr. Entin, I think he wants to direct this to you. Your summary of testimony states that the committee has curtailed the NCRS adjustment for long-life property and for structure. In fact, this committee has taken no action with response to NCRS. Are you referring to changes in the so-called Republican Contract and do you regard them as major changes?

Mr. ENTIN. I read in the papers that you were considering a version that would not apply full NCRS treatment to structures and longer lived assets, and I had thought that earlier versions did include them. If I have the timing of the change wrong, I apologize. But I wanted to make the point that the longer lived assets don't get the full treatment.

Mr. JACOBS. My mother thanks you, my father thanks you, but especially Mr. Ford thanks you.

The second question is for Mr. Schapiro. I believe that you are arguing that the neutral cost recovery system would create an incentive for taxpayers to keep property in service in order not to lose the ever-increasing depreciation deductions. Do you agree? And how would this phenomenon affect economic growth?

Mr. SCHAPIRO. Do I agree with that? Yes, but that is presumably not the question to me.

Mr. JACOBS. I have no authority to play favorites.

Mr. SCHAPIRO. I think that, yes, it seems to me that inevitably there is a tax credit which is provided for property as it remains in service. And the simplest case is real estate on straight line depreciation. Each year it is around, it just attracts this credit. It is just a tax benefit. It doesn't do anything else. And it doesn't reduce basis. So I would think there would be an incentive to keep these things around to keep the tax credit rather than sell it to somebody else who can use it.

Mr. CHRISTIAN. I would not agree with that, actually. I think my friend, Mr. Shapiro, is classifying the inflation adjustment and the interest adjustment as bonus depreciation. I would not classify it that way. The purpose of the inflation adjustment is simply to compensate the taxpayer for the adverse effects of inflation.

The purpose of the other adjustment is simply to compensate for the postponement of a deduction. I fail to see how that is a positive advantage that causes me to keep property around. Perhaps I have missed something.

Mr. JORGENSON. Mr. Jacobs, I would like to address the question that was left hanging, the impact of a proposal like this on economic growth. I think that is a very important issue. And although I tried to address it in my remarks, I didn't have a chance to give the details that are relevant.

First of all, I think that Ms. Dunn has raised a very important point here. What is it that we are trying to accomplish here?

The answer is that we are trying to increase the productivity of workers. That is what creates jobs, making workers more productive. That is true of paper. That is true of steel. It is true of high technology in this country, including the much despised service industries.

In order to do that, you have to use capital. The issue that tax policymakers must face is how to use capital efficiently and the purpose of a neutral system is to make sure that every dollar of an investment produces the maximum impact on productivity. Now, I suggested before that the impact of the last attempt at tax reform did increase neutrality and did produce a substantial contribution to economic growth. I estimate that to be, roughly, $1.25 trillion.

Moving to a system of completely neutral cost recovery, based on the idea of expensing would double that gain. In other words, the impact on economic growth would be another $1.25 trillion, something comparable in magnitude to the Federal budget.

So my conclusion is that we ought to talk about the impact on growth. That is what we are here to discuss. And a neutral cost recovery system has a great deal to contribute to economic growth.

Mr. JACOBS. And now the good news is, Mr. Chairman, I yield back the balance of my time.

Mr. BUNNING. Mr. Collins.

Mr. COLLINS. Thank you, Mr. Chairman.

And I thank each of you for your testimony. I have enjoyed listening to you, especially about the alternative minimum tax.

Mr. Jorgenson, I disagree with you about the 1986 Tax Reform Act being one of the best things that ever happened to this country. I believe that act led to the 1990 Tax Reform Act and the 1993 Tax Reform Act. And if we don't do anything, we are going to face a similar tax increase in the next 2 or 3 years.

Mr. Usher, you mentioned the fact that there are a lot of jobs that are being created today but they are low-income jobs, low-wage jobs. It was mentioned earlier the fact that we are facing a high employment rate, a low unemployment rate but a lot of them are those low-wage jobs. It takes two low-wage jobs to equal one of the jobs that comes from manufacturing and your industry. But that brings forth another situation. Low-income wage jobs qualify 35 million families for the earned income tax credit. So for every job that we can create on your side, we eliminate those type jobs over there—we are never going to eliminate them all. They are needed and they contribute, but we eliminate the need for the application and qualification of earned income tax credit which is a drain and transfer of funds from the Treasury.

A lot has been said about expensing. I thought depreciation in interest on cost sheets were supposed to equate out to the cost of equipment. Expensing all in 1 year would throw a disruption into the cash flow of the taxpayers' bank account, which is the Treasury.

But depreciation and interest is supposed to equal your cost or a company's cost of equipment. That is how you recoup your cash flow. But based on the current depreciation schedules linked with the alternative minimum tax, is it not true that you can actually pay tax, that you are paying tax, and that many companies are paying tax on the cost of equipment?

Mr. USHER. I would say for the large majority of the companies, the steel companies that are associated with AISI, that many of them are paying taxes while they are, in fact, in a loss position. And the thing that drives them to that situation is the fact that the length of the depreciable life for steel assets is twice what the normal rate is. So, in fact, instead of depreciating over 7 years as the normal taxpayer would do, they are depreciating over 15 years and, as such, while they would not be a taxpayer under the normal calculation, under the AMT calculation—while losing money—they are still paying taxes.

That tax money is money that could be used for investment in equipment. And it becomes a death spiral. You remain locked in an AMT status and you never get out. And that is why one of the recommendations that I would strongly make would be to shorten that depreciable life. This would allow you to recover the cost of that investment over the same period of life as a normal taxpayer.

And this business is no different than most other businesses. The technology is moving so fast that you have to keep investing in business. It is like being on a treadmill. If you stop, you are going to be left behind when measured by a world standard. And if you want to be world class, you have got to keep investing in the busi-

ness. And that is the problem with a lot of the steel industry, and I think it is true in chemicals and refining and paper and many basic manufacturing capital-intensive businesses—you have got to keep investing money. These people tend to find themselves in an AMT position and, once there, they are not able to generate sufficient cash flow to keep reinvesting in the business.

Mr. COLLINS. One other point: Mr. Shapiro, you mentioned the fact that a lot of companies may freeze assets instead of replacing them. How would that affect the economy?

I think it would affect the economy where equipment is held longer. There would be less need of production or manufacturing or assembling of that equipment. For example, a truck: If you rotate your truck on a 4-year basis, but yet due to encouragement or incentives, you keep it 8 years, then there are less trucks manufactured, less jobs needed for the assembly lines. I think the creation of jobs is the ultimate goal that we are trying to get to.

Mr. SCHAPIRO. Yes, I think that the incentive to freeze assets is a lot less for shorter term assets than it is for longer term assets. I was really thinking principally of assets that would go out 10, 15, 20 years. The question is do you just retire them or leave them alive merely to get the tax credits and maybe not sell them to someone. And they don't have to produce income, they are just tax credits, and that is all they do and they are valuable for that purpose as long as they are in service.

This is something extra. There is a check from the government under this system. And it seems to me that people would be inclined to do that rather than put them out of service. They would just leave them stacked up. It is pure economics if you look at the numbers. And I think the cash flows out there would so indicate. This is not to say that you might not buy new ones, too, you might well. But why would you get rid of anything? It just sits there and generates credits.

Mr. BUNNING. Mr. Payne.

Mr. PAYNE. Thank you very much, Mr. Chairman.

I want to thank this panel. This has been a good discussion concerning the neutral cost recovery system that certainly I have learned from.

I just have a question, and it is really for Mr. Usher and Mr. Sigler: Before I ask the question though, I would like to frame it just in a context. The New York Times on Tuesday had an article about this very system, and in the article, they said business executives worry that they would forgo some deductions in the early years only to have Congress change the law so that they never get the promised writeoffs. The president of the National Association of Manufacturers, Jerry Jaznowski, then is quoted saying there is some element of trepidation about buying a plan that you think may be changed in the long term.

We are now voting on a balanced budget amendment, and likely it will pass. We will be then in a position where we will need to find $1.2 trillion in deficit reduction between now and the year 2002. All the tax breaks that are in the Contract With America add another $400 billion to that. We will then be looking at $1.6 trillion. I think it is likely that many issues will be looked at in the

next few years as we try to accomplish that objective. Certainly this will be one of those issues.

So my question is, then, as you look at and think about this proposal in the light of what seems to be going on in terms of public policy, does it concern you that this might be somewhat speculative in that you might be required to give up something early on and find that you don't really reap the benefits?

I know that you are now under the alternative minimum tax so you are not affected anyway, but assuming that you were looking at this as a company that was looking for these benefits in the future.

Mr. USHER. I believe it is true that about 80 percent of the Federal revenue really comes from individuals' tax receipts. It seems to me that the thing that should be foremost in policy planning is the ability to create jobs for Americans who are going to become taxpayers.

As we look at different alternatives and how we can achieve this, we should certainly take into account the effects on the economy as a whole and the ability of businesses that want to invest money and build factories and build plants and make capital investments so that jobs can be created.

Absent increased investment in the U.S. steel business, 20 percent of the steel brought into this country will continue to be imported, and it will be made by Japanese, Korean and European steelmakers, and they will be paying taxes to Japan, Korea, and the European countries that they live in. I think from a national standpoint, it is much better to provide that type of mechanism that allows businesses that want to invest to invest, create jobs, and maintain jobs where taxpayers are paying taxes.

Mr. PAYNE. Let me say I agree with that, but I think the question really is, from a business perspective, do you think this is more speculative perhaps than other ways it might be structured to make it somewhat less speculative, such as changing depreciation schedules, AMT changes, and other such alternatives.

Mr. SIGLER. Maybe one way of looking at it is we have to spend money every year, and we determine how much we can spend based on our cash flow. That is, by the general strength of the company and the cash flow that it will generate. So if we say we can spend $700 million next year, we then have to choose which projects to go forward with. We have so many things we have to spend money on to fix, we have so many things that we want to spend money on for profit improvement, we have so many things we want to spend money on for expansion. The rate of tax depreciation will be factored into what our cash flow is and how much we will be able to spend. Since AMT is our primary tax system, any improvement in that depreciation system will get factored in and enable us to generate more cash flow.

Do we look at what the capital will cost 5 or 6 years out? Not really. You know, that is a very personal thing because I might have people in business disagreeing with me. I don't think we look at what the cost is for long term—you know, I have been doing this job for a long time, and what that cost is from the tax side has changed numerous times over the 20 years I have been in this job.

We can't anticipate what changes will occur in the Tax Code over the next 5 years, but we know it will change.

Mr. PAYNE. So you are motivated by——

Mr. SIGLER. The speed with which we recover the money we invest.

Mr. PAYNE. Recovery of the money and very little of it has to do with whatever the changes are in the Tax Code?

Mr. SIGLER. Within reason. I mean if we are talking about moving the Tax Code a percent or so over so many years, we would look at it as that might affect our cash flow. But how fast we recover the cost is a much bigger factor in my mind.

Mr. PAYNE. And the AMT is important because you can see an immediate result as it relates to your cash flow?

Mr. SIGLER. AMT just puts such a clamp on cash flow that everything else is affected too. It makes all of the other discussions of what are accelerated this or accelerated that irrelevant. AMT is a flat 20 percent we pay, no matter what, taking away the benefit of accelerated depreciation. For a capital-intensive business, that is a great big number.

Mr. PAYNE. Thank you.

Mr. BUNNING. Mr. English.

Mr. ENGLISH. Thank you, Mr. Chairman.

I have a couple of questions as they relate to AMT. Mr. Usher and Mr. Sigler, can you amplify on the testimony you have already provided to this panel with regard to the impact of the AMT on the competitive position of your industries.

Mr. USHER. I think when you are an AMT taxpayer and you look at a life of 15 years, it puts you on an international scale at the bottom of the pack in terms of capital recovery. You go around the world and there is no one that has a life that is that extended and yet, the equipment that you use to make steel, regardless of where you make it, is the same. So compared to a steel business a country that can recover this cost in 3 years, 5 years, or 7 years, AMT taxpayers in the U.S. steel business, which most of us are and where it takes 15 years, are put at an international cost disadvantage. In addition, because these costs are the same as the costs of energy or labor or whatever, and you have to add them up to make up total costs, it really puts us at a great disadvantage.

Mr. SIGLER. I think maybe the best way to show that we are at a competitive disadvantage because of AMT is to look at the amount of accumulated AMT credits we have because we haven't been able to use regular tax depreciation deductions. It is well in excess of $200 million that we have paid the government rather than investing in people and equipment.

Mr. ENGLISH. Both of you represent industries that have seen a considerable impact from the Clean Air Act and its regulations. I was wondering if you could comment on the combined effect of the Clean Air Act regulations and the AMT in terms of the excess burden it places on you.

Mr. USHER. Again, we feel very strongly that pollution expenditures certainly should be expensed. Just as a rough estimate, at U.S. Steel, we spend about half of our capital budget, which ranges from $300 to $400 million a year—about half of that just to keep the place going at its present level of capacity. We spend about 25

percent of our money for pollution equipment and about 25 percent for modernization and growth.

That 25 percent is a significant amount, $75 to $100 million some years, and you know, we get nothing out of that from a competitive standpoint. It needs to be done to comply with the law and we do it. But again it is something that, when you are competing internationally, it is a cost that you incur and, when you have to depreciate that over 15 years, it adds that much more to your inability to compete.

Mr. SIGLER. Our numbers are remarkably similar. I would say that between 20 and 25 percent of our capital expenditures would go to some form of environmental—I can't split it between water and air, but, I know that a good portion is for air. We might argue on the margin of parts per quadrillion whether you have to do this or have to do that, but essentially we have to spend a great deal on environmental and I would just second Tom's comments.

Mr. ENGLISH. Thank you.

Mr. Entin, welcome again. I appreciate your appearance for a third time before Ways and Means and its panels. As you are probably aware, earlier in the week Assistant Secretary Samuels testified before this panel and trotted out the argument that the neutral cost recovery system would create some tax shelters that might be an inducement for perhaps a lower use of capital than might otherwise be appropriate. Do you think these concerns are legitimate and, if so, how would we address them?

Mr. ENTIN. I don't think they are legitimate. I think he is thinking back to days when you had an overly generous investment tax credit and the total reward for investment was greater than the cost of the machine. I think he may be thinking back to the days when you had nonrecourse loans and people were being given very large writeoffs when they only had a small amount at risk. These are things that have been corrected. I don't think they apply to the modern Tax Code.

If he is merely saying that we are not double taxing capital as thoroughly as we normally do in the ordinary income tax, then I think that is not the right way of defining a tax shelter.

If I may on your time make a comment about a previous answer.

Mr. ENGLISH. Yes, I was going to follow up on that.

Mr. ENTIN. Thank you.

Many companies do look chiefly to their own cash flow for financing before they decide to buy property, but many other businesses borrow to buy property when it is very worthwhile obtaining that property. Many businesses issue new shares of stock when it is very worthwhile to obtain that property.

I don't think we can just say that only a tax provision that immediately increases the cash flow to a firm is going to help investment. NCRS is not just a minor one- or two-point change in the tax rate; it is something like a 16-percent cut in the cost of capital. Most firms do look at something that big and say, "Gee whiz, we could even issue a whole new bunch of shares and build two new profitable factories." NCRS is enough to get the country moving.

Second, a lot of firms aren't in the AMT hole. Granted, AMT should be fixed because it was an atrocious piece of legislation, but you also need to do something to encourage growth for the rest of

the economy as well. You are going to want to have a reputation for enacting tax changes that get people back to work all across the economy, so you do have to do something in the Contract With America to benefit all the industries, not just some of them, if you really want to show results.

Mr. ENGLISH. And I have noticed one of the things you have particularly strongly expressed is on the need to raise expensing.

Thank you very much, Mr. Chairman.

Mr. BUNNING. Mr. Ensign.

Mr. ENSIGN. Thank you, Mr. Chairman.

I just have to start with an aside. If you were here earlier by a comment that was made, and we have heard it almost on a daily basis from the other side, that one of the biggest ways we can free up capital is to make sure that we don't have a deficit. I just think that is kind of funny that the people you hear arguing against the balanced budget amendment are also the other side. But let's just put that aside for now and talk about neutral cost recovery.

My question is, to start with you, Mr. Entin, and we have heard these arguments about indexing for inflation, address indexing the debt for inflation. We have heard arguments that that would be the only way to make it fair.

Mr. ENTIN. Indexing the debt is an entirely different situation. That is not something that is of concern to the Treasury vis-a-vis the tax treatment of the capital. You have a borrower and a lender, which gets back a little bit to what Mr. Gibbons was saying earlier. Suppose there is 3 percent inflation, and a borrower and a lender have agreed on a 6 percent interest rate, and they make sure the loan and interest is being paid. Suppose 5 years down the road suddenly there is a burst of inflation which erodes the value of the principal. If it were a short bond or a note it would be rolled over. But this is a 30-year bond, so the lender is stuck with a 6 percent interest rate with an eroding principal, and the borrower is saying, "Gee, this is terrific, I am making out like a bandit." That is an equity issue that is between the borrower and the lender. It has nothing to do with the Treasury because the borrower is getting to deduct 6 percent interest and the lender is paying tax on 6 percent interest, so that is a wash. It has nothing to do with the Treasury. It really is an irrelevant argument vis-a-vis neutral cost recovery, and should never have been brought into it by the Treasury.

Mr. ENSIGN. Mr. Schapiro, would you like to address that.

Mr. SCHAPIRO. It seems to me there is an issue from the point of view of tax equity. Take the extreme case where someone acquires property by borrowing and then leases it. Now, that person really is fully protected, assuming that it is debt financed, against inflation I guess what people are saying is this: Is it right to give a person like that a tax benefit reflecting inflation on the asset when that person is protected against it, because that person has debt outstanding.

Yes, he made the deal with the lender, that is true, but in a tax system you ask is it a right thing to do to say that someone ought to get an inflation protection in a case when that person is not subject to inflation.

Now, much of what we have heard today is about people using assets in their own business. In an active business that may be one

thing, but when you think about the application of debt financing and leasing, which it certainly would go through in any competitive economy, you begin to see the sort of inequities that people say are associated with getting a benefit for inflation on an asset on which the taxpayer doesn't have the inflation risk.

Now, people may say that is a great deal that taxpayer made by borrowing the money. But in a question of a tax system, you say, OK, but should we give that taxpayer that tax benefit.

Mr. ENSIGN. Mr. Entin.

Mr. ENTIN. Lenders aren't completely unaware of the possibility that inflation might be higher in a few years than it is today, and that is factored into long-term interest rates. The lender and the borrower have already taken care of that problem between themselves. There is no need to worry about it in terms of tax policy.

Mr. ENSIGN. OK. Mr. Usher, we have heard a lot about manufacturing jobs leaving our country, and it would seem to me that one of the ways that we can partially correct that is by correcting the AMT. It would seem very difficult to me to argue against enacting some of the policies that we are talking about here in the Contract based on those.

Your comments?

Mr. USHER. I appreciate that, and I agree. As I said before, the manufacturing base in this country is important, we need to protect it, and this would help.

Mr. ENSIGN. OK. Thank you, Mr. Chairman.

Mr. BUNNING. Mr. Christensen.

Mr. CHRISTENSEN. Thank you, Mr. Chairman.

This morning I heard the ranking minority member say that Republicans don't borrow money. Well, I would like to remind the Republicans in this room and my Democratic friends who may be unaware, but Republicans borrow money to purchase homes, Republicans borrow money to start a business, and unfortunately Republicans also run up their credit card debt. I would also remind him that it was the $15,000 to $30,000 wage earners who crossed the line in droves this year to vote Republican because they were sick and tired of the taxation, regulation and the government bureaucracy that has continued to be piled upon them over the last 40 years. I guess I just get tired of the class warfare.

On this panel I consider the experts to be Mr. Sigler and Mr. Usher because they are out there in the real world. And I like the fact that Mr. Christian here has got his head conservatively screwed on straight and Mr. Entin also knows what he is talking about and Mr. Jorgenson, I didn't get your testimony, but I think you are also in there. Mr. Entin, yesterday Dr. Jane Gravelle from the CRS who is supposed to be working for the taxpayers came and talked about why a capital gains tax cut was such a bad deal for Americans. The day before that another academician spoke about why it was bad for America and 2 weeks ago Les Samuels talked about why it was bad for America.

Why is it that the people who are teaching the future leaders of this country don't understand what makes this country work? How can we reeducate the educators? Where are they getting offtrack? Is it government bureaucracy? Is it the fact that Miss Gravelle

spent 25 years of her life in government service? Mr. Schapiro, have you ever run a company?

Mr. SCHAPIRO. I didn't run a company, but I have run some business ventures and real estate, yes.

Mr. CHRISTENSEN. You have never owned and operated a company, though, have you?

Mr. SCHAPIRO. I have never owned and run a company, no, sir.

Mr. CHRISTENSEN. Mr. Entin, can you help me on this? I am frustrated. I was sent here by the taxpayers to try to change this place and I run against the Harvard and Yale types and they all think they have the answers and they don't.

Mr. ENTIN. There is a draft tax primer out of the University of Cincinnati business school I worked on a couple years ago which goes to some of the history of some of the notions that were built into the current income tax and some of the professors who started all this.

If I send that to you you might be able to see where the teachers of the current teachers came from and why they did these things. I think we are all imprisoned by what we learn in our first undergraduate course in economics, we forget to question our professors a little bit.

Some of the things that went on back then will probably give you an idea where all this came from, and it might startle you quite a bit because a lot of it was nonsense. I will send that over to you.

Mr. JORGENSON. Mr. Christensen, I would like to respond to your question. I am the only academic on this panel. Not only that, I teach at Harvard. I was a student at Harvard many years ago.

I think what you will find is that there has been a sea change in opinion among academics and especially among people that are going to testify before this committee. The kind of ideas that Mr. Christian has put before this committee, which are built around the idea of a fundamental shift away from taxation based on income toward taxation based on consumption is about as close to an academic consensus as anything I have ever seen in my relatively lengthy career.

That is not something that is specific to Harvard or Cincinnati or Yale or any other institution that you want to name. I think that the kind of ideas that are represented in the Contract, especially the idea of neutral cost recovery, are essentially ideas whose time has come, and that is just as true of academic life as it is of the business life.

Mr. CHRISTENSEN. Well, there is hope for Harvard, then.

Mr. Chairman, I appreciate your indulgence. I have been thinking about this for the last 4 hours, so I wanted to say thank you.

Mr. BUNNING. Mr. Levin will inquire.

Mr. LEVIN. Thank you, Mr. Chairman.

I am tempted to carry on the discussion about the Devil under the bed. I just think there are legitimate differences of opinion, there always have been, there always will be, and I am not sure we ought to look for demons. I went to the University of Chicago, which was one of the institutions which fostered conservative economics in this country.

So why don't we get back to talking about ideas, and I am sorry I wasn't here for all of the discussion, but I guess the last exchange

included some comment on Mr. Schapiro's chart and its indication that there could essentially be overcompensation. And I think the response was that when the original deal was made that was taken into account. Is that what you are saying, Mr. Entin?

If you go back to the table and it shows Mr. Schapiro's testimony, some rather startling figures, I think, which indicate that the way to handle this problem—and I am in favor of trying to stimulate growth in this country and access to capital—that this may be too coarse a way to do it, and it will have much too uneven an impact, and it will have some consequences that really aren't predictable and aren't really healthy.

I think, Mr. Schapiro, that is really what you are saying, so let's have a serious discussion for a minute or two about the figures in his chart.

Mr. ENTIN. The discussion I had a moment ago, however, was about the concept of indexing interest, which was a different question. The figures in the charts only represent in present value 100 cents on the dollar.

Looked at another way, the apparent excess above 100 cents on the dollar in nominal terms that you see in those charts merely represents the value by which current depreciation schedules underdepreciate or gyp the taxpayer. If you deflate all of those numbers to year one dollars, you get 100 cents on the dollar. There is no excess there at all.

I disagree with the notion that having a large writeoff in year 23, for example, for the slice of equipment that is supposedly wearing out in year 23 is going to lead people to lock in the investment. This is only compensation for what they were being deprived of by time and inflation over the period to that date.

Improving the writeoff by that amount in that year is appropriate. It will give them the money to go out and replace what has actually worn out. A new piece of property similar to the one they have been depreciating, which is on the market today, will have gone up with inflation over that period, and they will need the extra money to be able to turn around and replace what they are using up.

In addition, the NCRS adjustment does not merely apply to the property that you already have. It will also apply to property that you might be about to buy. Not only is your current property enhanced in value in your eyes, but so is the property you might turn around and buy if you sold the old property.

Mr. LEVIN. Maybe.

Mr. ENTIN. So I do not think this would have a serious impact in locking things in.

Mr. LEVIN. Mr. Schapiro.

Mr. SCHAPIRO. My only point is you wouldn't sell the old one. That is the whole point because it is there, and if it is sold you lose the benefits, and you have to keep it in order to get these ongoing benefits. That is the only point that is being made.

On the indexing point, it is really not indexing interest. It is indexing principal. Where you do not have an inflation risk on the principal element, does the tax system wish to provide a benefit reflecting inflation on one side when you are not at risk in the other?

That is purely a policy question. That is a question for this committee and for Congress.

It is not economics or anything. It is a question of how this committee and Congress wants to run the tax system. You are talking about elements of fairness, and you can decide it either way. But on the point of keeping old property, you only get the benefit each year you keep it. As soon as you sell it, it is gone; or if you abandon it, it is gone; and you don't keep getting that ongoing benefit.

I am not suggesting that perhaps it isn't appropriate to give a benefit in present value equal to the NCRS benefit up front. I mean, if someone said, "Is there any tax policy against immediate expensing," I would say as a tax technician, "No, that isn't a tax policy question." You can have a sound tax system and do that. It might cost a lot of money. If someone asks is there a tax policy against changing the AMT as a matter of sound tax administration, the answer is that there is no such tax policy against it. That is an economic question. I am arguing only that the NCR system runs into some odd, unexpected, unusual and maybe undesirable technical tax aspects.

Mr. LEVIN. Thank you.

Mr. BUNNING. The gentleman's time has expired.

Let me give a—we are in a 15-minute quorum call vote right now. Mrs. Johnson will end the questioning, and we will dismiss the panel, and the third panel will come forward when we get back. So Mrs. Johnson may inquire.

Mrs. JOHNSON. Thank you, Mr. Chairman, and I thank the panel.

I have enjoyed the discussion very much and I regret that I wasn't able to be here for your testimony, but I will review it because I am particularly interested in this aspect of the proposals before us. That is, the issue of adoption of neutral cost recovery as opposed to increasing expensing, and many of the points that you made are of great interest to me.

It does concern me that in adopting neutral cost recovery we should go to a richer, in a sense, reward for a certain kind of investment in our society when as important to growth as capital equipment is, training is equally important, service industries are an important gross sector and don't benefit from these tax expenditures by the government to nearly the degree that manufacturing does, and according to some of my manufacturers we actually have a plethora of equipment right now, having increased productivity dramatically in the last 10 years.

It also concerns me that we go to neutral cost recovery with all of its costs at a time when obsolescence is driving the useful life of equipment rather than wear and tear.

With those kinds of concerns in mind, it seems to me that at least what I take from this hearing is that fixing the AMT problems are terribly important and the combination of AMT reform and enriching expensing to maybe $50,000 or $100,000 which are ideas that came out of earlier hearings might be a combination of policies that would have far greater impact on economic growth than adopting neutral cost recovery. I open that to comment.

Mr. Sigler, welcome, it is a pleasure to have you. You have been very helpful to me in other instances.

Mr. SIGLER. Thank you.

I think one of the things you have to be careful of is what business you are talking to. You are talking to two people here who represent companies that have been hard hit by AMT. I think the point has been made here that it is different for others, but for us AMT is all encompassing and we have to make our investment decisions based on its effect.

I would say in response to the comments you made in your remarks, that we spend large amounts of money on training and employee development every year, and we expense them all. We get an immediate tax benefit for them, but when we spend $1 billion to build a pulp and papermill we can't recover those costs for 13 or more years. We are spending anywhere from $30 to $50 million in a mill for training each year because if you think about it, everybody changes jobs. We expense the $50 million, and that $50 million is back to use again or the tax effect of it, but that is not the case with investment in equipment. Investment in equipment—whatever equipment it is, whether it is a truck, or a paper machine—it gets handled in a more detrimental way for the company.

But expensing for all investment—whether it's equipment or training—is what we really would like.

Mrs. JOHNSON. The ideal is total expensing of equipment. I appreciate that.

Mr. USHER. We spent an awful lot of money on training. In fact, at our latest mill that we have brought on, we averaged about $55,000 per employee in training costs. We found that to be a great investment.

I don't want you to get the impression that I am running down service-type jobs. I am not. We use many service-type jobs but, in the final analysis, to maintain and increase the wealth of the country, you have to make things. You have to grow things, and you have to build things. That is how wealth is created, and it is the manufacturing sector that creates a great deal of this wealth.

Mrs. JOHNSON. I do appreciate that. I had some conversations recently that have focused on what it takes to create wealth in the service industry, and capital investment plays a smaller role in that. But there are some other things we could be doing in the Tax Code that would enable service industries to grow more rapidly.

So in looking at how much, in a sense, of the taxpayers' dollars we spend on capital equipment, I think we have to weigh that, but I do appreciate that.

I appreciate the panel's input on these issues. Thank you.

Mr. BUNNING. Thank you, panel, for being here, and we will recess until we finish our vote. We have 5 minutes. Thanks.

[Recess].

Ms. DUNN [presiding]. The committee will reconvene its hearings.

Our third panel today is composed of Cornelius Powell, chairman of Capital Formation Task Group, Chemical Manufacturers Association, and vice president of taxes, Air Products & Chemicals, Inc., from Allentown, Pa.; Victor Beghini, president, Marathon Oil Co. from Houston, Tex., who will be speaking to us today on behalf of the American Petroleum Institute; John D. McCallum, vice president of corporate tax, Potomac Electric Power Co. on behalf of the Edison Electric Institute; John Huber, government affairs counsel,

Petroleum Marketers Association of America; and Martin Sullivan, adjunct scholar from AEI.

And I would like to start the testimony with Mr. Powell.

STATEMENT OF CORNELIUS P. POWELL, CHAIRMAN, CAPITAL FORMATION TASK GROUP, CHEMICAL MANUFACTURERS ASSOCIATION, AND VICE PRESIDENT, TAXES, AIR PRODUCTS & CHEMICALS, INC., ALLENTOWN, PA.

Mr. POWELL. Thank you, Madam Chairwoman.

Philosophically, the neutral cost recovery system would be a welcome addition to the Internal Revenue Code. Its inclusion in the Contract With America was an acknowledgment of the need to move toward current expensing of capital expenditure for plant and equipment. It was also an indication of a commitment to achieve a competitive cost recovery system in the United States.

Despite a philosophical agreement, CMA does not believe the backloaded tax depreciation system embodied in NCRS is desirable, that is, we do not believe it is desirable. We have four main reasons.

First, front-end cash which would otherwise be available for new investment would be reduced under NCRS. In the chemical industry it would take until the end of the fourth year after a plant startup before the cash generated under the new system would equal that generated under the present system.

Second, the maximum eventual potential benefit to the chemical industry is not substantial before considering risks in the new system. Using typical analytical tools and assuming the 3 percent rate of inflation, the maximum present value of tax deductions under the proposed system over the current system for the chemical industry works out to only about 2.75 percent of original cost.

Third, concern exists among some member companies as to whether the intended benefit from the deferred and indexed depreciation would be fully achieved. This concern stems from the alternative minimum tax and concern as to possible future legislation.

Fourth, NCRS would inject a level of uncertainty into projecting future Federal tax revenue. For example, it is estimated that at a 3 percent inflation rate, the reduction in future tax revenue for an asset with a 20-year life would be 11.6 percent of original cost. The reduction in tax revenue would rise to 28.5 percent if the inflation went from 3 to 6 percent.

Now, the fact that the proposed neutral cost recovery system would be elective as proposed does not answer these concerns. In fact, one concern is whether as enacted it would remain elective.

Past that, if there is an election, taxpayers would tend to elect out of NCRS if they had an AMT problem or if they anticipated because of the cyclical nature of their business they would be moving into AMT. That would in effect stretch out the cash flow benefit, the timing of its realization.

In answer to the fundamental question the Speaker presented in his recent testimony, CMA does not believe NCRS would provide the additional incentive to create even 1,000 new jobs in the 1.1 million chemical industry employment.

It is suggested that as a first step in U.S. cost recovery reform you give consideration to eliminating or substantially modifying the alternative minimum tax. The AMT is bad policy, penalizes those that invest the most in new equipment and increases the current tax effective rate when earnings are down.

You cannot make a meaningful change in our tax recovery system without first fixing the minimum tax problem. We have listed suggested reforms in our written statement to the AMT.

Thank you for your attention.

[The prepared statement follows:]

STATEMENT OF
CORNELIUS P. POWELL
VICE PRESIDENT-TAXES
AIR PRODUCTS & CHEMICALS, INC.
ON NEUTRAL COST RECOVERY PROVISIONS
OF THE "CONTRACT WITH AMERICA"
ON BEHALF OF
CHEMICAL MANUFACTURERS ASSOCIATION

JANUARY 26, 1995

The Chemical Manufacturers Association (CMA) welcomes this opportunity to submit the views of the U.S. chemical industry on the provisions for an improved and more neutral cost recovery system expressed in the "Contract with America" and reflected in H.R. 9.

CMA is a nonprofit trade association whose 188 member companies represent more than 90 percent of America's productive capacity for basic industrial chemicals. Since 1991 the chemical industry has been the nation's leading exporter with an estimated $50 billion in 1994 exports. These exports help insure 1.1 million high wage, chemical industry jobs throughout the U.S.

SUMMARY

Although CMA supports the general philosophy of improved and more neutral cost recovery expressed in the Contract, we are very concerned that, as initially proposed, any revenue costs of an elective neutral cost recovery system (NCRS) would be principally financed by reducing 200 percent declining balance depreciation to 150 percent. From our industry's perspective, the potential increase in depreciation benefits under NCRS does not warrant the attendant risk and added complexity.

QUESTION PRESENTED BY THE SPEAKER

In answer to the fundamental question the Speaker presented in his recent testimony before this committee, we do not believe NCRS would provide the additional incentive needed to create 1,000 new jobs in the chemical industry. In the early years after enactment, NCRS could lead to a reduction in jobs. Thereafter, the impact of NCRS on job levels would depend on whether industry perceives that Congress will modify NCRS if it loses revenue. We believe that modification or termination of the alternative minimum tax (AMT) would likely produce more jobs than would the NCRS proposal.

CMA SUPPORTS THE GENERAL PHILOSOPHY OF NCRS

As indicated, CMA supports the general philosophy embodied in the NCRS proposal. A commitment to move toward the economic equivalent of current expensing is welcomed. It evidences the acceptance of the need for the U.S. to maintain a competitive cost recovery system. Despite our philosophical agreement, CMA does not believe that a move to the back-loaded tax depreciation system embodied in the NCRS is desirable. To focus on our very specific concerns, we list them below in as direct and forthright manner as possible:

- We find it undesirable to trade a part of the front-end cash tax recovery under the present system for the hope of improved future recovery.

- Applying a typical 11% cost of capital discount rate employed in analyzing new manufacturing projects and assuming a continuing inflation rate of 3%, the maximum benefit of the proposed system to the chemical industry is only about 2.75% of the original cost of the asset involved.

- This modest potential benefit from NCRS is not likely to stimulate new investment even if the perceived detriments and risks of the system are ignored.

- One perceived detriment is that under NCRS, tax cash recovery

would be delayed. For chemical companies, the catch up point would not be until the end of the fourth year after plant startup.

o Many companies are not short on investment opportunities. They are short on cash. It simply is not prudent for them to borrow additional cash to undertake new projects. If they adopt NCRS, these companies would have to cut back on capital investment that otherwise could have been financed by cash generated by tax depreciation deductions under the present law.

o One risk our members see is the uncertainty as to their capacity to utilize the deferred and increased depreciation contemplated under NCRS because:

- They have concern as to whether, once enacted, NCRS would be modified as the deferred deductions begin to reduce tax revenues.

- A future economic turndown could reduce the taxpayers capacity to use the write-off as it becomes available. The taxpayer may have insufficient profits and, as a result, fall into a tax loss or minimum tax paying position.

- A substantial turndown in the company's profit could occur.

o Many chemical companies enter into long-term fixed-price requirement contracts and build new plants from which to supply the required product. Typically, these contracts would not provide for a price adjustment to reflect changes in the income tax law. NCRS would introduce a higher element of uncertainty in the negotiation of these fixed-price contracts in the sense that the further out the expected tax recovery, the greater the risk.

o Collateral impacts under other provisions of the code would have the effect of reducing the NCRS benefit by a modest amount. These areas include:

- The depreciation in excess of plant cost would reduce the tax benefit available under the Foreign Sales Corporation export incentive.

- The uniform capitalization rules would have the effect of removing depreciation capitalized as part of the cost of inventory from further indexing.

- The present value tax benefit on a failed project would be less than under the current system.

- Because the applicable GDP deflator would have to be estimated, some taxpayers would find it necessary to make conservative estimated tax payments in order to avoid the risk of penalty for underpayment.

o Various proposals to substantially restructure the federal tax system are now being given serious consideration. Adopting NCRS would tend to impede reform for a restructured system by virtue of the tax deductions deferred until later. Consequently, a greater revenue loss could then be involved in the transition to the new system. The taxpayer whose depreciation deductions were deferred under NCRS could receive lower tax benefits because of lower tax rates under the restructured system.

o Many capital intensive companies are now paying position or are working off AMT credits generated in prior years. Until these companies are entirely out of the minimum tax system, the present value benefit from additional depreciation under the neutral system will not be at the full 35% corporate rate. The present value benefit will be somewhere between 20% and approaching 35% depending on how long after the depreciation otherwise became available the taxpayer works out of its AMT position.

ELECTING OUT OF NCRS

It is recognized that as proposed, the taxpayer could elect out of the neutral cost recovery system. Assuming the election is retained, in any election of NCRS, our concern is that:

- o Taxpayers who foresee difficulty in using NCRS effectively will not elect the system. This could include those working out of AMT and those concerned about future legislation designed to reduce the presently anticipated benefit of NCRS. Thus, the presently anticipated front-end revenue might not be there to finance the proposed change in law.

- o Under NCRS, depreciation in excess of cost will be generated. This will result in increased financial earnings. Assuming an election is available under NCRS, a taxpayer concerned with the stock market reaction to a competitor's reported earnings from participation in NCRS might feel constrained to adopt the NCRS system even though it would otherwise not find it desirable from the taxpayer's cash standpoint to defer tax depreciation.

REVENUE IMPACT

Because NCRS is tied in part to the rate of inflation, we believe it will be difficult to predict the future tax revenues generated under the system. As we have stated, NCRS would provide little incentive for new investment and jobs in the chemical industry and, therefore, may not generate additional taxable profits.

Our test of the impact of inflation indicates that the eventual tax revenue reduction on a 20 year MACRS asset at 3% per year inflation rate would be 11.6% of the original cost of the asset. At a 6% inflation rate, the loss in revenue would rise to 28.5% of the cost of the asset. Admittedly, these projections oversimplify the problem. Certainly, additional tax revenue would be generated by virtue of the higher inflation, but there is a heightened risk of revenue uncertainty when the amount of the future deduction under NCRS is tied to inflation.

Attachment A sets forth our estimate of the reduction in tax revenue attributable to assets in various groups at different levels of inflation.

AMT REFORM AS AN ALTERNATIVE

While the present capital cost recovery system can be improved, capital intensive manufacturing industries, including the chemical industry, would benefit directly from your effort to repeal or to lessen the burden of the AMT. Because these reforms would increase front-end cash flow available for investment in equipment and jobs even when earnings are low, they are likely to have more significant impact on employment levels in manufacturing than would NCRS.

Most importantly, neither improved capital cost recovery nor reform of AMT (which itself is largely a penalty on depreciation), should be financed by reducing 200% declining balance depreciation to 150%.

Many chemical companies are not currently paying the AMT because of the strong current domestic sales and export demand for their products. Yet, the pernicious effect of the AMT on our operations remains. The chemical industry is highly capital intensive and fixed costs, principally depreciation on equipment, remains high even when income declines. In addition, the industry must also continue to make new capital expenditures to meet Congressionally mandated environmental standards regardless of current economic conditions. Should our sales and exports decline because of a downturn in the domestic economy or increased worldwide competition, many chemical companies could again be paying the AMT when their cash needs are greatest. In the recent recession, this problem was replicated across American industry and may even have extended the duration of that recession.

Without fundamental structural change in AMT, its principal effect will be to continue to punish America's basic heavy industries during periods of economic slowdown. These industries will find it increasingly more

difficult to compete internationally during these periods. There are serious public misconceptions about why and under what circumstances corporate taxpayers pay the AMT. Most misunderstood is the effect of the AMT in an economic downturn or recession. One principal consequence of this tax is that American manufacturers that regularly pay Federal income taxes will have to pay the AMT precisely when their cash needs to finance new investment and jobs are greatest.

POSSIBLE AMT CHANGES

We are appreciative of the work of this Committee in its efforts in 1993 to alleviate these problems, but much still remains to be done. Alternatives include:

- The AMT penalty on depreciation would be reduced significantly by having AMT depreciation periods match those provided for regular income tax purposes.
- Accelerated depreciation on capital expenditures to meet Congressionally mandated and voluntary environmental standards should not be subject to the AMT.
- Congress should also reconsider the limitation imposed on the use of accumulated AMT and other tax credits against AMT liability.

We again commend the framers of the "Contract with America" for having included provisions for improved capital cost recovery and AMT reform. The vital spirit of that contract is to achieve effective, responsible progress toward these goals for America.

The Federal budget imposes limits on how much reform this committee can undertake. Progress toward real AMT reform, however limited, is the most important progress toward a rational capital cost recovery system that Congress can make at this time. We look forward to working with you on this all-important subject.

Attachment A

MCRS

ESTIMATED FEDERAL REVENUE REDUCTION

AS A PERCENT OF PLANT COST*

MACRS Write Off Period	Inflation Rate	
	3%	6%
5 year	5.5%	8.3%
7 year	8.2%	12.7%
10 year	12.6%	20.4%
15 year	8.2%	19.0%
20 year	11.6%	28.5%

* Represents future reduction in revenue without discount to reflect time value.

Ms. DUNN. Thank you very much, Mr. Powell.

We will continue with Mr. Beghini.

STATEMENT OF VICTOR G. BEGHINI, PRESIDENT, MARATHON OIL CO., ON BEHALF OF THE AMERICAN PETROLEUM INSTITUTE

Mr. BEGHINI. Thank you, Madam Chairwoman.

My name is Victor Beghini. I am president of Marathon Oil Co. I am testifying on behalf of the American Petroleum Institute.

API represents approximately 300 companies engaged in every aspect of the oil and gas industry. I am pleased to appear today to discuss the proposed neutral cost recovery system.

The stated goal of NCRS is to reduce the cost of capital in order to make American industries more competitive, stimulate additional investment, and create new jobs. API members heartily endorse that goal.

The oil and gas industry is a vital part of the Nation's economy and is also one of the country's most capital-intensive industries. We are therefore vitally concerned with the effect of cost of capital on our ability to find, develop, and deliver new energy resources.

In our exploration and production operations, because many promising sources of new reserves are located offshore in deep water or in operationally difficult frontier areas, huge capital investments and very long lead times are required.

Typically an oil and gas project in these areas can take over 7 years to reach the producing stage. It is only then that we can begin to recover our capitalized cost. Onshore lower 48 reserves require increasingly sophisticated drilling and recovery techniques which are also high cost. In the refining and marketing segment of our business, we are faced with enormous costs imposed by government environmental regulations.

These are unfunded mandates which are intended to be of a general societal benefit, but they also reduce a company's income and return on investment. Obviously our industry has a very strong interest in proposals that would reduce the cost of capital. As the Tax Reform Act of 1986 amply demonstrated, tax policy does have a significant impact on the cost of capital.

While TRA did provide a rate reduction for all taxpayers, it did so at the expense of capital-intensive industries such as ours by extending depreciation periods, repealing the investment tax credit, and adding the alternative minimum tax under which taxpayers face not only tax acceleration but possibly even double taxation because of the limitation on the use of foreign tax credits.

While NCRS represents some improvement in the treatment of depreciable capital expenditures, there are concerns about its design and coverage, and it should not be viewed as a substitute for a fundamental reform of the AMT.

First, over the long term, there is a cumulative benefit when you analyze the effect of NCRS on a typical investment profile for the oil and gas industry, but as the earlier panel testified, some taxpayers would actually pay more taxes in the early years of NCRS. The Treasury revenue estimate of $18.4 billion for the first 5 years confirms this fact. This cash flow drain will likely have a negative effect on the economy.

Second, while application of NCRS to alternative minimum tax depreciation provides some relief for AMT taxpayers, far more fundamental reform is needed if we are to remove the current disincentive for capital investment. For oil and gas companies, many of whom are subject to the AMT, the minimum tax has the perverse effect of penalizing them when prices decline and when investment in property, plant, and equipment increases.

Furthermore, while Congress intended the AMT as a temporary prepayment of tax, it actually represents a permanent tax increase for some oil and gas companies. Once a capital-intensive company gets into the AMT position, it is exceedingly difficult to get out. NCRS does not address these fundamental AMT flaws.

Finally, I must note that under the NCRS proposal, the oil and gas industry's depletable assets would not be provided indexing of cost recovery deductions. The segment of the oil and gas industry represented by integrated oil companies is the only segment of U.S. capital-intensive industries that currently does not have accelerated cost recovery for a substantial portion of its capital investment.

The exclusion of depletable assets from NCRS only exacerbates that disparity because such assets would also be denied the benefits of NCRS indexing. Cost depletion deductions should be included in any neutral cost recovery system.

In summary, Madam Chairwoman, we support your efforts to improve capital cost recovery. To encourage more investment in the oil and gas industry and to eliminate the disparate treatments of depletable assets, the NCRS concept should be applied to cost depletion.

Let me close by again emphasizing fundamental reform of the AMT must be an integral part of any proposed goal to improve capital recovery and enhance economic growth in this industry.

Thank you.

[The prepared statement and attachments follow:]

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WRITTEN STATEMENT TO ACCOMPANY
TESTIMONY OF
VICTOR G. BEGHINI, PRESIDENT
MARATHON OIL COMPANY

ON BEHALF OF THE AMERICAN PETROLEUM INSTITUTE

REGARDING THE PROPOSED NEUTRAL COST RECOVERY SYSTEM
TITLE II OF H.R. 9, THE JOB CREATION AND WAGE ENHANCEMENT ACT

Committee on Ways and Means
U.S. House of Representatives
January 26, 1995

This statement is submitted by the American Petroleum Institute (API) for the record of the January 26 hearing of the House Ways and Means Committee on the proposed Neutral Cost Recovery System (NCRS), Title II of H.R. 9, the Job Creation and Wage Enhancement Act. API represents approximately 300 companies involved in all aspects of the oil and gas industry, including exploration, production, transportation, refining and marketing.

The goal of the NCRS proposal is to reduce the cost of capital by increasing depreciation deductions to achieve the economic equivalent of expensing. API heartily endorses the overall goal of improving capital cost recovery, and we commend the Committee for moving expeditiously to address this important concern.

Proposals to modify the current system of capital cost recovery are of particular importance to API's member companies because of the capital intensive nature of oil and gas operations. The capital intensiveness of an industry may be defined as the ratio of its percentage share of the national capital stock relative to its percentage contribution to national income. When this measure is used, as Table 1 indicates, the petroleum industry can be seen as one of the nation's most capital intensive industries, when compared to other major manufacturing and service industries. Of the sectors surveyed, only electrical utilities are more capital intensive. If one simply uses an industry's percentage share of net property, plant and equipment as the measure of capital intensiveness, oil and gas production and refining are still seen to be capital intensive relative to other major manufacturing and selected service industries. Only the communication industry and electric services have larger shares.

Because the industry is so capital intensive, API members are vitally concerned with the effect of the cost of capital on their ability to find new energy resources, and develop and deliver them to the American consumer at a reasonable price. In exploration and production operations, because many promising sources of new reserves are located offshore in deep water or in operationally difficult frontier areas, huge capital investments and very long lead times are required. Typically, an oil or gas project in these areas can take over 7 years to reach the producing stage. It is only then that a company can begin to recover its capitalized costs. Onshore lower 48 reserves require increasingly sophisticated drilling and recovery techniques which are also high cost. In 1991--the latest year for which complete industry data are available--the petroleum industry invested $22 billion in exploring for and developing oil and gas reserves.

In the refining and marketing segment of the business, the industry is faced with enormous costs imposed by government environmental regulations. For example, the National Petroleum Council estimates that over the period 1991-2000, refiners will be required to expend $37 billion to comply with environmental mandates. These are unfunded mandates which are intended to be of general societal benefit. But, they also reduce a company's ability to add to the manufacturing capacity of the industry and decrease a company's income and its rate of return on investment.

Neutral Cost Recovery System

Investment in new plant and equipment is quite sensitive to capital cost recovery rates. In 1981, the capital cost recovery system relevant to most investment in the United States was improved, moving toward the goals of full recovery, simplicity and economic efficiency. Succeeding tax Acts culminating with The Tax Reform Act of 1986 reversed this favorable development. While TRA '86 did provide a rate reduction for all taxpayers, it did so at the expense of capital intensive industries such as the petroleum industry by extending depreciation periods, repealing the investment tax credit, imposing complex production period capitalization requirements, and adding the Alternative Minimum Tax under which taxpayers face not only tax acceleration but possibly even double taxation because of the limitation on the use of foreign tax credits. NCRS would partially redress the capital cost recovery dilution, and in that regard would be an improvement over current law.

Under current law, depreciable costs are recovered over a statutory asset life dependent on the use of the asset. Even in the absence of inflation, this extended recovery period results in a loss of the present value of the recovery of capital costs. Secondly, inflation during the recovery period adds an additional loss by driving up the replacement cost of the asset. As a result of both factors, current law may cause a loss of over half of real asset value over time, depending on asset life, inflation, and discount rates, as seen in Table 2.

The proposed neutral cost recovery system attempts to eliminate the disincentive to investment created by the current system. However, rather than simply allow for full expensing of the capital, it provides for a system of indexation for both inflation and deferral value which exacerbates the recovery problem early in the asset life (by substituting double declining balance depreciation schedules with 150% declining balance schedules for many asset classes) in return for increased nominal recovery later in the asset life.

One concern with NCRS is this move from 200% to 150% declining balance depreciation for some assets. It is clear that over the long term there is a cumulative benefit when one analyzes the effect of NCRS on a typical investment profile for the petroleum industry. But, because of the move from 200% to 150%, some petroleum companies and companies in other industries would actually pay more taxes in the early years of NCRS. The Treasury estimate of an $18.4 billion revenue increase for the first five years confirms this fact. This cash flow drain will likely have a negative effect on the economy. Thus, it would seem to frustrate the overall goal of the proposal: to stimulate economic activity and create new jobs by increasing taxpayer cash flow.

Furthermore, since the benefits of NCRS are significantly "back-loaded" with cash tax savings available for some assets only five to seven years after enactment, taxpayers will not realize the benefits unless full implementation of the proposal is assured.

An additional concern with regard to the design of the proposal has to do with complexity. API's members, as other corporate taxpayers, face large compliance costs because of complexity of the tax law. One goal of any tax legislation should be to reduce that burden. NCRS, as proposed, requires a quarterly inflation adjustment calculation. Making the adjustment annually rather than quarterly would be an improvement.

Cost Depletion

The segment of the oil industry represented by integrated oil companies is the only segment of U.S. capital intensive industries that currently does not have any accelerated cost recovery for a sizeable portion of its capital investment -- that portion that is subject to cost depletion. Using API and Department of Energy data for 1991, the latest year for which complete information is available, API estimates that of $4.0 billion invested in capitalizable exploration and development costs, over one-fourth ($1.2 billion) must be recovered through this method.

Typically, the largest of the depletable costs is the cost of acquisition of the right to extract oil or gas. This is treated as a capital cost for both financial and tax purposes. Another significant portion of capitalized costs of an oil or gas property (for tax purposes) consists of geological and geophysical exploration costs. For successful projects these costs may be expensed for financial accounting purposes while they must be capitalized for tax purposes. Cost depletion is typically taken by the unit-of-production method -- which limits current capital cost recovery to an estimate of how much of the property's total remaining output is represented by current production. Thus, when a barrel of oil is produced, it is ratioed with remaining reserves and multiplied by the adjusted tax basis of the property involved to determine the amount of the current depletion deduction. For a long-lived property, this method of recoupment is one of the slowest methods of capital recovery available under current law. Even very modest rates of inflation will very rapidly erode the real value of cost recovery deductions under the unit of production method. Real costs of capital invested are thus "underrecovered" primarily due to the effects of inflation. These costs should be included in any "neutral" cost recovery system.

Geological and Geophysical Costs (G&G)

Geological and geophysical costs (G&G) are costs associated with surveying and evaluating a potential oil and gas property. Geological studies and geophysical surveys are the initial steps in evaluating an oil and gas prospect. The costs of core drilling, seismic studies and other G&G activity are incurred for the purpose of ascertaining the existence, location, extent and quality of any deposit of oil or gas.

Technological change in the petroleum industry is increasingly being recognized as one of the most significant determinants of future domestic oil and gas supply prospects. Recent studies completed by the Department of Energy, the National Petroleum Council, the Gas Research Institute, and API, as well as a number of recent academic studies, have all documented the major influence of technological change on stabilizing or reversing the decline in domestic supplies of oil and gas. For example, DOE estimates that sustained modest increases in drilling productivity could increase the level of ultimately recoverable oil resources by nearly 40% within the next 15 years.

While a number of innovations have contributed to recent and expected increases in drilling productivity, G&G expenditures have played a major role, and are expected to play even a more significant role in the future. In Salomon Brothers annual survey of oil and gas industry spending plans, respondents for the last three consecutive years have identified seismic technology as the innovation with the greatest impact on upstream spending decisions. For 1995, 75% of respondents identified seismic technology (G&G) as the most influential technological innovation affecting such choices.

While there still is no technology that permits us to reliably identify the location of oil and gas without drilling, recent improvements in seismic technology have provided a rapidly improving capability to visualize complicated geological structures. This provides more information than previously available to target drilling activity. The additional information can sometimes make it economic to seek out and successfully develop far smaller reservoirs than would have even been considered a decade ago. Such technology has effectively enabled the industry to substitute G&G for some drilling activity.

Ironically, however, current tax treatment inhibits the development and application of such substitution. Under current treatment, a taxpayer typically cannot recover much more than half of the present value of the cost of successful G&G efforts over the course of a 20 year field life with cost depletion. Furthermore, the administrative costs of determining and tracking G&G expenditures are burdensome to both the industry and the IRS. The current tax treatment penalizes the utilization of these critical new technologies.

Under today's conditions, oil and gas exploration is being carried out in increasingly hostile environments and at increasingly higher costs. Geological and geophysical costs are an important and integral part of the exploration process on a daily basis and, as such, should be treated as ordinary and necessary business expenses. Spreading their recovery over the life of the field results in little or no benefit on a present value basis because of the long lead times which characterize oil and gas development. They should be allowed as a current deduction.

Alternative Minimum Tax

While application of NCRS to Alternative Minimum Tax depreciation provides some relief for AMT taxpayers, far more fundamental reform is needed if we are to remove the current disincentive for capital investment. At the minimum, the NCRS should not be biased against AMT taxpayers. For petroleum companies--the vast majority of whom are subject to the AMT--the minimum tax has the perverse effect of penalizing them when prices decline and when investment in property, plant and equipment increases. Furthermore, while Congress intended the AMT as a temporary prepayment of tax, it actually represents a permanent tax increase for some petroleum companies because once a company gets into an AMT position it is very difficult to get out because continuing or expanding investment in depreciable property triggers additional AMT penalty. NCRS does not address these fundamental AMT flaws.

The effect of the AMT is to drive up the after tax cost of capital and to depress new investment in plant, property and equipment. A 1991 study by the American Council for Capital Formation found that the cost of capital for AMT companies making new investments was increased by a range of 10 to 22 percent over the cost of capital under the regular Modified Accelerated Cost Recovery System.

This increased cost of capital and reduced cash flow significantly depresses the level of new investment necessary to remain competitive. Typically it is these capital intensive industries that provide a large fraction of the high paying jobs in the economy. The longer lived manufacturing assets such as those used in automobile manufacturing, chemicals, oil and gas production and refining, pulp and paper, and steel are subject to the greatest increase in the cost of capital as a result of the AMT.

While twin objectives of the Tax Reform Act of 1986 were tax simplification and compliance cost reduction, neither objective was accomplished. A 1993 Tax Foundation study entitled "The Income Tax Compliance Cost of Big Business" reports that "there is near unanimity among senior corporate tax officers that TRA 1986 added complexity to the tax system, resulting in a combination of higher compliance costs and less accurate information transmission [to the IRS]." The Alternative Minimum Tax was the item most often mentioned as contributing to that complexity.

Conclusion

To summarize, the goal of NCRS to improve capital cost recovery is laudable and API commends the Committee for moving to address the issue. Capital intensive industries, such as the petroleum industry, were hurt by the Tax Reform Act of 1986 and NCRS would partly redress that problem. However, it does not go far enough to alleviate the effect of the Alternative Minimum Tax. Finally, the petroleum industry has a portion of its capitalized costs subjected to an extremely slow form of recovery--cost depletion. These costs should be included in any "neutral" cost recovery system.

TABLE 1: "CAPITAL INTENSITY BY INDUSTRY"

(Corporate Net PPE/Total U.S. Corporate Net PPE x 100)

	DEPRECIABLES (%) (1)	DEPLETABLES (%) (2)	LAND (%) (3)	PERCENT OF TOTAL U.S. CORPORATE NET PPE (4)	CONTRIBUTION TO NATIONAL INCOME (%) (5)	CAPITAL INTENSITY (4)/(5)
OIL AND GAS PRODUCTION AND REFINING	6.81	51.58	4.28	7.89	1.65	4.78
PIPLINES EXCEPT NAT. GAS	0.07	0.04	0.01	0.06	0.12	0.53
GAS PRODUCTION AND DISTRIBUTION	2.29	2.38	0.23	2.14	0.58	3.69
MOTOR VEHICLES AND EQUIPMENT	2.54	0.00	0.74	2.34	1.12	2.09
PAPER AND ALLIED PRODUCTS	2.16	3.84	0.75	2.10	0.94	2.23
CHEMICALS AND ALLIED PRODUCTS	4.45	4.73	2.69	4.32	2.20	1.97
ELECTRIC SERVICES	9.97	1.48	0.86	9.04	1.87	4.83
FOOD MANUFACTURING	2.76	0.07	2.49	2.66	2.05	1.30
MACHINERY, EXCEPT ELECTRICAL	2.30	4.11	1.54	2.27	2.22	1.02
ELECTRICAL AND ELECTRONIC EQUIPMENT	2.76	0.06	0.02	2.57	1.84	1.40
COMMUNICATION	8.95	0.02	0.01	8.14	2.37	3.44

Source: "Corporation Income Tax Returns" Source Book 1991 Statistics of Income, SOI Division, Dept. of Treasury.

Table 2. Present Value of Allowed Depreciation by Asset Life, current system (as percent of initial capital cost)

	5 Year	7 Year	10 Year	15 Year
4% discount 2% inflation	90.3	86.3	78.2	61.6
8% discount 4% inflation	82.3	75.8	68.8	54.5
16% discount 8% inflation	70.2	61.1	55.7	45.0

Ms. DUNN. Thank you very much, Mr. Beghini.

We will move on then with Mr. McCallum.

STATEMENT OF JOHN D. McCALLUM, VICE PRESIDENT, CORPORATE TAX, POTOMAC ELECTRIC POWER CO., ON BEHALF OF THE EDISON ELECTRIC INSTITUTE

Mr. MCCALLUM. Good afternoon, Madam Chairwoman and members of the committee.

I am John D. McCallum, vice president of corporate tax of Potomac Electric Power Co., which is more commonly known in this city as Pepco. I am here today to testify on behalf of the Edison Electric Institute, referred to as EEI and Pepco.

EEI is the association of the Nation's investor-owned electric utility companies. Our member companies provide electric service to 76 percent of all ultimate electric customers in the Nation. We appreciate the opportunity to appear today to present our views on the neutral cost recovery system proposed in H.R. 9.

In summary, let me state that as the most capital-intensive industry in our Nation, with currently over $500 billion in plant and equipment, we strongly support the concepts contained in this neutral cost recovery proposal. We believe it would reduce the cost of electricity for all our customers and therefore the cost of virtually all U.S. produced goods and services.

We also strongly support an attempt to achieve the goals of this proposal to the extent we can afford to do so in a deficit neutral manner without tax increases. Our analysis of this proposal leads us to the following three principal conclusions, each of which along with some certain general recommendations are discussed in greater detail in our written statement.

First, in regard to achieving cost recovery neutrality, as highlighted by the chart on page 4 of our written statement, the proposed NCR system will reduce the bias against capital investment, but it will not achieve a fully neutral nor equal system of cost recovery for all taxpayers. Capital investment in long-life property, that is, property with a 15-year or greater life, is the most disadvantaged under current law, and it will continue to be substantially disadvantaged under the proposed NCR system.

In order to achieve a truly neutral depreciation system, capital investment in this long-life property will need to receive equal treatment to that of other property under the proposed system, including the full neutral cost recovery ratio. Such treatment is critical in order to achieve the objective of neutral cost recovery.

Our second area of discussion is in regard to neutral cost recovery in competition. We believe the proposed NCR system should increase our Nation's ability to create jobs and to compete internationally. We also strongly believe that the proposed NCR system should be fundamentally clarified by this committee to ensure a level playingfield for all domestic competitors.

Our principal concern here is that our industry, once highly regulated, is rapidly moving toward less regulation and more competition. As a result, nontraditional electric suppliers compete with our industry, and we need to ensure they have the same tax treatment under the tax law as we do. This could be achieved by providing that similarly situated property, regardless of ownership form or

guideline class should have the same neutral cost recovery treatment.

Our third area of discussion is in regard to environmental property. We wish to point out to the committee that the proposed NCR system does not incorporate section 169 of the Internal Revenue Code which provides for 60-month amortization of qualifying pollution control facilities.

As highlighted by the chart on page 9 of our statement, it is important to include such property because the cost recovery mechanism provided by section 169 has been substantially eroded over the years by tax law changes. This could be addressed by including such equipment in the 5-year life category.

We also recommend that the AMT be generally modified to exclude adjustments for recovery of capital investment in environmental equipment. We believe such treatment is consistent with good public policy.

In conclusion, we strongly support the concepts contained in the proposed NCR system, and we urge your consideration of our comments.

We thank the committee for the opportunity to present our views today, and we are available for any questions that you may have.

Thank you.

[The prepared statement follows:]

STATEMENT
OF
JOHN D. MCCALLUM
VICE PRESIDENT - CORPORATE TAX
POTOMAC ELECTRIC POWER COMPANY
ON BEHALF OF
THE
EDISON ELECTRIC INSTITUTE
AND THE
POTOMAC ELECTRIC POWER COMPANY

REGARDING
THE
NEUTRAL COST RECOVERY SYSTEM
OF
TITLE II OF H.R. 9
THE JOB CREATION AND WAGE ENHANCEMENT ACT OF 1995

BEFORE THE
COMMITTEE ON WAYS & MEANS
U.S. HOUSE OF REPRESENTATIVES

January 26, 1995

Good day, Mr. Chairman and members of the Committee. I am John D. McCallum, Vice President - Corporate Tax of Potomac Electric Power Company (Pepco), an investor-owned electric utility which serves over 1.9 million people in the metropolitan area of our Nation's capital. I am here today to testify on behalf of the Edison Electric Institute (EEI) and Pepco. EEI is the association of the Nation's investor-owned electric utility companies. Member companies of EEI generate approximately 79 percent of all the electricity in the country and provide electric service to 76 percent of all ultimate electric customers in the Nation. We appreciate the opportunity to appear today to present our views on the Neutral Cost Recovery (NCR) System proposed in H.R. 9, The Job Creation and Wage Enhancement Act of 1995.

In summary, we applaud the introduction of Chairman Archer's proposal providing for the NCR system and we strongly support it. We believe it will reduce the cost of electricity for our customers and therefore the cost of virtually all U.S.-produced goods and services. Concurrent with its enactment, we also strongly support a congressional commitment to pay for this proposed NCR system through prudent reductions in the cost of the federal government and not from tax increases. Our analysis of the proposed NCR system leads us to the following conclusions and recommendations, each of which is discussed in greater detail later in our statement:

1) <u>Cost Recovery Neutrality</u>

The proposed NCR system will reduce the bias against capital investment but it will not achieve a fully neutral, nor equal system of cost recovery for all taxpayers. Capital investment in long-lived property is disadvantaged under current law and will continue to be substantially disadvantaged. In order to achieve a neutral depreciation system, capital investment in long-lived property (<u>i.e.</u>, property with a 15-year or greater life) also will need to receive the full neutral cost recovery ratio, including the 3.5% real rate of return. Such treatment is critical in order to achieve the objective of neutral cost recovery.

If cost recovery neutrality is not achievable under our current income tax system, then it may be appropriate to examine alternative tax systems in lieu of the income tax. Such systems are used elsewhere in the world and focus more on taxing consumption rather than savings and investment. In that regard, we commend Chairman Archer

and other members of this Committee on both sides of the aisle who have stated their intent to more closely examine such alternatives later in this Congress. As we have closely examined the issue of broad-based consumption taxes, we would be pleased to share our analysis and conclusions with this Committee in the appropriate forum. We look forward to that opportunity.

2) **Neutral Cost Recovery and Competition**

The proposed NCR system should increase our Nation's ability to create jobs and to compete internationally. We also strongly believe that the proposed NCR system should be fundamentally clarified by this Committee to ensure a "level playing field" for all domestic competitors. This could be achieved by providing that similarly situated property, regardless of ownership form or guideline class, should have the same neutral cost recovery treatment.

3) **Environmental Property**

We are also concerned that the proposed NCR system does not incorporate Section 169 of the Internal Revenue Code (IRC) which provides for 60-month amortization of qualifying pollution control facilities. This could be addressed by allowing environmental property to be included within the five-year NCR system life category similar to previously introduced H.R. 4299[1]. The inclusion of such equipment in the five-year NCR system life category is important because the cost recovery mechanism provided by Section 169 has been substantially eroded by tax law changes. The AMT should also be generally modified to exclude adjustments for recovery of capital investment in environmental equipment.

4) **Other Recommendations**

We have also included herein certain other recommendations regarding tax normalization and the proposed quarterly convention. We strongly support the continuation of normalization of all book to tax timing or temporary differences attributable to the NCR system. We have concluded that the adjustments attributable to the proposed NCR ratio are not temporary differences; however, EEI has not concluded whether such adjustments should or should not be subject to mandatory normalization. We also recommend that the Committee consider minimizing the administrative cost and burden of the proposed quarterly convention by adopting an annual convention.

Each of these conclusions/recommendations is discussed more fully below.

Cost Recovery Neutrality

The electric utility industry (Industry) is the most capital intensive industry in the Nation with over $500 billion of capital investment in plant and equipment. Our Industry invests over $2 of capital for each $1 of annual revenue, substantially more than most other industries. We strongly support the goal of enacting a

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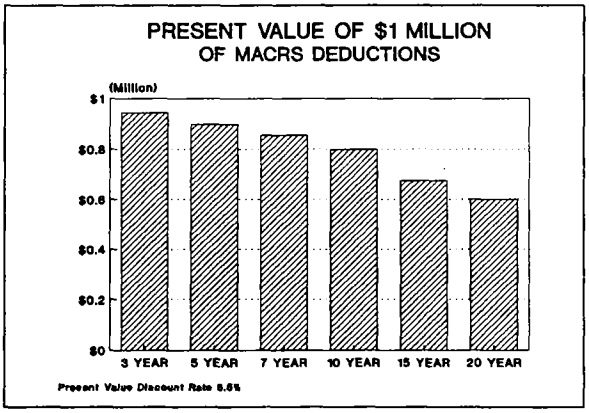
[1] H.R. 4299, introduced on February 25, 1992, would have established a new class of property identified as "environmental property" with a five-year recovery period.

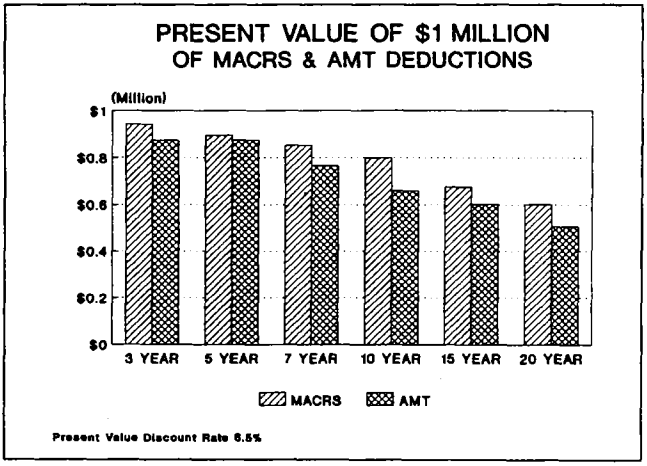
depreciation system which treats recovery of all taxpayers' capital investments equally. Provided below is a discussion and comparison of the current depreciation system and the proposed NCR system.

The Current Depreciation System - MACRS

The current depreciation system, the Modified Accelerated Cost Recovery System (MACRS), contains substantial bias against capital intensive industries with long-lived equipment. For our Industry, the majority of our capital investment falls into the 15 and 20-year MACRS categories. As highlighted by the following chart, the present value of the depreciation deductions provided by our current depreciation system do not provide a neutral, nor equal cost recovery system for taxpayers.



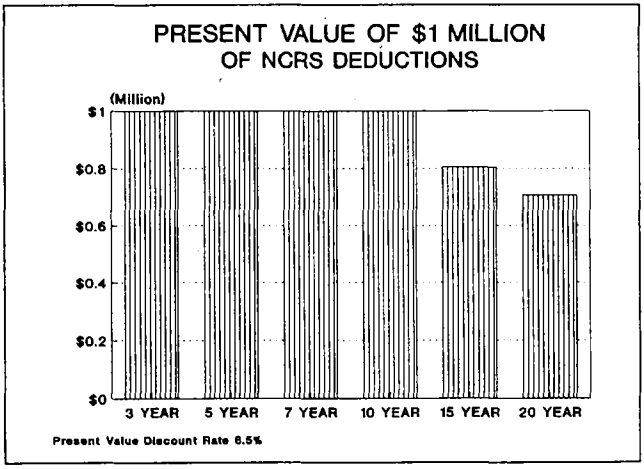
Additionally, current depreciation deductions allowed under our regular tax system are eroded for many taxpayers by an AMT system which penalizes capital investment. The following chart demonstrates the effect of the AMT on MACRS taxpayers.



In summary, the current depreciation system contains a substantial bias against capital investment in long-lived equipment and a key goal of any proposed recovery system should be the elimination of such bias. All taxpayers should be treated equally with respect to their capital investment.

The Proposed Neutral Cost Recovery System

The proposed NCR system will reduce the bias against capital investment but it will not eliminate such bias for all taxpayers. As highlighted by the following chart, substantial bias will still exist against long-lived equipment.



The proposed NCR system helps to reduce the bias against capital investment by providing a 3.5 percent real rate of return for property with three, five, seven and ten-year MACRS lives. The proposal also provides an inflation adjustment for all property including those with 15 and 20-year MACRS lives and real property.

The proposed system creates a new two-tier depreciation system where one group of assets receives a 3.5 percent real rate of return and others do not. This raises new concern about attaining equity and fairness in a competitive environment where we should be seeking to achieve a level playing field for all domestic business. This concern arises because the NCR system will not fully correct the present bias toward longer-lived equipment. The solution to this problem is to provide all NCR system assets ultimately with the same equivalent present value for their cost recovery deductions. In order to achieve a truly neutral depreciation system, capital investment in long-lived property (i.e., property with a 15-year or greater life) will also need to receive the full neutral cost recovery ratio, including the 3.5% real rate of return. Such treatment is critical in order to achieve the objective of neutral cost recovery.

If cost recovery neutrality is not achievable under our current income tax system, then it may be appropriate to examine alternative tax systems in lieu of the income tax. Such systems are used elsewhere in the world and focus on taxing consumption rather than savings and investment. In that regard, we commend

Chairman Archer and other members of this Committee on both sides of the aisle who intend to more closely examine such alternatives later in this Congress. As stated previously, we have closely analyzed this issue. We would be pleased to make our findings available to the Committee.

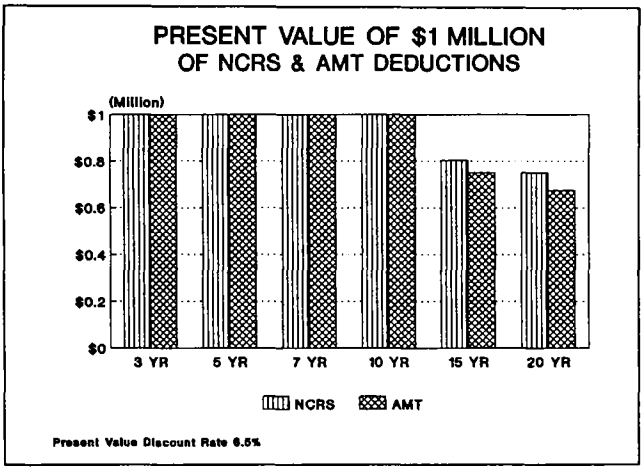
The NCR System and the AMT

With regard to the NCR system and the AMT, we commend Chairman Archer for the proposed adoption of the NCR system modifications to the AMT which will help ensure both compatible and reasonable treatment thereunder. Highlighted below is a table which compares the life and method used for the regular tax and AMT purposes under the proposed NCR system.

SUMMARY TABLE OF
NCR SYSTEM
LIFE/METHOD

Regular Tax		AMT		NCR Ratio	
NCR Property Life	Base Depreciation Method	AMT Life	AMT Method	Real Return Adjustment (3.5%)	Applicable Inflation Adjustment
3 Yr	150% DB	5 Yr	150% DB	Yes	Yes
5 Yr	150% DB	5 Yr	150% DB	Yes	Yes
7 Yr	150% DB	10 Yr	150% DB	Yes	Yes
10 Yr	150% DB	16 Yr	150% DB	Yes	Yes
15 Yr	150% DB	20 Yr	150% DB	No	Yes
20 Yr	150% DB	28 Yr	150% DB	No	Yes

As shown in the graph which follows, although the AMT lives are longer than regular tax lives under the NCR system, over time the NCR ratio results in the AMT providing a neutral cost recovery system for all taxpayers, except those with capital investments in long-lived property.



In order to achieve a neutral AMT cost recovery system for all taxpayers, the full NCR ratio, including the 3.5% real rate of return, should be applied to all property.

In addition, the goal of the AMT should be one of revenue neutrality with regard to the costs incurred to meet environmental regulation. Currently, however, the AMT includes adjustments for recovery of capital investment in environmental equipment, such as pollution control property. This can result in heightened AMT costs, which increase the overall cost of environmental compliance. Adjustments for environmental property should be excluded from the AMT computation in order to achieve AMT neutrality with regard to environmental policy. Specifically, Section 56(a)(5) relating to the AMT adjustment for pollution control equipment should be eliminated.

Neutral Cost Recovery and Competition

EEI wishes to emphasize the importance of having a neutral cost recovery system which helps our ability as a nation to compete and to create jobs in the domestic economy. The Industry's views on certain facets of the effects of neutral cost recovery on international competition and competition in the domestic economy are discussed below.

International Competition

The cost of producing electricity by our Industry is borne by our customers who, in turn, include such costs in the price of their U.S.-produced goods and services. Virtually every product or service produced in the U.S. includes as a part of its price the cost of the electricity consumed. The cost of electricity is in part a function of the capital cost recovery system available under the tax law for capital investment in such equipment. If other nations have better cost recovery systems, which many do, the cost of their products and services will be proportionately less. We, as a Nation, must have a cost recovery system equal to our competitors if we are to compete and prosper.

Today our Nation enjoys the best electric system in the world, thanks in no small part to the wisdom of this Committee in the past. However, other nations are rapidly investing in new electric

infrastructure. We estimate that our Industry also will be investing substantially in new plant and equipment in the amount of $75 billion over the next three years. During the period from 1995 through 2002 based on current plans, we expect to invest between $1.5 and $4.0 billion each year for environmental equipment as a result of the Clean Air Act of 1990. A neutral cost recovery system which reduces the cost of capital investment will help our Nation compete in the new one-world economy.

Competition in the Domestic Economy

Our Industry, once highly regulated, is rapidly moving toward less regulation and more competition as a result of energy policy changes at the federal level, including the enactment of the Public Utility Regulatory Policy Act of 1978 (PURPA) and the recently enacted Energy Policy Act of 1992. Non-traditional and non-regulated competitors in the electric business have established themselves and are growing rapidly. We need to ensure a level playing field for all competitors in our industry, be they investor-owned utilities, independent power producers, co-generators, or income tax exempt utilities.

Any cost recovery system enacted should fundamentally ensure that similarly situated property, regardless of form of ownership or guideline class, should have the same neutral cost recovery treatment. Today, biases exist which need to be corrected. For example, in certain cases, if a turbine electric generator is placed in service by a co-generator, the current MACRS depreciation treatment for the turbine electric generator is determined by the co-generator's business activity. As a result, a shorter life, be it seven years, ten years or fifteen years, and in most cases a more accelerated depreciation method is available dependent upon the co-generator's business activity versus the electric utility's business activity which requires a 20-year life with a 150 percent declining balance depreciation method. This bias as it exists in the current MACRS is heightened by the proposed NCR system. As currently drafted, the NCR system increases the unlevel playing field and unfair competition which should be corrected to ensure neutral cost recovery for all competitors.

Similarly, as technological advances occur, which result in opportunities and infrastructure investments in the information super highway, capital investment by electric utilities in technologies (such as fiber-optics) should not receive any different cost recovery treatment than other taxpayers with similarly situated property. We urge the Committee, for competitive reasons, to ensure the NCR system fundamentally provides that similarly situated property, regardless of ownership form or guideline class, will have the same neutral cost recovery treatment.

EEI wishes to further emphasize that substantial other competitive biases exist for certain segments of the electric utility business. The proposed NCR system, as modified by our discussion above, would help to overcome such bias. For example, governmental and tax exempt electric utilities (such as municipals and cooperatives) already have, in effect, a neutral cost recovery system because they are exempt from federal income tax. Furthermore, they receive huge subsidies from the federal government in the form of low interest or tax exempt loans. The cost of these subsidies is borne for the most part by U.S. taxpayers other than by the customers of the governmental and tax-exempt electric utilities. This means that customers of the investor-owned electric utilities, which serve 76 percent of all ultimate electric customers in our Nation, bear the unsubsidized cost of their electricity plus as U.S. taxpayers a portion of the cost of subsidizing the customers of governmental and other tax-exempt electric utilities. Although these governmental subsidies had their time and place in helping to provide electrification to every home in America, they are now misplaced in this new era of

budget deficits, deregulation and competition. These subsidies should be thoroughly reviewed.

Environmental Property

We are also concerned that the proposed NCR system does not incorporate Section 169 of the IRC which provides for 60-month amortization of qualifying pollution control facilities. This can be addressed by allowing environmental property to be included within the five-year NCR system life category similar to previously introduced H.R. 4299[2]. The cost recovery treatment of capital investment in environmental property such as pollution control equipment has been substantially eroded by tax law changes and is currently counterproductive to good public policy. The AMT should also be generally modified to exclude adjustments for recovery of capital investment in environmental equipment.

The cost recovery benefit of current law Section 169 has been substantially eroded by the special limitations of Sections 169(f) and 291(a)(5) and by Section 56(a)(5) of the AMT. Currently, for regular tax purposes, only 60 percent of qualifying pollution control capital investment is eligible for amortization under Section 169 as a result of the limitations of Sections 169(f) and 291(a)(5). The remaining 40 percent of the qualifying pollution control capital investment is required for regular tax purposes to be depreciated over the 20-year MACRS life for our Industry. This cost recovery benefit has for AMT purposes been further eroded by Section 56(a)(5) of the IRC, which provides that the total basis of the capital investment in the pollution control equipment must be amortized for purposes of computing the AMT preference adjustment over 28 years, using the straight-line method. Capital investment in environmental property should be included in the five-year NCR system life category.

Additionally, the definitions of qualifying pollution control property need to be updated to include expenditures and new technologies to comply with the Clean Air Act of 1990[3]. This definition should include emissions monitoring equipment, fuel switching, blending or co-firing modifications, boiler repowering modifications, nitrogen oxide controls, flue-gas desulfurization and/or other sulfur-dioxide controls, fluidized bed combustion, and coal gasification facilities, advanced coal cleaning facilities and air toxics control equipment and other emerging environmental

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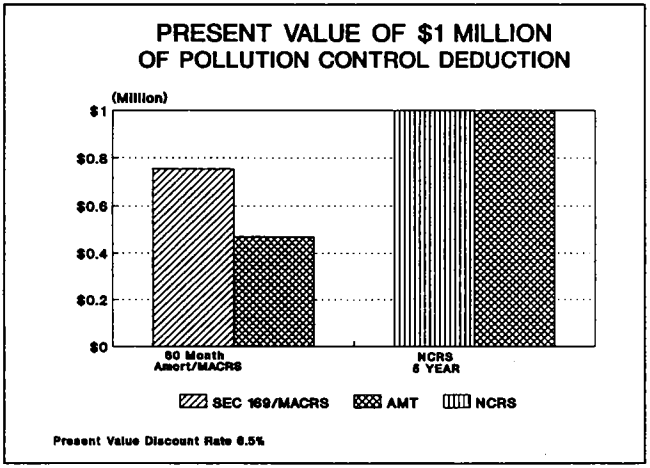
[2] H.R. 4299, introduced on February 25, 1992, would have established a new class of property identified as "environmental property" with a five-year recovery period.

[3] H.R. 4299 defined "environmental property" as follows: Environmental property is defined as a new identifiable item of property which is used in connection with a plant or other property in operation before January 1, 1991, to prevent, abate, or control water or atmospheric pollution or contamination by removing, altering, disposing, storing, or preventing the creation or emission of pollutants (including dust), contaminants, wastes, or heat, and property which monitors the creation or emission of pollutants (including dust), contaminants, wastes, or heat. The term includes only property which does not significantly increase the output or capacity, extend the useful life, or reduce the total operating costs of such plant or other property (or any unit thereof), or alter the nature of the manufacturing or production process or facility. Special rules would be applicable to buildings and leased property.

technologies. Our Industry estimates, based upon current plans, that it will invest between $1.5 to $4.0 billion each year in such equipment during the period 1995 through 2002 as a result of the Clean Air Act of 1990. As shown below, the cost recovery for capital investment in environmental property such as pollution control equipment under the current MACRS and AMT law highlight the need for the inclusion of environmental property in the five-year NCR system life category.



Other Recommendations

Normalization

Although our Industry strongly believes that normalization of depreciation book to tax timing or temporary differences is the proper method of tax accounting required to allocate tax expense to our customers, we have concluded that the permanent differences created by the unique nature of the neutral cost recovery ratio are not temporary differences. We recommend the NCR system be specifically clarified to state that the temporary differences related to assets under the NCR system would be subject to the mandatory normalization provisions of Section 168 of the IRC consistent with current law. The Industry has not reached a conclusion regarding whether or not the adjustment attributable to the NCR ratio should or should not be subject to mandatory normalization. We would be pleased to work with the Committee in regard to this matter.

Quarterly vs. Annual Calculations

The proposed NCR system requires ongoing calculations to be applied to property relating to the quarter the property was placed in service. This requirement adds substantial ongoing complexity and resulting administrative cost for both business and government. We recommend the Committee consider minimizing such administrative burden by adopting an annual rather than a quarterly convention.

Conclusion

In summary, we strongly support Chairman Archer's proposed NCR system consistent with our comments provided herein. The proposed NCR system is of benefit to our customers and will reduce the cost of virtually all U.S.-produced goods and services. We conclude it will help make America more competitive and it will help create more jobs. A key goal for a fair and equitable neutral cost recovery system is for it to enable our Nation to be more competitive and to provide a level playing field for all to compete. We urge the Committee, to ensure the proposed NCR system fundamentally provides that similarly situated property, regardless of ownership form or guideline class, will have the same neutral cost recovery treatment. Finally, we recommend the proposed NCR system be modified to include environmental equipment in the five-year NCR system depreciation category and that such equipment be eliminated from being subject to adjustments under the AMT. We thank the Committee for the opportunity to present our views and we look forward to working with you in the future with regard to this proposal and other important matters.

Ms. DUNN. Thank you very much, Mr. McCallum.

We will move along now with John Huber.

STATEMENT OF JOHN HUBER, GOVERNMENT AFFAIRS COUNSEL, PETROLEUM MARKETERS ASSOCIATION OF AMERICA

Mr. HUBER. Madam Chairwoman and members of the committee, thank you for providing an opportunity to present testimony on the legislative proposals to improve the cost recovery system for business investment.

PMAA is a federation of 41 State and regional trade associations representing more than 10,000 independent small business marketers throughout the United States. The impact of the current schedules for depreciating property are a strong concern to marketers and are clearly inappropriate.

There are two main areas of concern to marketers. First is the impact of the recently enacted Omnibus Budget Reconciliation Act of 1993, and the uniform 15-year schedules for all intangible property. This has a great impact on marketers and heating oil retailers in particular.

The other area of concern is the 39.5 year depreciation schedule for nonresidential real property, which prior to OBRA was 31.5 years. For many marketers who deliver fuel in bulk, the value of the business relates directly to the customer served.

A strong customer list and an extensive penetration of a particular geographic market makes for a valuable business. Without such a list, the business is merely a bulk plant, a small office building, and a few trucks. The customers are the business. Unfortunately customers do not last forever. Homeowners move, farmers sell out, trucking companies go bust. Thus, a customer base is always eroding.

Prior to the enactment of OBRA, most heating oil dealers amortized their customer list over a 7 to 10 year period. This time was recognized by the courts. The move to 15 years damaged these small businesses.

A second area of concern to petroleum marketers are covenants not to compete. Under common law these covenants must generally be no longer than 5 years.

In the heating oil industry the value of this covenant not to compete will generally range between 20 and 40 percent of the value of the business. A depreciation schedule of 15 years puts a large gap between the value of the covenant and its depreciation schedule and undermines the value of an ongoing business.

A third area of concern involves the depreciation schedules for nonresidential real property. The primary investment activity of our marketers involves the construction of service stations or gas station convenience stores.

Marketers are now having to replace many of their tanks that are currently in the field. This has led to a great deal of investment by petroleum marketers as they decide what stations to continue to operate and how their stations should be modernized, either through replacement or renovation. Under the existing code, some of the investments in gas station convenience stores are subject to a 39.5 year straight line depreciation schedule.

Industry practice is that these facilities are either worn out or no longer suitable for the market after 15 years, and therefore marketers who are investing in the industry are in a much faster schedule than allowed by the code.

PMAA believes that these extended depreciation schedules for this type of property embodied in section 168 are inappropriate. PMAA would encourage the committee to reexamine the existing schedules in section 168 and shorten the schedules or create additional classes of nonresidential real property.

PMAA is pleased that the committee is considering a capital gains tax reduction. We believe such an approach will spur investment and provide the appropriate rewards for those businesses investing in America's future. We believe that this item should be a top priority for enactment.

Finally, PMAA is very supportive of the provision to allow expensing of a small part of the capital investment in each year. An increase from $17,500 to $25,000 is a small increase, but it will be helpful.

PMAA is very pleased that the committee has developed a very solid approach to improve the climate for capital investment. These capital investments are clearly the key to continued growth.

We do believe that the committee should consider taking steps to bring the existing depreciation schedules of the code into closer conformity with actual industry practice. We believe the practice in recent years of extending the schedules to raise revenues has seriously undermined the principal of matching revenues and expenditures, which is the basis for an income tax.

Finally, PMAA remains concerned with the excise tax collection procedure and looks forward to working with this committee in the future and significant reform to those changes.

Thank you.

[The prepared statement follows:]

TESTIMONY OF JOHN HUBER
PETROLEUM MARKETERS ASSOCIATION OF AMERICA

Mr. Chairman, and members of the Committee, thank you for providing an opportunity to present testimony on the legislative proposals to improve the cost recovery system for business investments. The Petroleum Marketers Association of America (PMAA) is a federation of 41 state and regional trade associations representing more than 10,000 independent petroleum marketers throughout the United States. These marketers sell in excess of forty percent of the gasoline, 75 percent of the home heating oil and 60 percent of the diesel fuel consumed in this country. Eighty-nine percent of PMAA's membership is classified as small business under size categories established by the Small Business Administration.

The impact of the current schedules for depreciating property are of strong concern to marketers, and most believe that the schedules established are inappropriate. There are two main areas of concern to marketers. First, is the impact of the recently enacted Omnibus Budget Reconciliation Act of 1993 (OBRA) and the uniform fifteen year schedules for all intangible property. This has a great impact on marketers and heating oil dealers in particular. There is a great deal of consolidation in this industry, and the value of the firm is generally the value of the intangibles. Second, is the impact of the 39.5 year depreciation schedule for non-residential real property, which prior to OBRA was 31.5 years.

INTANGIBLE ASSETS

Briefly, PMAA members have a variety of different methods of delivering petroleum products to their customers. First, PMAA members deliver heating oil directly to homeowners and commercial customers. Second, many members deliver motor fuels to farmers, trucking companies, and construction crews who need fuel delivered to them or to a particular site.

For marketers who are active in these two areas, the value of the business relates directly to the customers served. A strong customer list and an extensive penetration of a particular geographic area makes for a valuable business. Without such a list, the business is merely a bulk plant, a small office building, and a few trucks, whose value is reduced with every new environmental regulation. **The customers are the business.**

Unfortunately, customers do not last forever. Homeowners move. Farmers sell out. Trucking and construction companies go bust. Additionally, some customers find the service or price of a competitor to be better and begin purchasing product from that company. Additionally, the Clean Air Act Amendments will require many customers to transfer their fleets to alternative fuels. As a result, they will not only be lost to a particular marketer, but they will be lost to the entire petroleum marketing industry.

Mr. Chairman, what I am trying to say is that a customer list is the most important asset for many petroleum marketers, but unfortunately, it does not normally last 15 years. Prior to the enactment of this legislation, most heating oil dealers amortized their customer list over a seven to ten year period. This time was recognized by the courts, and is in line with surveys indicating that, on average, homeowners move every six years. The move to 15 years was clearly inappropriate.

A second area of concern to petroleum marketers are covenants not to compete. Because many of the companies operated by PMAA members were developed through the hard work of a single individual who penetrated a market and developed a loyal customer base, businesses who acquire that company often enter into a contract preventing that individual from becoming a competitor. Under common law, those covenants must have reasonable terms, which generally means five years.

In the heating oil industry, the value of this covenant not to compete will generally range between 20 percent and 40 percent of the value of the transaction. A depreciation schedule of fifteen years would put a large gap between the value of the covenant and its depreciation schedule and could substantially harm the acquiring company.

TANGIBLE ASSETS

A second area of concern involves the depreciation schedules for non-residential real property. The primary investment activity of our marketers involves the construction of service stations or gas station convenience stores. Under, the environmental laws, marketers are now having to replace many of their tanks that are currently in the field. This has led to a great deal of investment by petroleum marketers as they decide what stations to continue to operate, and how their stations should be modernized either through replacement or renovation. This heightened level of activity will continue for at least four more years.

Under the existing code and pursuant to Internal Revenue Service guidance, some of the investments in gas station convenience stores are subject to a 39.5 year straight line depreciation schedule. Industry practice is that these facilities are either worn out, not modern enough to attract customers, or no longer suitable to the market after approximately fifteen years, and therefore marketers who are investing in the industry are depreciating the stations much more quickly on their own books than the Internal Revenue Code allows for tax accounting.

PMAA believes that these extended depreciation schedules for this type of property embodied in section 168 are inappropriate. PMAA would encourage the Committee to reexamine the existing schedules in Section 168 and shorten the schedules or create different classes of non-residential real property.

JOB CREATION AND WAGE ENHANCEMENT ACT

PMAA is very pleased that Congress is now considering ways to improve the depreciation deductions for businesses. In particular we are pleased that the Committee is considering a capital gains tax reduction. We believe such an approach will spur investment and provide the appropriate rewards for those businesses investing in America's future. We believe that this item should be a top priority for enactment.

We also believe that an inflation adjustment within the capital gains is vital. Taxing gains which emanate from inflation is clearly inappropriate and has undercut the value of many productive investments and created a windfall for the Treasury.

PMAA, however, is concerned with the methodology to allow for an improved cost recovery system. In particular, a change from the 200 percent declining balance to a 150 percent declining balance gives concern to PMAA. This reduced schedule would result in an immediate negative impact on marketers investing in personal property. Marketers invest considerable sums in the assets affiliated with their real property and make considerable investment in rolling stock. A delayed depreciation schedule would thus be harmful.

Finally, PMAA is very supportive of the provision to allow expensing of a small part of the capital investment in each year. While, $25,000 is a small percentage of a marketer's likely investment, it would certainly be a benefit to marketers.

CONCLUSION

PMAA is very pleased that the Committee has developed a very solid approach to improve the climate for capital investment. These capital investments are the key to continued growth in America and are thus of vital interest to both business and their employees.

We do believe that the Committee should consider taking steps to bring the existing depreciation schedules of the Code into closer conformity with actual industry practice. We believe the practice in recent years of extending the schedules to raise revenues has seriously undermined the principle of matching revenues and expenditures which is the basis for an income tax. We would thus respectfully encourage the Committee to more closely examine those schedules and take steps to make the schedules reflect economic reality.

Ms. DUNN. Thank you very much, Mr. Huber.

We will do our wind-up speaker, Dr. Martin Sullivan.

STATEMENT OF MARTIN A. SULLIVAN, PH.D., ADJUNCT SCHOLAR, AMERICAN ENTERPRISE INSTITUTE

Mr. SULLIVAN. Thank you, Madam Chairman, and distinguished members of the committee.

My name is Martin Sullivan. I am a self-employed economic consultant and an adjunct scholar at the American Enterprise Institute. It is an honor for me to be here today, and I hope my views will be helpful to you.

The neutral cost recovery system is an approach to tax depreciation that is radically different from any other. Under NCRS, $100 of equipment with a useful life of 5 years generates approximately $120 of depreciation deductions. A $100 investment in a building generates approximately $300 of depreciation deductions.

The key feature of NCRS depreciation is the adjustment of depreciation allowances for inflation and for the time value of money. This adjustment increases deductions so that their present value is equivalent to expensing.

Expensing is the ultimate in accelerated depreciation. Where debt financed property is expensed, that property's effective tax rate is negative, thus NCRS goes beyond relief and provides a subsidy for most business investment in new equipment.

Negative effective tax rates mean that new assets will generate more deductions than income. Under NCRS many capital-intensive firms will be able to eliminate their corporate income tax liability, even though they are profitable.

There is no doubt that NCRS will result in an enormous increase in the buying and selling of tax benefits. Because of the passive loss rules, partnership tax shelter activity on the scale like that before 1986 is not possible. But the existence of the passive loss rules does not mean that there will not be tax shelters as a result of NCRS. It only means that their form will change.

Tax shelter activity will shift to the corporate level. In order to convert unusable tax deductions into cash, taxless corporations will engage in leasing transactions which will effectively allow them to sell their tax benefits.

In addition to tax-motivated leasing, NCRS will clearly provide a large tax incentive for mergers and acquisitions. This is the granddaddy of sheltering transactions. In the typical case, a capital-intensive firm that is generating deductions in excess of income, will put excess deductions to work by merging with a profitable labor-intensive firm.

If enacted, NCRS would impose unduly complex and costly tax rules on U.S. businesses. Sometimes complexity in the code is unavoidable, but that is not the case in this situation. What is so frustrating about the complexity of NCRS is that the same economic benefits can be provided much more simply. This is the Rube Goldberg of tax breaks. NCRS forces taxpayers on Main Street to face a whole new set of complicated rules and regulations so that the folks inside the beltway can game the budget rules.

NCRS will provide the most generous system of capital recovery ever enacted into Federal tax law. Yet, it is entirely possible for

NCRS to be scored officially as raising revenue. You don't need to be an economic expert to know there is something fishy about this, and this point will not be lost on the bond traders on Wall Street.

For purposes of preparing this testimony, I constructed a depreciation revenue-estimating model. Like the Treasury Department's estimates, my model shows that the cash flow effects of NCRS are net positive for the government over the first 5 years, but afterward, NCRS rapidly turns into a big loser for the government. My model estimates the total 10-year cost in terms of cash flow at $150 billion. But even these long-term cash estimates do not accurately portray the costs of this proposal.

Our current methods of accounting for revenue changes are flawed. We only score cash flows and we do not score the real economic costs. In order to assess the real costs of this proposal, I estimated the cost of an investment tax credit economically equivalent to NCRS. I believe this is the best measure of the true cost of NCRS.

When the cost of an economically equivalent tax credit is estimated, NCRS can be seen for what it really is, a budget buster of monumental proportions. What was scored in the 5-year window as a small increase in revenue under conventional cash flow accounting becomes a $160 billion revenue loser in the first 5 years. Over the 10-year budget window, the total real economic cost to the government of NCRS is estimated to be $370 billion.

It is this type of discrepancy between official cash flow estimate and real economic costs that will spook the financial markets. If NCRS is enacted and the hundreds of billions of dollars of real costs are not matched by real spending cuts or tax increases of similar magnitude, long-term interest rates will rise. Because of this rise in interest rates, and the crowding out of private investment by increased Federal debt, there is a significant chance that NCRS could have detrimental effects on capital formation.

This concludes my oral testimony. I am very grateful to the committee for this opportunity to share my views.

[The prepared statement follows:]

TESTIMONY ON THE "NEUTRAL COST RECOVERY SYSTEM"

BY

DR. MARTIN A. SULLIVAN

ADJUNCT SCHOLAR
AMERICAN ENTERPRISE INSTITUTE

BEFORE THE COMMITTEE ON WAYS AND MEANS
OF THE
UNITED STATES HOUSE OF REPRESENTATIVES
104TH CONGRESS

JANUARY 26, 1995

Good Morning Mr. Chairman and distinguished Members of the Committee. My name is Martin Sullivan. I am a self-employed economic consultant and an Adjunct Scholar at the American Enterprise Institute. Over the past 15 years I have conducted research and analysis in academia, for the Congress, for the U.S. Treasury Department, and for clients in the private sector, on tax incentives for capital formation. It is an honor to be here today and I hope my views will be helpful to you.*

1. Some Basics About NCRS

The Neutral Cost Recovery System (NCRS) is an approach to tax depreciation that is radically different from any other that has existed since the inception of the income tax. By statute and by regulations, previous Congresses and Administrations have on numerous occasions tinkered with depreciation methods and lives in such a manner that affected only the timing of deductions. Whatever system they devised, a $100 purchase of depreciable capital always got a $100 of deductions. Under NCRS depreciation, every $100 expenditure for depreciable capital will routinely generate deductions substantially in excess of $100. In the example presented at the end of this testimony (Table 1), $100 of equipment with a useful life of 5 years generates depreciation deductions of approximately $120 over the its life. Similar calculations show a $100 building with a useful life of 39 years generating approximately $300 of depreciation deductions over its life.

NCRS would be available to both corporate and noncorporate taxpayers for capital placed in service after December 31 of 1994. Taxpayers could elect the NCRS on a property-by-property basis, and, importantly, NCRS would also be available for computing deductions under the alternative minimum tax.

NCRS divides depreciable property into two categories. Property with a recovery period of 10 years or less would be required to make three changes from current law: (1) replace the 200-percent declining balance method with the less accelerated 150-percent declining balance method; (2) multiply these allowances by a factor to account for cumulative amount of inflation since the asset was placed in service; and (3) again multiply by a factor representing the cumulative real return

* The views expressed in this statement are those of the author and do not necessarily reflect those of the American Enterprise Institute.

that could have been earned by the amount of that deduction since the time the asset was placed in service. For property with a useful life of greater than ten years, the only change from current law is that allowances are adjusted for inflation.

Adjustments (2) and (3)--which may be referred to jointly as the "cost recovery adjustment"--make sure that no matter in what year a deduction is taken, it is equal in present value to taking the unadjusted deduction in the first year. Thus, applying a cost recovery adjustment to all the depreciation allowances over the useful life of an asset results in total deductions equal in present value to a complete write-off of the asset in the first year. Completely writing off assets in the first year is commonly referred to as "expensing."

It is noteworthy that the cost recovery adjustment achieves the economic equivalent of expensing not only under the prescribed 150-percent declining balance, but also under straight-line depreciation, the 200-percent declining balance, or any other method. (For an example showing this, see Table 2.) Thus, the required switch from 200- to 150-percent declining balance plays no role in achieving equivalency with expensing. It does unfortunately have the effect depriving small and growing firms of precious cash flow. Since the adjustment serves no useful purpose, it can only be concluded that it was included in NCRS to allow a small immediate acceleration of cash flow to the government so that this enormous tax reduction can be official scored as a tax increase.

Expensing is the ultimate in accelerated depreciation. It provides an up-front deduction which by itself has a present value large enough to shelter all the income from property placed into service. Thus, solely as a result of expensing, the property has an effective tax rate of zero. If the property is to any extent financed with debt, additional deductions in the form of interest are available to shelter other income. Thus, when a debt-financed property is expensed, the property's asset's effective tax rate is negative. In part because tangible capital serves as good collateral for lenders, most investment in plant and equipment is routinely financed by debt to at least some degree. Thus, NCRS goes beyond tax relief and provides a *subsidy* for most business investment in new equipment.

As noted above, negative effective tax rates mean that new assets will generate more deductions than income. Under NCRS, many capital intensive and highly leveraged firms will be able to completely eliminate their corporate income tax liability even though their financial statements report that they are profitable. The minimum tax does not prevent this because NCRS depreciation methods will also be used for the alternative minimum tax.

Inflation adjustment for longer lived property under NCRS is a substantial benefit relative to current law. However, the benefits provided under NCRS to long-lived property are not as generous as it is to those received by short-lived property that is subject to a full cost recovery adjustment. Given this major disparity in treatment between equipment and structures, this "neutral" system is markedly non-neutral. In particular, because of the high concentration of equipment investment in manufacturing, it is generally the case that manufacturing will be advantaged over other sectors of the economy.

2. Tax Shelters and Tax-Motivated Leasing

In addition to the NCRS bias in favor of equipment over structures, there are several other inefficient distortions to economic behavior induced by NCRS. When tax rates fall below zero as they do under NCRS, new assets will generate more deductions than income. These excess deductions can be used to shelter income from sources other than new capital. Sheltering transactions can take a variety of forms. None of them are particularly attractive from a policy perspective in that they usually involve a distortion in the allocation of capital or businesses engaging in transactions that are purely tax-motivated.

Businesses generating excess deductions from depreciation of their new NCRS capital will first use these excess deductions to shelter the income generated by their pre-NCRS capital. New and growing firms generally will have relatively little pre-NCRS capital income. Therefore, new and growing firms unable to utilize the all of their generous NCRS deductions will be at a tax disadvantage relative to established firms.

Over time, more and more firms will be able to eliminate their entire tax liability as a result of NCRS. The number of tax-free businesses will grow because the proportion of total capital depreciated under NCRS will grow and because NCRS deductions will be backloaded. Once businesses are no longer subject to tax but continue to generate deductions, they are likely to engage in a wide variety of tax motivated transactions to get some value from their unused NCRS deductions.

NCRS will clearly provide large tax incentives for mergers and acquisitions. This is the granddaddy of sheltering transactions. In a typical case, a capital-intensive firm that is generating deductions in excess of income can put these deductions to work by merging with a profitable labor-intensive firm. Because NCRS's deductions are heavily backloaded, capital intensive firms that are not already in a tax loss position will have several years to seek out the right partner.

Were it not for enactment of passive loss limitation as part of the Tax Reform Act of 1986, much of the sheltering activity resulting from NCRS would probably involve partnerships of individuals investing in leveraged and tax-advantaged capital. These partnerships would generate tax losses that could be used to shelter other sources of individuals' taxable income. Although partnership tax shelter activity on the scale like that before the 1986 Act is not possible with the passive loss rules currently in place, there is no doubt that the enormous increase in the supply of marketable tax deductions wrought by NCRS will increase pressure on the current passive loss rules.

With individuals largely prevented by the passive loss rules from wholesale participation in the tax shelter market, tax shelter activity will shift to the corporate level. On the corporate side, large numbers of capital-intensive firms will have no tax liability and soon will be accumulating tax losses. In order to convert these otherwise unusable tax deductions into current benefit, tax-free firms will engage in leasing transaction with firms that have taxable income. The taxable firms will purchase assets and lease them to tax-free firms. The taxable lessor firms will pass some of the tax benefits through to the tax-free lessees through reductions in the lease rate, and will keep for themselves whatever is left after the lawyers and accountants get their share. These

transactions will have little or no economic substance beyond those motivated by taxation.

3. Complexity

If enacted, NCRS would impose unduly complex tax rules on U.S. businesses. Sometimes complexity in the Code is unavoidable, but this is not the case here. What is so disappointing about NCRS is that there are many other ways to provide American businesses with the same tax benefits more simply and more efficiently. For example, the same economic benefits could be provided by expensing. Under NCRS, businesses would instead be required to recovery their capital cost over many years and these annual allowances would be subject to adjustments. Short-lived property would require a different set of adjustments than long-lived property. Moreover, for each class of property, in order to accurately index depreciation allowances, NCRS requires taxpayers to keep separate accounts for investments made in each quarter, instead of each year, as is now allowed under current law.

Although I do no not know who is responsible for the design of NCRS, it has "Made in Washington" stamped all over it. Clearly, this Rube Goldberg of tax breaks was not conceived on the Main Streets of America. Business men and women who have to deal with these tax rules will privately tell you that they would much prefer relief from the AMT, or extension of R&E credit, or expensing, or a simple lowering of tax rates.

4. Shortfalls in Official Scorekeeping and Maintaining Confidence in Financial Markets

NCRS would provide the most generous system of capital recovery every enacted into Federal tax law. It is entirely possible, however, for it to be scored officially as *raising* revenue. You do not need a Ph.D. economics to know their is something fishy about this, and the point will not be lost on financial markets trying to assess the seriousness of deficit reduction efforts in Congress.

It is possible for NCRS to be scored as a tax increase because of two serious shortcomings in the accounting for revenue effects of legislative changes. First, current accounting only measures changes in cash flows and not real economic costs. Second, official scorekeeping has a limited horizon that until recently did not extend beyond five or six years into the future. (The Senate has now begun to use ten-year horizons to evaluate revenue changes.)

What is particularly troubling about NCRS from the perspective of financial soundness is that NCRS appears to have been specifically designed to take advantage of these shortcomings. For example, as noted above, the combination of indexing allowances of short-lived property for the cumulative amount of inflation and real returns achieves the economic equivalent of expensing. Given these adjustment factors, the required change from 200-percent to 150-percent declining balance depreciation has no substantial economic effect (for example, the after-tax cost of capital would not be affected) except to give the appearance under current rules that this proposal is a revenue raiser.

In its estimate of an earlier (more generous) version of NCRS, the Treasury Department estimated that under official accounting methods NCRS would *raise* approximately $18 billion in revenue over fiscal years 1995-2000. For purposes of preparing for this testimony, I constructed my own revenue estimating model. In my model NCRS as described in H.R. 9 would raise perhaps $3 billion over fiscal years 1995-2000.

In addition the Treasury Department also provided estimates Treasury estimated total costs at $120 billion over fiscal years 1995-2005. My model estimates total costs over fiscal years 1995-2005 to be approximately $160 billion. Thus, like the Treasury Department's estimates, my model shows that the cash flow costs of NCRS are heavily backloaded.

But even these long-term cash flow changes do not accurately portray the real cost of NCRS. In order to allow the Committee to better assess the real costs of this proposal, I also used my estimating model to calculate the cost of the investment tax credit that would be economically equivalent to NCRS. I believe this is the best measure of the true cost of NCRS because when an asset is placed in service it will be irrevocably entitled to a stream of additional tax deductions (because the chance of retroactive tax increases are close to nil). The real cost to government--and the real benefit to the taxpayer--is the change in the present value of those deductions multiplied by rate of tax, and this is exactly how the equivalent investment tax credit is calculated. These rates of credit vary depending upon the useful life the asset and are shown at the end of this testimony (Table 3).

When I estimate the revenue costs of investment tax credits economically equivalent to NCRS, the impact on Federal finances over the 1995-2000 fiscal year changed from *positive* $3 billion under cash flow conventional accounting changed to *negative* $160 billion. Over the 1995-2005 budget window, the impact changed from negative $167 billion to negative $370 billion.

It is this type of discrepancy between the official cost estimates and real economic costs that will spook financial markets. If the 1995-2000 budget window is used and NCRS is officially scored as revenue neutral or even a small revenue raiser when its real costs for that period are $160 billion, and that $160 billion loss to government is not matched by a real spending cuts or tax increases of a similar magnitude, long term interest rate will rise as financial markets anticipate the demand for increased federal borrowing in the future to make up this shortfall. Moreover, unless foreigners invest more heavily in the United States, increased government demand for funds will likely crowd out private investment and frustrate the objective of NCRS.

Besides this large and direct impact on the supply and demand for financial capital, there is an additional negative impact of this gimmickry embodied in NCRS. A backdoor increase in the Federal deficit is more detrimental to market confidence than are increases in the deficit that are plain for all to see. This is because use of gimmicks sends a troubling signal that the Federal government is not really serious about reducing the deficit. It tells the market that when the going gets tough, the government will resort to more gimmicks. If the Federal government cannot be square with the American people and soundly finance the Contract with America, how sincere can be its efforts to eliminate the deficit by 2002?

Conclusion

The objective of NCRS is to promote economic growth with tax incentives for investment. However, much of the benefit of lower taxes on capital will be offset by higher interest rates and reduced availability of funds if the costs of NCRS are not honestly accounted and paid for. Under NCRS many profitable corporations would no longer pay corporate tax and owners of many noncorporate businesses would pay no income tax at all. As these tax-free businesses generated more losses, tax-free businesses would have large incentives to merge with taxable businesses or to sell their tax benefits to taxable businesses. Finally, NCRS's attractiveness to business is substantially curtailed by its complexity and its negative impact on cash flow.

* * * * * *

Table 1. Comparison of Current Law and NCRS Depreciation

CURRENT LAW: 5 -YEAR LIFE, DOUBLE DECLINING BALANCE, HALF-YEAR CONVENTION

YEAR		1	2	3	4	5	6
DEPRECIATION @200%		20.00	32.00	19.20	11.52	11.52	5.76
NOTE:							
TOTAL ALLOWANCES	100.00						
PRESENT VALUE @ 8%	$87.62						

NEUTRAL COST RECOVERY SYSTEM: 5-YEAR LIFE, 150 PERCENT DECLINING BALANCE, HALF-YEAR CONVENTION, ADDING ADJUSTMENTS FOR INFLATION AND EXPENSING

YEAR		1	2	3	4	5	6
DEPRECIATION @150%		15.00	25.50	17.85	16.66	16.66	8.33
INFLATION ADJUSTMENT FACTOR		1.000	1.050	1.103	1.158	1.216	1.276
'EXPENSING' ADJUSTMENT FACTOR		1.000	1.035	1.071	1.109	1.148	1.188
NEW DEPRECIATION		15.00	27.71	21.08	21.38	23.24	12.63
NOTE:							
TOTAL ALLOWANCES	121.04						
PRESENT VALUE @ 8%	$101.38						
NOTE:							
REVENUE EFFECT OF CHANGE TO NCRS WITH 35% RATE		1.75	1.50	-0.66	-3.45	-4.10	-2.40

Table 2. A Comparison of the 150- and 200-Percent Declining Balance Methods--NCRS Adjustments Achieve Equivalent Present Value of Deductions Irrespective of the Depreciation Method Used

150 PERCENT DECLINING BALANCE

YEAR	1	2	3	4	5	6
DEPRECIATION @150%	15.00	25.50	17.85	16.66	16.66	8.33
INFLATION ADJUSTMENT FACTOR	1.000	1.050	1.103	1.158	1.216	1.276
'EXPENSING' ADJUSTMENT FACTOR	1.000	1.035	1.071	1.109	1.148	1.188
NCRS DEPRECIATION	15.00	27.71	21.08	21.38	23.24	12.63

NOTE:

TOTAL ALLOWANCES	121.04
PRESENT VALUE @ 8%	$101.38

200 PERCENT DECLINING BALANCE

YEAR	1	2	3	4	5	6
DEPRECIATION @200%	20.00	32.00	19.20	11.52	11.52	5.76
INFLATION ADJUSTMENT FACTOR	1.000	1.050	1.103	1.158	1.216	1.276
'EXPENSING' ADJUSTMENT FACTOR	1.000	1.035	1.071	1.109	1.148	1.188
NCRS DEPRECIATION	20.00	34.78	22.68	14.79	16.07	8.73

NOTE:

TOTAL ALLOWANCES	117.04
PRESENT VALUE @ 8%	$101.13

Note: Present values do not equal $100 because mechanics of statutory draft only approximate the formula necessary to achieve expensing equivalence. To achieve equivalence, the capital recovery adjustment should equal $(1+r+p)^n$ where r is the real rate of interest, p is the rate of inflation, and n is the number of years since the property was placed in service. The statutory draft uses an adjustment equal to $(1+r)^n*(1+p)^n$. This creates a bias for the cost recovery adjustment to be larger than that necessary to provide the equivalent of expensing.

* * * * * *

Table 3. Rates of Investment Tax Credit Providing Equivalent Tax Benefits to those Provided Under NCRS

Class Life	ITC Rate
3 years	2.70%
5 years	4.82%
7 years	6.73%
10 years	9.32%
15 years	7.18%
20 years	8.28%
27.5 years	9.81%
39 years	10.61%

Ms. DUNN. Thank you very much, Dr. Sullivan.

We will move to questioning now, and Mr. Collins will inquire.

Mr. COLLINS. Thank you, Madam Chairman.

Mr. Sullivan, I gather from your testimony that the NCRS is not your ideal way of improving capital costs for recovery, and I think that is putting it mildly. What do you think of the suggestion of improving the alternative minimum tax that others have already made?

Mr. SULLIVAN. There really is no economic basis for an alternative minimum tax from an economic perspective. Reducing the alternative minimum tax, if honestly paid for, is a much preferable way of providing capital tax breaks.

Mr. COLLINS. Thank you, that is all I have, Madam Chairman.

Ms. DUNN. Mr. Rangel will inquire.

Mr. RANGEL. Thank you.

Dr. Sullivan, we are going to have to assume that the Contract With America had economists working on it just as smart as you. You and the Treasury seem to believe that this is a tremendous budget buster; $150 billion loss. All of us support a balanced budget. Certainly, scoring is very, very important in our business, because there will be devastating cuts unless we can find the right numbers.

Now, why as an economist, would you believe that anyone for political reasons would want to cook the books to come up with these types of numbers when they, too, are dedicated to providing services and balancing the budget?

Mr. SULLIVAN. Well, I am only an economist, I can't speak to motivations.

Mr. RANGEL. Well, let me rephrase the question. Economists that support different figures forgetting political motivation, how do they justify it?

Mr. SULLIVAN. The one thing that has not been part of this discussion today that is critically important when we are talking about the economic impact of NCRS, is whether it is going to be paid for or not.

Mr. RANGEL. Dr. Sullivan, that is a part of the Contract. It has got to be paid for. As a matter of fact, it has to be paid for before we mark up the bill. But you don't know what to pay unless you know what the cost is.

And it seems to be a tremendous difference of opinion between people, such as yourself, and the U.S. Treasury Department, and those people that have been used to give estimates to those who put together the Contract. So, forget the cost—nobody with the Contract is indicating that they want the tax relief and not pay for it. That is universal.

Now, my question is, why would they come up with such different figures? And you have to assume good intent for purposes of my question. They are professional people.

Mr. SULLIVAN. I do not believe the figures that I have drawn up are controversial. I think it is very clear to everybody that this is a tremendous drain on the U.S. Treasury. With all due respect to the diverse opinions, I think this is a fact.

The real problem with NCRS is not even within the code sections that describe it. If it is not financed, if it is not paid for in a mean-

ingful way, and there is an end run around the budget rules, NCRS will have a very detrimental impact on the financial markets.

Mr. RANGEL. I know that there are various opinions about this recovery program on the panel, but does anyone challenge his analysis of the cost?

Mr. MCCALLUM. Mr. Rangel, I would make a comment, and I would try to segregate, for a moment, the difference between this proposal trying to get us to a competitive depreciation system with the rest of the world and financing that system. I think you are talking about financing that system, and I think we are saying that it should be paid for and that is, in your judgment, all of you, to make sure that that happens and that it is done correctly.

Mr. RANGEL. I will accept that challenge. But you have to tell me what it costs so I would know how to pay for it. And if you are talking about something that is so—so expensive, we just have to weigh how fast we move to competition.

Most Members of Congress agree with the testimony that we have to catch up with the other countries. But politically, we agree that we cannot cause an increase in our deficit and a failure of people to rely on our economy. And when these numbers come like they are, and there is a dramatic difference of opinion, assuming good faith, we have to rely on people such as yourself to help us to make these decisions.

So, this panel will leave the question regarding this tremendously expensive tax provision.

Thank you, Madam Chairlady.

Ms. DUNN. The gentleman's time has expired.

The questioning will be continued by Mr. English.

Mr. ENGLISH. Thank you, Madam Chairman.

Dr. Sullivan, we heard an earlier panel discuss the concern of Secretary Samuels expressed earlier this week that the NCRS system creates the possibility of some new tax shelters. I judge from your testimony, that you share that concern?

Mr. SULLIVAN. Yes, I do, Mr. English.

Mr. ENGLISH. Could you talk a little bit about the specifics briefly.

Mr. SULLIVAN. The 1986 act, with passive loss limitation rules, eliminated what we call the dentist in New Jersey-type of tax shelter where individuals are able to join partnerships and eliminate tax on their unrelated income. That will not occur under NCRS.

However, because you have all of these losses in the economy, 10 and 20 and 30 billion dollars' worth of losses without any income, businesses, because they are innovative, will try to engage in transactions to shelter that income.

There are two primary forms of sheltering that will occur: Leasing, mergers, and acquisitions. The economic forces will just be too strong for anybody to resist.

Mr. ENGLISH. I would like to explore kind of without polemics, the question of the difference between your revenue numbers and those from the Treasury. Is there any methodological difference between your models?

Mr. SULLIVAN. I don't believe so. My model is a much cruder model than the Treasury's model. But I used the same basic meth-

odology. I would not have even brought it before the committee if I did not think it would be generally accepted as accurate.

But my second set of figures, the larger set of figures, is different from Treasury's. It is methodologically different from the Treasury's and different from any official estimate, because I try to measure the real costs and not just cash flows.

Mr. ENGLISH. Let me shift gears a second. You commented on the efficacy of addressing the AMT problem and that impacts on certain classes of industries. My own view is that we also need broader relief for capital investments throughout the economy.

And I wonder if you would comment on the provision raising the small business equipment expensing threshold from $17,500 to $25,000. I wonder, particularly for small dynamic manufacturers like I have in my district, would raising that threshold further to, say, $100,000 have a benefit, and from an economics standpoint, how would you analyze that kind of a tax change?

Mr. SULLIVAN. Raising the expensing limitation under 179 would certainly be a superior change in the law relative to this provision. It is simpler. It achieves the same economic effects, but in particular, for small businesses, it provides much more cash flow, which is critical for them. Unfortunately, under current scoring rules, that type of change is unduly penalized because the cash flows are frontloaded and we only measure the cash flow costs.

Mr. ENGLISH. Thank you.

Mr. Beghini, welcome.

In your testimony, you discuss some of the problems associated with the AMT, and I was wondering what specific changes could be made to the AMT that would help your industry?

Mr. BEGHINI. Well, one of the first changes that was mentioned by the first panel would be to conform the AMT depreciation rate to the regular tax depreciation rate. In addition, we believe that AMT tax credits should be applicable against future AMT liability.

We would like to see the IDC, the intangible drilling costs, preference item repealed. We would like to exclude environmental-related assets from AMT depreciation. We would like to see the 90-percent foreign tax credit limitation removed. And we would like to repeal the LIFO adjustment, which in our industry is a very, very large adjustment when we get price spikes.

Ms. DUNN. The gentleman's time has expired.

Mr. ENGLISH. Let me just say, I appreciate Mr. Powell being here. I wish I had had an opportunity to question him. Air products has been a good neighbor in the Allegheny Valley just outside of my district.

Ms. DUNN. A vote is appearing on the floor within 5 or 10 minutes, so I ask that questioners and responders be brief.

Mr. Christensen will inquire.

Mr. CHRISTENSEN. Dr. Sullivan, I usually pick on people who I don't agree with, but I like you because you are self-employed and I appreciate you coming here and I respect your opinion. I appreciate the fact that your viewpoints here were very well thought out. I am not sure that I agree with them all, but I do respect the fact that you are a self-employed economic forecaster.

I wanted to ask Mr. Powell if there were any other tax ramifications that were affecting the Chemical Manufacturers Association

that we could take a look at on this committee that would help you and your association? Is there anything facing your particular industry, similar to Mr. Beghini, or is it all the same?

Mr. POWELL. Well, I must say, I haven't thought about that recently and I am sure if I had some time, we could come up with items that are truly troublesome. But I think capital recovery in the chemical industry is very important, we are the largest exporter of the United States and we are faced with competition. If we want to produce in the United States, we need capital recovery. And I would say that elimination of the AMT would be a strong first step for us.

Mr. CHRISTENSEN. Thank you, Madam Chairman.

Ms. DUNN. Thank you.

Mr. Payne.

Mr. PAYNE. Thank you very much, Madam Chair.

I had one point of clarification for Dr. Sullivan. Did I understand you to say that there would be two kinds of tax shelters that would be created by the neutral cost recovery provision, leasing and mergers and acquisition? I understand the leasing part. Could you explain why mergers and acquisitions might become a tax shelter product or industry under this provision?

Mr. SULLIVAN. Certainly, I would be glad to. A capital-intensive business—eventually, and this becomes increasingly the case over time because of all the benefits that are backloaded—will zero out, that is, pay no income tax. Also, the minimum tax liability will not be a factor because NCRS also applies to the minimum tax. These capital-intensive corporations will have large amounts of unused tax deductions.

The only way for them to use their NCRS deductions if they don't go the leasing route, would be to merge with a profitable firm, which would typically be a labor-intensive, service-sector firm, with a steady flow of profits. This profitable firm would be able to shelter its income against those unused losses generated by capital-intensive firms.

Mr. PAYNE. And that really becomes a situation that would occur, as I have looked at these schedules, perhaps in 6, 7, 8, 9, 10 years? It is a problem that is down the road?

Mr. SULLIVAN. Yes, one big difference between expensing, which is up front, and NCRS, which is very backloaded is that you will see it coming. The corporate treasurers will see it coming and they will be able to create a lot of value by corporate marriages with good suitors who have a tax situation which is compatible to creating this value. So they will have time. And it will occur starting 4, 5, 6 years out. That is when the big wave would occur.

Mr. PAYNE. Wouldn't expensing provisions have the same potential impact?

Mr. SULLIVAN. Expensing will have the same impact, but because the cash flow effects are up front, it will happen much more quickly.

Mr. PAYNE. So you are saying that more expensing could lead to more tax shelters more quickly, as a result of mergers and acquisitions?

Mr. SULLIVAN. Yes, I would say that relative to NCRS, expensing on a broad scale would also have incentives for mergers and acqui-

sition, and that is more likely to occur earlier rather than later in time.

Mr. PAYNE. As I say, this is only a point of clarification because I am in favor of expensing. This committee passed a provision more generous than the $17,000 which was enacted, in fact, it was $25,000 as it came out of this committee last session. That is something that I hope we will revisit, which is why I was interested in knowing your thoughts on it.

Mr. SULLIVAN. $17,000 to $25,000 is on such a small scale that I don't think that would result in a merger and acquisition problem.

Mr. PAYNE. Thank you very much.

Ms. DUNN. Thank you, Mr. Chairman.

Questioning will resume with Mr. Herger.

Mr. HERGER. Madam Chair, I will yield to Mr. Collins.

Ms. DUNN. Thank you.

Mr. Collins.

Mr. COLLINS. Thank you, I appreciate the gentleman yielding.

The comment was made I believe it was Mr. McCallum, pointed out that what we have to weigh here is a decision between cost and competition. Was not that a fair statement?

And you agreed with that, Dr. Sullivan. That seems to be a simple decision to weigh. However, due to the laws and the regulations that we have to operate under, it does throw a roadblock in our way because we have to deal with the cost.

But my point is, and I have said this all along, that I think the biggest competitor or the stiffest competition to American business and American jobs, is the Congress. It is the U.S. Government. And if a corporation who is in global competition is facing a tax policy that prohibits them from being competitive, is that not an incentive to move that business offshore to where they can become competitive?

Mr. MCCALLUM. Mr. Collins, I agree with what you are saying. If we look at our depreciation system, it really is a tool for business to compete. And if we don't have as good a tool as other nations around the world, then we will ultimately lose that competition.

Now, the issue of being able to pay for this system, if the facts are that we cannot afford that today, that does not take away from the fact that we are failing to provide American business competitive tools. And if the issue is one of trying to pay for this, and we can't do it today, then certainly I know this committee, many members on this committee, have talked about the alternative tax systems that exist around the world that favor savings and investment and focus more on taxing consumption.

And I know that Chairman Archer and members of both sides of the aisle have talked about taking up that discussion later this year. And those types of systems may ultimately have to be the long-term solution to this problem if we can't deal with it here today.

Mr. COLLINS. The question is, though, is that tax policy, the existing tax policy itself, for a business who is noncompetitive in the global market, that tax policy then if they can move to a competitive area is an incentive to relocate; one incentive.

Mr. McCALLUM. It is certainly one element that would be an incentive to move elsewhere, especially if you were a very capital-intensive industry where your capital investment is keyed to that pricing decision for you and your ability to compete.

Mr. COLLINS. Thank you.

Ms. DUNN. Thank you very much panel. We appreciate the brevity of the panel and the members.

We will recess for the duration of the vote, and I urge members to return as quickly as possible.

And we will seat the third panel.

Thank you.

[Recess.]

Mr. HERGER [presiding]. The Ways and Means Committee will reconvene, and if our third panel could please step forward.

Gary Kachadurian, secretary, member of the executive committee of the board of directors of the National Multi Housing Council, and also on behalf of the National Apartment Association and principal, RREEF Funds, Chicago, Ill.; also Edmund G. "Gill" Woods, president, National Association of Realtors and president, Edmund G. Woods Co., Holyoke, Mass.; James J. Didion, chairman, National Realty Committee, chairman and chief executive officer of CB Commercial Real Estate Group, Los Angeles, Calif.; and Kemper Freeman, Jr., president, International Council of Shopping Centers and president, Kemper Development Co., Bellevue, Wash.; and Calvin Johnson, professor of law at the University of Texas, Austin, Tex.

I thank our panelists.

And Mr. Kachadurian, if you would proceed, please. We do have 5 minutes and your statements—your printed statements will be, without objection, submitted for the record.

Mr. Kachadurian.

STATEMENT OF GARY T. KACHADURIAN, PRINCIPAL, RREEF FUNDS, CHICAGO, ILL., AND SECRETARY AND MEMBER OF THE EXECUTIVE COMMITTEE OF THE BOARD OF DIRECTORS, NATIONAL MULTI HOUSING COUNCIL, AND ALSO ON BEHALF OF THE NATIONAL APARTMENT ASSOCIATION

Mr. KACHADURIAN. Thank you, Mr. Chairman and members of the committee.

Thank you for this opportunity to appear before you today to discuss the issue of capital gains. My name is Gary Kachadurian. I am a principal of the RREEF Funds of Chicago, Ill., and serve as secretary and member of the executive committee of the board of directors of the National Multi Housing Council.

Through our legislative joint program with the National Apartment Association, we represent the majority of the Nation's firms participating in the multifamily rental housing industry. Our combined memberships are engaged in all aspects of development and operation of multifamily rental housing, including ownership, construction, development, financing and management.

There are approximately 15 million multifamily units defined as a complex of five or more units in the United States. In normal economic times, rental housing is the fifth largest contributor to the U.S. economy.

The National Multi Housing Council and National Apartment Association are dedicated to providing clean, safe, affordable living for millions of Americans. Because our industry is so competitive, Federal and State tax policies have a direct and substantial impact on the livability as well as rent levels that are enjoyed by occupants.

Mr. Chairman, the National Multi Housing Council and National Apartment Association strongly support the capital gains provisions included in H.R. 9. We want to commend the foresight shown in this legislation that reduces capital gains rates, brings the concept of indexing for inflation and rejects onerous depreciation recapture provisions.

Real estate is emerging from one of the worst periods in its history. After several years of a severe economic period for real estate and many foreclosures, only recently have we begun to see the cost and availability of credit for purchase or development of multifamily housing return to somewhat normal conditions.

Any broad-based capital gains legislation that omits real estate will cause a tremendous amount of disintermediation in the capital markets as money flows away from real estate into those investments that benefit from a reduction in the tax. This will lead to fewer Federal income and payroll taxes being collected from real estate companies and their workers, foreclosures, pressure on the banking and financial system, a reduction in property values and finally a reduction in tax revenues to State and local governments who rely on property taxes for a majority of the money they receive to fund school systems, fire departments, police departments, and other services. Any reduction in capital gains rates must include real estate.

In 1992, President Bush proposed a reduction in the capital gains rate. Unfortunately, he coupled this reduction with an onerous provision that required full recapture of all previously taken depreciation at ordinary income rates. A meaningful reduction in the capital gains rate that does not include an onerous depreciation recapture provision, will lead to new investment in tens of thousands of existing apartment units across America whose present owners have no financial incentive to invest in needed capital improvements.

This new investment is badly needed and will result in the creation of many jobs for carpenters, painters, electricians, plumbers, appliance makers and others. Little, if any, of this new investment will occur under the present capital gains rate of 28 percent because of something referred to as the exit tax.

The provisions of H.R. 9 aid in solving the exit tax problem for properties that have substantial negative capital accounts by their partners. Under current law, most dispositions of older properties would result in huge gains on paper for tax purposes without enough actual cash from the sale to pay the taxes.

At present, existing partners are unable to sell these properties for a sufficient amount of cash to pay the taxes that would be due. Therefore, these investments will remain frozen for many years.

There will be a very positive revenue effect accruing to the U.S. Treasury from the unlocking of investments in more than 1 million apartment units.

Just a few weeks ago Speaker Gingrich asked you to challenge members of the corporate community regarding creation of high-paying jobs in the United States. Speaking for the multifamily housing industry, we believe that a significant reduction in the capital gains tax will result in thousands of new high-paying jobs for modernization of more than 1 million apartment units here in America.

Thank you very much.

[The prepared statement follows:]

TESTIMONY OF GARY T. KACHADURIAN
NATIONAL MULTI HOUSING COUNCIL

Mr. Chairman and Members of the Committee, I thank you for this opportunity to appear before you today to discuss the issue of capital gains. My name is Gary Kachadurian. I am a Principal of RREEF Funds of Chicago, Illinois and serve as Secretary and a member of the Executive Committee of the Board of Directors of the National Multi Housing Council. Through our legislative joint program with the National Apartment Association, we represent the preponderance of the nation's firms participating in the multifamily rental housing industry. Our combined memberships are engaged in all aspects of the development and operation of multifamily housing, including ownership, construction, finance, and management of rental properties.

There are approximately 15 million multifamily units, defined as part of a complex of five or more units, in the United States. A study by Regis J. Sheehan & Associates for the U.S. Departments of Labor, Commerce, and HUD showed that in 1993 "the rental housing industry's contribution to the Gross Domestic Product was about $153.2 billion dollars representing 2.3% of our economy." In normal economic times, rental housing is the fifth largest contributor to the United States economy.

The National Multi Housing Council and National Apartment Association are dedicated to providing clean, safe, affordable living for millions of Americans. Because our industry is so competitive (just look at any metropolitan apartment guide), federal and state tax policies have a direct and substantial impact on the liveability as well as rent levels that are enjoyed by occupants.

SUPPORT FOR REDUCTION IN THE CAPITAL GAINS TAX

Mr. Chairman, the National Multi Housing Council and National Apartment Association commend you for sponsoring H.R. 9, the Job Creation and Wage Enhancement Act of 1995 and we strongly support provisions in Title I of this legislation that would reduce the current capital gains tax rate and index the adjusted basis of assets for inflation beginning in 1995. We believe that a reduction in the capital gains rate will actually bring in more money to the U.S. Treasury as real estate capital assets are unlocked by existing investors and new money is brought in for investment and modernization by new investors.

REAL ESTATE MUST BE INCLUDED

Real estate is emerging from one of its worst periods in history. After several years of a severe economic period for real estate and many foreclosures, only recently have we begun to see the cost and availability of credit for purchase or development of multifamily housing return to somewhat normal conditions. Even today, credit for the construction and modernization of multifamily housing is not as broad as for many other areas of investment.

Any broad-based capital gains legislation that omits real estate will cause a tremendous amount of disintermediation in the capital markets as money flows away from real estate and to those investments that benefit from a reduction in the tax. The resulting scarcity of credit for real estate will drive our industry into another extraordinarily difficult period. This in turn will lead to fewer federal income and payroll taxes being collected from real estate companies and their workers, foreclosures, pressure on the banking and financial system, a reduction in property values, and finally a reduction in tax revenues to state and local governments who rely on property taxes for a majority of the money they receive to fund school systems, police and fire departments, and other essential services.

Any reduction in capital gains rates must include real estate.

THE DEPRECIATION RECAPTURE ISSUE

In 1992, President Bush proposed a reduction in the capital gains rate. Unfortunately, he coupled this reduction with an onerous provision that required full recapture of all previously taken depreciation at ordinary income rates. The theory was that since the basis of a real estate asset had been reduced by depreciation which taxpayers had deducted from their ordinary income, recapture was necessary in order to be "fair" when lowering the capital gains rate. In practice, nothing could be further from the truth.

There is nothing wrong with depreciation recapture as long as it does not affect the economic rate of depreciation that has been taken in the past. The fact is that real estate is subject to economic depreciation, especially in the case of multifamily housing.

In addition, recapture would be both punitive and confiscatory vis-a-vis other investments. For example, if I invest in the stock of a manufacturing company, I benefit from the cash flow that company is able to attain as a result of good operations and depreciation deductions. When I sell that stock, I am not assigned a pro rata portion of the depreciation that the company took to enhance its overall cash flow. Likewise, taxpayers should not have to incur an onerous provision for recapture of depreciation on real estate investments at ordinary income levels. Real estate assets do depreciate at an economic rate and recapture is not necessary to bring "fairness" to a reduction in the capital gains rate.

If an onerous recapture requirement is included in any capital gains reduction, then real estate will experience the same capital disintermediation I outlined above. The net result of the 1992 proposal, which would have lowered capital gains tax rates but required full depreciation recapture, was to actually bring in more revenue from real estate under static revenue scoring. The reason? The recapture provision resulted in a confiscatory tax and the likely result was that real estate assets would continue to be "frozen" in existing investor accounts. Much needed new capital investment would not occur and, in fact, capital markets would once again shun real estate credit advancement.

Mr. Chairman, we applaud you for not including a depreciation recapture provision in H.R. 9.

A LOWERING OF THE CAPITAL GAINS TAX WILL BRING IN MUCH NEEDED FUNDS FOR MODERNIZATION OF TENS OF THOUSANDS OF APARTMENT UNITS

A meaningful reduction in the capital gains rate that does not include onerous depreciation recapture provisions will lead to new investment in tens of thousands of existing apartment units across America whose present owners have no financial incentive to invest in needed capital improvements. This new investment is badly needed and will result in the creation of many new jobs for carpenters, painters, electricians, plumbers, appliance makers, and others.

For example, Drever Partners of San Francisco, California has acquired over 18,000 units during the past 7-1/2 years with investment groups comprised primarily of tax-exempt investors. The capital improvements have averaged $4,000 per unit, or a total of more than $72 million for improvements alone. A reduction in the capital gains rate would attract similar private investors willing to make the improvements necessary for capital appreciation.

As just one example, I know of a major apartment owner in New Jersey who would pour in $1.5 million into modernization of a building that would cost $23 million.

Mr. Chairman and Members of the Committee, this type of anecdotal evidence does not even scratch the surface. In the case of apartments, a meaningful lowering of the capital gains tax rate would result in thousands of new, good paying jobs here in America.

THE "EXIT TAX" PROBLEM

Little, if any, of this new investment will occur under the present capital gains rate of 28% because of something referred to as the "exit tax." The provisions in H.R. 9 aid in solving the exit tax problem for properties that have substantial negative capital accounts by their partners. Under current law, most dispositions of older properties would result in huge gains on paper for tax purposes without enough actual cash from the sale to pay the taxes. At present, existing partners are unable to sell these properties for a sufficient amount of cash to pay the taxes that would be due. Therefore, these investments will remain frozen for many years with no incentive for existing owners to put in capital to preserve and modernize the units for tenants. This problem will become even more critical considering the millions of units that will be affected as HUD Section 8 contracts expire over the next few years.

Some estimate that a more likely figure of $7,000 to $10,000 per unit would be invested by new

partners in the modernization of existing apartment units. There are estimates that more than one million units are in need of capital improvements, but existing owners do not have the financial incentive to spend the money.

Mr. Chairman and Members of the Committee, just a few weeks ago Speaker Gingrich asked you to challenge members of the corporate community regarding creation of high paying jobs in the United States. Speaking for the multifamily housing industry, we believe that a significant reduction in the capital gains tax will result in thousands of new high-paying jobs for modernization of more than one million apartment units here in America. To accomplish this, the Committee may have to look at bringing negative basis in apartment investments to zero when applying the new capital gains rates.

The U.S. Treasury stands to receive a large increase in revenues from capital gains taxed at a significantly lower rate. You have heard this before and it is true: the great reservoir of fixed investments that are "locked" for many years to come would, in short order, be freed and new money brought in that is vitally needed. In the case of multifamily housing, thousands of new jobs would be created as new investors spend money to modernize existing apartment units. Modernized apartments will enhance both federal and state and local taxes and greatly improve living conditions and neighborhoods.

CONCLUSION

The National Multi Housing Council and the National Apartment Association strongly support the capital gains provisions included in H.R. 9. We want to commend the foresight shown in this legislation that reduces capital gains rates, brings in the concept of indexing for inflation, and rejects onerous depreciation recapture provisions.

Mr. HERGER [presiding]. Thank you for your testimony, Mr. Kachadurian.

Mr. Woods.

STATEMENT OF E.G. "GILL" WOODS, PRESIDENT, NATIONAL ASSOCIATION OF REALTORS, AND PRESIDENT, EDMUND G. WOODS, INC., HOLYOKE, MASS.

Mr. WOODS. Good afternoon Mr. Chairman.

My name is Gill Woods. I am the president of the National Association of Realtors and Edmund G. Woods, Inc., and I am representing this afternoon 750,000 members of the National Association.

First, let me thank the committee for inviting me here to speak. And I certainly would like to commend Chairman Archer and his cosponsors for drafting a thoughtful and meaningful bill dealing with capital gains.

Ever since the enactment in 1986 of the Tax Reform Act, the National Association of Realtors has worked for more equitable treatment for many small- and medium-sized investors that were trapped in the real estate that they couldn't afford to get rid of because of this bill.

Most, if not all, of these investors were not astute enough to bail out of their holdings in the late eighties when the major players were able to get out with fairly favorable capital gains treatments.

Now, there are thousands of small investors. Interestingly, 20 percent of all families in this country own real estate investment who have income between $25,000 and $50,000. We are not talking about people that are just worth tons of money, but many of these individuals are frozen into investments because of taxes. And what is most unfair is that these taxes by and large are based on inflation, not on real gains and property value.

And let me just give you a very quick example. If you purchased a four family house here in Washington 15 years ago and paid $100,000 for it, today, because of inflation and only because of inflation, let's say, 5 percent a year, compounded over 15 years, that property would have to sell for $200,000 just to get back your original investment without making one single dime of profit. But if I sold that piece of property or you sold it at that figure, you would owe State and Federal taxes close to $40,000, and that is even though you made no profit whatsoever.

And that is why I say so many of these small investors are frozen into their properties. The Contract With America goes a long way to solve this problem in the future by indexing future gains to inflation and helping present owners by reducing the capital gains rate of taxation by 50 percent. These two aspects alone would make this part of the Contract With America important to our members and millions of investors throughout the country. But there is certainly another aspect that will help thousands of families, especially in the hard-hit areas like New England and California, where real estate values have fallen precipitously, in some areas 40 to 50 percent.

And that is by allowing families that bought at the very, very top of the market in the early eighties, the mideighties to at least get some relief from their out-of-pocket capital losses when they sell

their home at a loss. Under Chairman Archer's bill they would be allowed to deduct at least $3,000 per year from their income until that loss was used up.

Under the present tax law, if they are forced to sell a house at a loss for any reason, that is your tough luck. Many young families that I have seen, and I have done business with, have seen their entire savings wiped out just because of a forced job relocation they had no say in. At least these families will now have a chance to get part of their losses back over a period of time.

Let me change gears just for a moment and briefly discuss the American dream savings account. One of the provisions intended is to provide funds for a downpayment for first-time buyers. And I can tell you as a practicing real estate broker, the biggest obstacle to home ownership is not interest rates, but it is the cash it takes for downpayments and closing costs today. If you turn to the handout that you have right here and you look toward the back on charts A and B, you will see that there is a substantial dropoff in home ownership in the under-35-year-old age group. Studies have shown it is not because of lack of interest, it is not because of lack of income, but it is because of the inability to put together the downpayment that is required to purchase a home.

Because of the 5-year holding period in the American dream savings account, it will have almost no effect on home ownership until the year 2000, and that is just too far away. Believe me, there are thousands of young families out there that need assistance now. They don't need assistance 5 years from now, and is there a way to do it, too.

If funds from current IRAs and 401(k)s could be used without a tax penalty, then tens of thousands of young families could go out and purchase their first home now. And if we allow parents and grandparents to help out their children in the same manner as suggested by Congressman McCrery, we could double that figure of first-time home buyers using this method to purchase a home immediately.

Thank you very much.

[The prepared statement and attachments follow:]

STATEMENT OF THE

NATIONAL ASSOCIATION OF REALTORS®

BEFORE THE HOUSE WAYS AND MEANS COMMITTEE

JANUARY 26, 1995

INTRODUCTION

Mr. Chairman and Members of the Committee. My name is E. G. "Gill" Woods, the 1995 President of the National Association of Realtors®. I am also President of Edmund G. Woods, Inc., a residential real estate firm in Holyoke, Massachusetts. I appear here today on behalf of the 750,000 members of the National Association of Realtors® (NAR). The Association represents virtually every facet of the real estate industry, including REALTOR® brokers and salespersons, developers, counselors, appraisers and property managers. We wish to thank you for holding these hearings and for receiving our testimony on the Republican Contract with America, particularly those parts of H.R. 6 and H.R. 9 that deal with American Dream Savings Accounts, capital gains and the Neutral Cost Recovery System. Each of these provisions has the potential to benefit real estate markets nationwide.

Real estate contributes about 16% of the goods and services that comprise our national economy. The industry has repeatedly demonstrated its capacity to lead the nation out of recession into economic recovery and growth. The Contract with America presents a balanced real estate package with provisions that apply to both the residential and commercial sectors, and to owners, potential owners and investors. The Contract corrects some imbalances that exist in the present system and some inequities that arose from the reforms of the 80's, but it does not undermine the appropriate reforms that were enacted then. Thus, the package, when enacted, does not carry the potential for re-igniting the go-go market that lead to over building and see-through buildings.

While the tax battles of 1992 and 1993 were often divisive and partisan, the debate then concerning the real estate provisions was bipartisan and widely agreed upon. We are hopeful that the same bipartisan spirit can prevail in this debate so that important goals of enhancing savings and investment, and achieving a healthy real estate economy across the country can be reached.

Our message today may sound overly familiar to some long-time members of this Committee. Indeed, we have previously presented testimony on most of the real estate issues found in the Contract. The predictions we made in 1986 about the dramatic decline in the real estate market if Congress enacted its proposed real estate provisions all, unfortunately, came true. During the period 1989-1992, some locations around the country experienced as much as a 30 percent decline in value of real estate in their markets. Imagine the effect on local tax bases of that decline. Local governments were forced to cut back on schools, safety and basic services that all our citizens have come to expect in their daily lives. Imagine, too, the effect on the owners of those properties. Many of these owners are average Americans -- retirees, working people, owners of small commercial and residential properties who are affected in dramatic ways by the sharp fall in values.

Federal Reserve data show that fairly significant amounts of non-owner-occupied real estate are held by households in income groups below $50,000. These individuals are adversely affected when real estate values fall. Retirement incomes are reduced, improvements are delayed, and family savings plans are eroded. Thus, any decline in property values reaches well beyond the syndicators and the glass see-through towers built in the 80's.

We strongly believe the provisions of the Contract that we will discuss below will help stabilize real estate values and strengthen local tax bases and economies.

H.R. 6 AMERICAN DREAM SAVINGS ACCOUNT

H.R. 6 proposes a new type of Individual Retirement Account (IRA) known as an American Dream Saving Account (ADSA). The new ADSA is an effort to create a tax-deferred and/or tax-free savings vehicle from which individuals can draw in order to pay for the fundamental necessities of life - shelter and education - or to protect them from its harshest catastrophes -- medical expenses and long-term care. ASDA funds are deposited with after -tax dollars. The earnings on the funds accumulate tax-free, (or at least tax-deferred), and then, if a 5-year holding period is satisfied, the funds may be withdrawn tax-free for use as retirement income or for specified uses. By limiting the allowable tax-free purposes, the bill's authors assure that the accounts could not be used simply as a tax-deferral or avoidance mechanism.

NAR of course applauds H.R. 6 and any vehicle that might enhance our nation's very low savings rate. High capital formation and savings rates can have the effect of lowering interest rates, and low interest rates are always good for housing. Our greatest interest, of course, is the incentive for potential first-time homebuyers. We urge this Committee to incorporate such an investment incentive into any plan it reports to the House for consideration.

Be assured that NAR unequivocally supports investments that, in turn, encourage homeownership. We do, however, wish to point out that, as we understand the terms of H.R. 6, we will be past the year 2000 before any funds deposited in an ADSA would be available for use by first-time homebuyers. Thus, there is minimal immediate stimulative effect for housing. In order for the funds in an ASDA to be withdrawn tax-free, they must remain in the account for 5 years. Thus, funds deposited in 1996 would not be available for downpayments until the year 2000.

Moreover, it is not clear whether the 5- year holding period is a fixed or moving period. That is, if an individual deposited the allowed $2000 in the account beginning in 1996, and deposited $2000 each year thereafter, would funds deposited in 1998 be available for tax-free withdrawal in the year 2001, along with the 1996 funds, or would only the 1996 funds and their earnings be available in 2001? If the 5-year period is a moving period, then it would take 8-10 years, depending on the return on investments, to have $10,000 of tax-free funds available for a downpayment. Over the same 8-10 year period, however, the individual who put away $2000 a year in an ordinary interest bearing savings account would have $16,000 - $20,000 plus earnings available for a downpayment. While it is true that those earnings would have been taxed in an ordinary savings account, it is also true that under any measure, the ordinary savings accounts generates more funds for a one-time expenditure like a down-payment.

These observations apply, of course, only if the 5-year holding period is a moving measure. If the initial deposit creates the sole baseline for determining the holding period for all assets in the account, then all funds in the account would be eligible for tax-free distribution at the end of 5 years. Thus, on this assumption, if an individual opened an ADSA in 1996, and deposited $2000 yearly, then all $10,000, plus earnings, could be distributed tax - free beginning in 2001. Again, we note, that there is no current benefit to housing. Charts A and B illustrate the need for an incentive for homeownership for younger people. Those charts show a continued downward trend for homeownership in general, but an upward trend in the age for a first-time home purchase. Most importantly, the charts show that the incidence of homeownership among people under 35 is only half the rate of homeownership among all age groups over 45. These are alarming trends.

When young people are asked to identify barriers to homeownership, they invariably cite the difficulty of amassing a downpayment. Clearly, some incentives are appropriate.

ADSA's drafters may believe that the IRA rollover provisions in H.R. 6 provide an adequate mechanism for the accumulation of funds for a big-ticket item like a downpayment. In recent years, economists have learned that saving is a life-cycle process, and that younger people tend to save much less than middle-aged and older people. We would point out, however, that first-time home purchases generally occur in the young adult or very early middle age phases of an individual's life. Thus many prospective first-time homebuyers often have not yet begun to save through IRA's, precisely because they need the greater liquidity of other non-IRA, savings mechanisms to fund a downpayment. Thus, the rollover provision appears to be helpful for middle-aged and older Americans who have savings and use them for education expenses, medical expenses, long-term care needs or retirement. A rollover provision generally is of less benefit to a younger person who has saved outside of the IRA market in order to accumulate downpayment funds that would be subject to penalties if used before age 59 and 1/2.

A useful interim or transition device that the Committee may wish to consider is presently embodied in Senator Roth's bill S. 12, which contains an IRA proposal nearly identical to one that passed Congress twice in 1992, but was not enacted. This proposal permits a penalty-free withdrawal from an IRA or 401(k) plan for use as a downpayment by a first-time homebuyer. Significantly, it also permits a parent or grandparent to make penalty-free withdrawals to assist a child or grandchild in making a downpayment for a first-time home purchase. NAR actively advocated this approach in 1992, and strongly believes the "parent and grandparent pass-through " is crucial to making any new IRA plan a genuine vehicle for advancing first time home buying. It is our understanding that Rep. McCrery has been studying the merits of the "parent and grandparent pass-through" for purpose of first time home buying. NAR looks forward to working with Rep. McCrery and other members of the committee in strengthening the ADSA in this manner.

Accordingly, we would urge the Committee to modify H.R. 6 so that ADSA funds of a parent or grandparent can be used for a downpayment by a child or grandchild for the purchase of a first time home. This modification is consistent with the rule in H.R. 6 that applies to education expenses, and, again, would make the ADSA a far more significant tool to enhance homeownership.

H.R. 9 - JOB CREATION AND WAGE ENHANCEMENTS ACT OF 1995

Capital Gains

The National Association of Realtors® enthusiastically and actively supports all efforts to restore a meaningful capital gains differential. An exclusion and indexing are both important elements of a differential, and we fully support both provisions. In particular, we commend Chairman Archer and other committee co-sponsors for retaining current law on depreciation recapture. We will work aggressively to preserve the integrity of the bill as it concerns recapture, and urge the Committee to resist any effort to modify current law recapture treatment.

We also commend the Chairman for avoiding any temptation to expand the alternative minimum tax (AMT). The AMT is a backdoor, burdensome tax. We applaud the fact that certain incentives are not extended in one area only to be recouped through the AMT. The drafters did well in not extending its harsh impact.

Capital Gains and Real Estate -- One of the things that we know about Americans is that they buy real estate. Generally, they buy as much real estate as they can afford. They buy homes, condos, cottages at the lake, hunting lodges, speculative parcels, a safe new home for mother, and farms and ranches. It is no accident that one of our great American epics is Gone With The Wind - - a story of devotion to Tara and to the land.

The incidence of the ownership of real estate is more wide-spread than one might expect. Federal Reserve data in the Survey of Consumer Finances show a remarkably high incidence of ownership of real estate, other than a principal residence, by individuals in

income classes below $50,000. The 1992 Survey shows that 63.8% of all families own a principal residence, and that 20% of all families own investment real estate. Among families with $25,000-$50,000 of income, 69% own a home, and a surprising 20% also own investment real estate. Among families in the $50,000-$100,000 income category, 85% own their home, and 30% own investment real estate.

The reasons for ownership are varied, and, some of those reasons, we fully admit, are likely to be influenced by the tax effects of ownership. The important fact to note is that real estate, in addition to a principal residence, is held more widely than CDs, mutual funds, stocks and bonds. Since it is widely held, the markets for it are large and diverse. We strongly believe that the power of those markets can be augmented through the unlocking power of reduced capital gains taxes. (Source: 1992 Survey of Consumer Finances, Federal Reserve Bulletin, Oct., 1994.)

One of the things that we can't measure in that market is pent-up demand. You can't after all, measure transactions that haven't occurred. Every Realtor® we meet, however, has stories to tell about properties that would have sold except that the tax beating of current law was too great. They have hardships stories, as well, about people in reduced circumstances forced to sell their assets, only to face large tax bills.

Our members tell us that the single most important issue in the Contract with America is capital gains. We urge the Committee to enact the provisions of HR 9, and we give our full support to that effort.

The Exclusion -- Before its repeal in 1986, the capital gains exclusion operated as a sort of rough justice to give taxpayers some incentive to hold property for the long haul, while giving an imprecise recognition to the effects of inflation on an investment. Real estate tends to be a very illiquid investment, so it was particularly important to the holders of real estate that some means of mitigating the impact of inflation would be available. The repeal of the capital gains exclusion in 1986 destroyed even that imprecise mechanism. Lower tax rates simply did not overcome the impact of removing the exclusion.

In 1993, we requested that this Committee review the impact of a tax rate increase as it would affect capital gains taxes. In 1993, President Clinton proposed, and Congress narrowly enacted, a tax rate increase. At the same time, the capital gains rate stayed constant at 28%, and was not increased. A little discussed anomaly thus arose. The effect of the higher tax rates was that one class of upper-income taxpayers enjoyed the benefits of the equivalent of a 30% exclusion, while families with less than about $85,000 of taxable income paid tax on all of their gain. Our 1993 testimony pointed out that fundamental disparity and urged this committee to review its fairness. Other issues took the spotlight, and that review did not occur. Nonetheless, a significant volume of capital gains transactions occurs for individuals with less than $85,000 of taxable income, even though the dollar amount is relatively small. Many of those taxpayers will have only a limited number of capital gains transactions in a lifetime, yet their limited number of assets are presently taxed less advantageously than the larger, diversified portfolio of an upper income individual. Now, the Contract offers the Committee an opportunity to redress the fundamental unfairness of having of creating two classes of taxpayers -- those with a capital gains differential, and those without a differential. We therefore vigorously support restoration of a 50% exclusion for all individuals.

Indexing -- NAR supports the provisions that permit indexing on a sale of assets. While many of our members would prefer that there would be a look-back provision, we acknowledge that such a provision would be costly to enact and to administer. We take no position on the choice of index used, but simply urge that the compliance provisions associated with administering an indexing scheme be as simple as possible. We look forward to working with the IRS to develop record-keeping and compliance programs that will be easily understood by taxpayers. Taxpayers will need some education about the record-keeping challenges posed by an indexing scheme, and we are committed to doing our part in assisting in that effort.

Loss on Sale of Principal Residence -- The idea of a loss on a sale of a principal residence was basically a foreign concept in most of our experience until about 1982-83. Then, the price of oil plummeted, and once prosperous housing markets slumped. Since then, regions as diverse as Los Angeles, New England, the Rocky Mountains and others have experienced reductions in value to housing prices and many families have incurred real, not paper, losses on sales of their homes.

The tax system has never permitted a homeowner to reflect this painful and very real economic loss. Chairman Archer for several years has sought to provide taxpayers relief from this type of personal economic catastrophe. Now, the Contract has incorporated his efforts to provide such relief. The Association's governing bodies will vote on that proposal next week, and we fully anticipate that they will give it their full support.

Depreciation -- Neutral Cost Recovery System

The Proposal - - H.R. 9 proposes a new Neutral Cost Recovery System (NCRS) designed to provide a taxpayer with the economic equivalent of expensing assets. In the case of real estate, the straight-line allowance is indexed for inflation so that, over time, the nominal amount of the depreciation allowance increases because of the compounding effects of inflation. Charts C and D illustrate these mechanics. Chart C presents a real estate asset with a depreciable basis of $39,000, and shows what the depreciation allowances would be under current law, under the present inflation scenario of 2.6 %, and at a higher rate of 5%. Chart D show those same results in graph form. Obviously, a period of higher inflation would produce even larger allowances and a steeper incline on the graph.

NAR has no formal position on NCRS, but the proposal is certainly consistent with our policy of supporting depreciation systems that reflect an economically viable recovery system for investment in an asset. We do, however, wish to share with you some of our concerns about NCRS.

NCRS is a very back-loaded regime. Hence, the significant tax benefits to do not begin to accrue until later years. In terms of budget scoring vocabulary, this means that the big revenue losses are outside the budget period. Because of this reality, we are very concerned about the prospects for having the rules change in midstream. After all, in 1981 the depreciable life for real estate was 15 years. In 1982: 18 years. In 1984: 19 years. In 1986, the life went to 31.5 years for commercial property. Even more significantly, the entire tax regime for real estate was turned on its head with the passive loss rules. The passive loss rules had the effect of a substantial retroactive tax increase on real estate. The loss of deductions and other financial and inventory factors combined to cause a decline in property value of as much as 30%. Our members know first-hand that the tax rules affecting real estate can change rapidly and retroactively, and with harsh punitive effects. It is not clear that investors would make an election to use NCRS in light of that knowledge. Moreover, the trade off between back-loaded deductions and the loss of indexed basis on disposition of NCRS properties is a troubling combination. It is difficult to assess the interaction of the depreciation and capital gains tradeoffs, because of the difficulty in projecting the variables of holding period and inflation.

We are grateful that the Committee is reviewing cost recovery, however, because there are some problems with current law. We are hopeful that the committee will be able to address these problems in the context of that review.

Tenant Improvements -- Throughout the debate (1988-1993) on the passive loss rules and other corrections to the taxation of real estate, our industry has recognized the requirements of the budget process, and has worked with this Committee to find ways to "pay for" the revisions we have sought. For good or for ill, the method that was chosen was to revise the rules for depreciation. Very reluctantly, NAR supported the 1993 proposal to extend depreciable lives of commercial real estate to 39 years, notwithstanding our regrets about the impact of that change. We accepted the changes to depreciation with the

understanding that they were the means of "paying for" the 1993 efforts to improve real estate taxation.

We must comment, however, that extending the life of commercial property to 39 years exacerbates a gross distortion in one aspect of commercial development. When a developer or owner secures a new tenant for either a new or existing building, the developer or owner often must build out and configure the space to satisfy the needs of the tenant. Prior to the enactment of ACRS in 1981, the costs of these tenant improvements were amortized over the term of the lease. In 1981, when ACRS, with its artificial 15-year depreciable life for real estate was adopted, it was a reasonable tradeoff to drop this leasehold improvement amortization rule in exchange for the simplification brought about by lumping all costs of a structure into a single 15-year life for the entire property.

Now, however, we are light years away from a 15-year life, and the trade-off made in 1981 is no longer valid. It not unreasonable to assert that the life of a building shell can be the 31.5 years of pre-1993 law, or even the 39 years of current law. It is absurd, however, to believe that the interior elements of any structure will last that long. It is similarly absurd to think that the costs of improvements made for a tenant who may stay only for a period as short as 3-5 years, will last 39 years. Yet under current law, the costs of tenant improvements must be written off over 39 years. Even at the end of the lease, the remaining unamortized costs will remain outstanding, to be written off over the remaining unexpired depreciable life and not immediately deductible. This violates all familiar accounting concepts of matching income with expense, and does great violence to common sense and to the rate of return on the improvements.

As the Committee deliberates on cost recovery, we urge you to review this problem, and to find a solution to the problem of amortizing the costs of tenant or leasehold improvements. The optimal solution, of course, would be to apply traditional accounting concepts and match costs against the income, by returning to the pre-1981 rule that permitted the costs to be amortized over the term of the lease. If revenue constraints make this impossible, then we would be pleased to work with the Committee to craft a solution that more nearly reflects the reality of economic lives for these improvements. We understand that representatives Shaw and Rangel have been examining the problems inherent with current law in this area and are interested in developing a fair and balanced solution to this problem. We are appreciative of their efforts and look forward to working with them and other members of the committee in this regard.

In a slightly broader context, we note that many of our members have expressed interest in restoring some sort of modified component depreciation scheme to reflect the reality that few internal elements of a building last for anywhere near 39 years. We do acknowledge that abuses of this system occurred in the past, so we recognize that it would be important in moving toward a component-type system that safeguards against abuses be designed. We do not have a specific plan to advance at this time but would hope that such options could be explored with the Committee in the coming months.

Estate Tax Reforms -- NAR supports the expansion of the unified estate and gift tax credits.

Home Office Deduction -- NAR supports the clarification of the home office deduction provisions.

Expensing -- NAR supports the increase of the expensing provisions from $17,500 to $25,000.

CONCLUSION

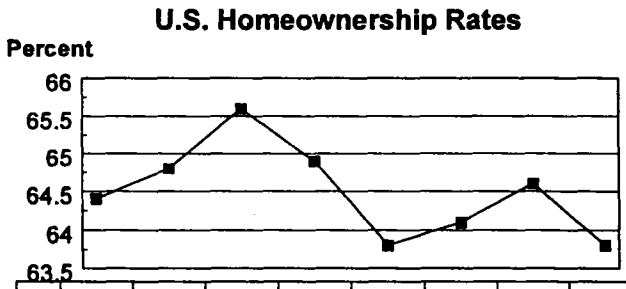
We appreciate this opportunity to express our views, and would be pleased to respond to your questions.

CHART A

HOMEOWNERSHIP RATES

During the 1980s, homeownership declined. High mortgage rates and home price inflation of the 1970s and early 1980s prevented young households from making the step to homeownership. Moreover, demographic factors, such as, the growth of single-person and single-parent households, prevented many young households from becoming homeowners. Even the percentage of young married households, who historically become homeowners, fell during this period.

During the early 1990s, a slight upward trend in homeownership began to emerge. Increases in homeownership by older households led the way. However, with the continual increase in mortgage interest rates in 1994, since they reached a 25-year low in October of 1993, the trend has begun to reverse itself.



Years	1973	1976	1980	1983	1986	1990	1993	1994 Qtr 2
%	64.4	64.8	65.6	64.9	63.8	64.1	64.8	63.8

Source: Joint Center tabulations of the 1973,1976, and 1980 American Housing Surveys, and the 1983, 1986 and 1993 Current Population Surveys

CHART B

HOMEOWNERSHIP RATES

Secong Quarter: 1994

(in percent)

Homeownership Rates	
United States	63.8
Northeast	61.3
Midwest	67.5
South	65.2
West	59.7

Homeownership Rates by Age of Householder	
Less Than 35	36.8
35 to 44	64.6
45 to 54	75.2
55 to 64	79.1
65 and over	77.2

Data Source: U.S. Census Bureau- Housing Vacancies and Homeownership - 2nd Qtr 1994

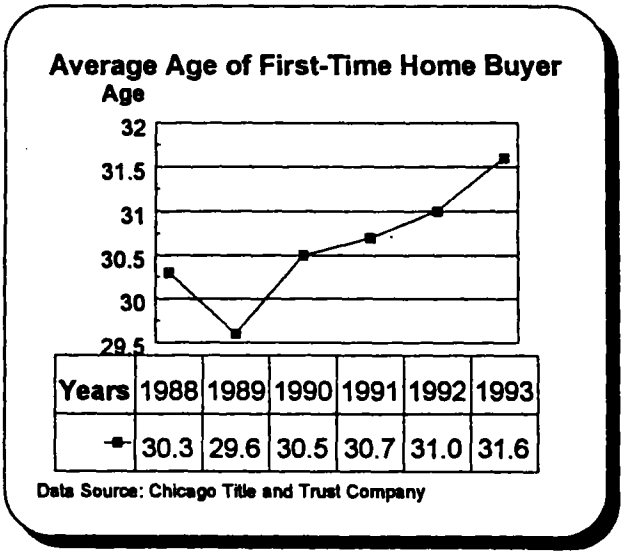
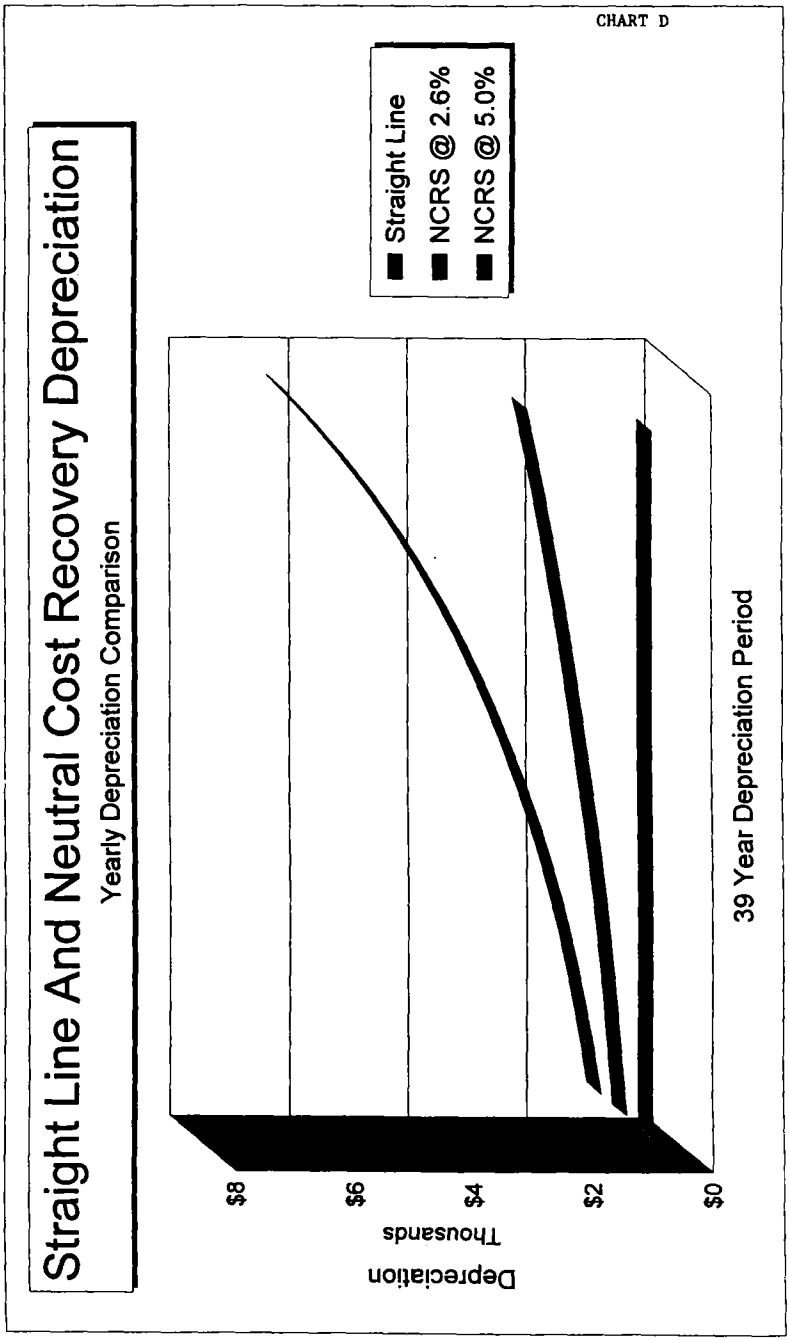


CHART C

Comparison of Straight Line And Neutral Cost Recovery Depreciation Methods

Period	Year	Straight Line Deprecation	Neutral Cost Recovery @ 2.60%	Neutral Cost Recovery @ 5.00%
1	1995	$1,000	$1,000	$1,000
2	1996	$1,000	$1,026	$1,050
3	1997	$1,000	$1,053	$1,103
4	1998	$1,000	$1,080	$1,158
5	1999	$1,000	$1,108	$1,216
6	2000	$1,000	$1,137	$1,276
7	2001	$1,000	$1,166	$1,340
8	2002	$1,000	$1,197	$1,407
9	2003	$1,000	$1,228	$1,477
10	2004	$1,000	$1,260	$1,551
11	2005	$1,000	$1,293	$1,629
12	2006	$1,000	$1,326	$1,710
13	2007	$1,000	$1,361	$1,796
14	2008	$1,000	$1,396	$1,886
15	2009	$1,000	$1,432	$1,980
16	2010	$1,000	$1,470	$2,079
17	2011	$1,000	$1,508	$2,183
18	2012	$1,000	$1,547	$2,292
19	2013	$1,000	$1,587	$2,407
20	2014	$1,000	$1,629	$2,527
21	2015	$1,000	$1,671	$2,653
22	2016	$1,000	$1,714	$2,786
23	2017	$1,000	$1,759	$2,925
24	2018	$1,000	$1,805	$3,072
25	2019	$1,000	$1,852	$3,225
26	2020	$1,000	$1,900	$3,386
27	2021	$1,000	$1,949	$3,556
28	2022	$1,000	$2,000	$3,733
29	2023	$1,000	$2,052	$3,920
30	2024	$1,000	$2,105	$4,116
31	2025	$1,000	$2,160	$4,322
32	2026	$1,000	$2,216	$4,538
33	2027	$1,000	$2,274	$4,765
34	2028	$1,000	$2,333	$5,003
35	2029	$1,000	$2,393	$5,253
36	2030	$1,000	$2,456	$5,516
37	2031	$1,000	$2,519	$5,792
38	2032	$1,000	$2,585	$6,081
39	2033	$1,000	$2,652	$6,385
Totals		$39,000	$66,197	$114,095

CHART D


Straight Line And Neutral Cost Recovery Depreciation
Yearly Depreciation Comparison
Straight Line
NCRS @ 2.6%
NCRS @ 5.0%
Depreciation
Thousands
$8
$6
$4
$2
$0
39 Year Depreciation Period

Mr. HERGER. Thank you very much for your testimony, Mr. Woods.

Mr. Didion.

STATEMENT OF JAMES J. DIDION, CHAIRMAN, NATIONAL REALTY COMMITTEE, AND CHAIRMAN AND CHIEF EXECUTIVE OFFICER, CB COMMERCIAL REAL ESTATE GROUP, LOS ANGELES, CALIF.

Mr. DIDION. Thank you, Mr. Chairman and members of the Ways and Means Committee, good afternoon. My name is Jim Didion and I am chairman of the National Realty Committee, real estate's roundtable in Washington.

NRC members are engaged in all aspects of the real estate business as leading owners, advisers, builders, investors, lenders and managers. While not in Washington on NRC's behalf, I am typically traveling the company on behalf of my company, CB Commercial, or at work in Los Angeles where we headquarter in California. I am chairman and CEO of CB Commercial, one of the Nation's largest diversified commercial real estate companies.

The National Realty Committee appreciates the opportunity to present testimony today regarding select provisions of the Contract With America's Job Creation and Wage Enhancement Act.

Federal tax policy should be rational and balanced and serve as neither a disincentive to prudent real estate investment nor an incentive to unjustifiable excessive real estate investment. As an illustration of our long-term commitment to prudent policy, in 1981, the NRC testified against overly generous depreciation for nonresidential real estate. At that time, we believed that such a policy would lead to the economic overpricing and overbuilding of assets.

Indeed, given real estate's significant role in our Nation's economy, America's cities, all taxpayers and savers have a stake in reasonable growth-oriented real estate tax policy and the sound real estate asset values that such policy helps ensure.

Today, I would like to offer NRC's views on two critical issues being addressed by this committee, capital gains and depreciation. Regarding both issues, NRC believes Tax Code modifications are necessary so that real estate assets and business activities are taxed fairly, consistently, and accurately over time. So that capital formation, economic growth, and urban investment are facilitated and so that traditional real estate cycles are not unnecessarily exaggerated.

Specifically, a lower capital gains tax would help assure sound real estate asset values, encourage business activity, and spur economic growth. All of which are deterred by today's excessively high capital gains tax.

It should come as no surprise then that NRC strongly supports the capital gains tax reforms contained in the Job Creation Act. Why?

First, the act would cut the capital gains tax to a more appropriate line to incent savings through investment and assets; second, it would allow for indexing so that inflationary gains are not taxed; third, it would apply to currently held as well as newly acquired assets; fourth, it would apply to individually held and cor-

porately held assets; and fifth, the proposal very importantly maintains real estate's historical depreciation recapture treatment.

In a nutshell, this is the most thoughtful capital gains proposal I have seen in 15 years. It represents sensible change and it should be adopted.

Regarding depreciation, NRC also views inclusion of a neutral cost recovery system in the Contract With America as conceptually a significant and positive step. We agree that the current depreciation system should be reviewed and modified. In the case of real estate, it is the so-called leasehold improvements issue which I will explain briefly that NRC views as the most egregious flaw in the current system and one that should be addressed most immediately.

Simply stated, leasehold improvements, improvements constructed specifically for tenants, are the internal building components that are typically reconfigured, changed or somehow improved on a regular basis to meet the changing need of new and existing tenants; internal walls, ceilings, partitions, plumbing, lighting and finishes, these and all the elements that might be part of improvements made within a building shell to accommodate a specific tenant's requirements.

The problem with respect to the Tax Code is that today's depreciation rules don't differentiate between the life of tenant improvements which typically corresponds with the tenant's lease term and the life of the overall building structure. Current rules subject both to a 39-year depreciation schedule even though tenant improvements, in most cases, have absolutely no useful life beyond the average lease term of 7 to 10 years.

Compounding the problem is significant ambiguity concerning whether a real estate owner can close out and deduct currently any unrecovered costs at the time a leasehold improvement is destroyed. To make matters worse, the current policy works against urban reinvestment and construction job opportunities as improvements are delayed or not undertaken at all. And a widespread shift to more energy efficient environmentally sound building elements is discouraged because of their typically higher expense.

To address this issue, the cost of leasehold improvements should be recoverable over the improvement's true useful lives, such as the lease term or some other time period necessarily much shorter than today's 39-year requirement. Equally important, it should be clarified that owners are permitted to fully deduct and close out any unrecovered leasehold improvements expenses remaining at the time a leasehold improvement is demolished.

Both Congressman Shaw and Congressman Rangel, as well as others on this committee, have shown a great deal of interest on this issue and we look forward to working with them and you, Mr. Chairman, toward corrective action.

In conclusion, Mr. Chairman, the National Realty Committee again wishes to express its thanks for the opportunity to testify here today. We are encouraged by the tax proposals contained in the Contract's capital gains and depreciation reform and we are pleased to join down the path for a more rational, reasonable and growth oriented Tax Code.

Thank you.

[The prepared statement follows:]

TESTIMONY OF JAMES J. DIDION
NATIONAL REALTY COMMITTEE

Introduction

Mr. Chairman, members of the Ways and Means Committee, good afternoon. My name is Jim Didion. I am chairman of National Realty Committee, and chairman and CEO of CB Commercial Real Estate Group, one of the nation's largest diversified commercial real estate companies.

We appreciate the opportunity to present testimony today regarding select provisions of the Contract With America's Job Creation and Wage Enhancement Act.

National Realty Committee believes that federal tax policy should be rational and balanced . . . and serve as neither an incentive to unjustifiable, excessive real estate investment nor a disincentive to prudent real estate investment. That's why in 1981 NRC testified before Congress against overly generous depreciation for nonresidential real estate, believing such a policy inevitably would lead to uneconomic overpricing and overbuilding of assets. And that's why in 1986 we strongly urged that Congress reject the passive loss proposals, believing that those rules would undermine the economics of real estate values, increase bankruptcies and cause great stress to lenders and local tax bases.

Indeed, given real estate's significant role in our nation's economy, America's cities, taxpayers and savers all have a stake in reasonable, growth-oriented real estate tax policy and the sound real estate asset values that such policy will help ensure.

We welcome the opportunity to work with you, Mr. Chairman, and members of this Committee, to enact a set of positive tax laws for real estate and the nation. Combined with the positive economic and market factors now in place, rational government policies toward real estate should help sustain the current real estate recovery and minimize unnecessary and unusual exaggerations in real estate cycles. As recent history illustrates, secure real estate asset values and adequate liquidity are important keys to ensuring that the national economy is in a position to enjoy long term economic growth and good health.

Summary

Today I'd like to offer NRC's views on two critical issues included in the Contract With America's Job Creation and Wage Enhancement Act: capital gains and depreciation tax reform.

Regarding both issues, NRC believes tax code modifications are necessary so that real estate assets and business activities are taxed fairly, consistently and accurately over time . . . so that capital formation, economic growth and urban investment are facilitated . . . and so that the heights and depths of real estate cycles are not unnecessarily exaggerated.

Specifically, a lower capital gains tax, as proposed in the Contract With America, would help assure sound real estate asset values, encourage business activity and spur economic growth — all of which are deterred by today's excessively high capital gains tax.

At the same time, today's depreciation rules are inadequate and they should be modified so that they recognize the true economic life of buildings and the leasehold, or tenant, improvements made to them.

Capital Gains Taxation

National Realty Committee strongly supports the capital gains tax reforms contained in the Contract With America's Job Creation and Wage Enhancement Act. Here's why.

The Contract's capital gains reforms would cut the capital gains tax and thereby increase liquidity and unlock investments.

The combined burden of federal, state and local taxes on capital gains makes it more difficult to raise capital for needed and appropriate acquisitions, refinancings, and development opportunities. All of which are the source of much economic vibrancy, innovation and job creation. In addition, there is a strong disincentive in many cases to dispose of real property because of the relatively high rates of tax on gain. This "lock-in" effect discourages the employment of real estate in its highest and best use. Unlocking investments is vital to the optimum functioning of an efficient economy.

The Contract's capital gains reforms would adopt an indexing system so that inflationary gains are not taxed.

Gain on the sale of real property is strongly influenced by inflation. Even at low rates of inflation, taxpayers who sell real estate at a nominal profit are paying tax on a fictional element of profit represented by inflation. Eliminating the tax on inflationary gains is logical and wise long term tax policy. However, we do want to bring to the Committee's attention two shortcomings we see in the indexation provision as written.

First, we note with some concern that this indexation proposal would not apply to so-called "net leased" assets. We believe that the definition in the legislation of a net leased asset is too broad (for example, we would urge at a minimum that only "fixed" options to renew be counted). We urge the Committee to look closely at this provision as many real estate assets may be arbitrarily and unintentionally excluded.

In addition, the indexation feature as drafted would not appear to completely account for the affects of inflation on depreciable real property. This can best be illustrated by noting that the provision would deny any benefit to an asset whose adjusted basis is zero — that is, any asset held for its entire projected useful life. This is because, under the proposal, indexed basis is to be substituted for adjusted basis in calculating gain. Indexed basis is to be determined by multiplying adjusted basis by an inflation factor in the year of sale. If adjusted basis is zero, indexed basis will be zero — therefore denying inflation indexation benefits to precisely those assets held the longest. Arguably, indexing "adjusted basis" may be appropriate in cases where the asset receives, through the depreciation system, the present value of expensing. But since real estate assets do not, and are not proposed to, receive such treatment under this proposal, this capital gain indexation approach does not adequately account for inflation. Indexation of original cost is likely a more appropriate approach in real estate's case.

We would welcome discussing this matter in greater detail with the Committee staff.

The Contract's capital gains reforms would apply to currently held assets as well as to assets acquired subsequent to the enactment of the legislation.

Although some have suggested that a capital gains tax cut should apply solely to new investments, we strongly disagree. To exclude currently held investments from a capital gains tax cut would substantially devalue such assets and introduce very troubling implications for lenders and local tax bases, to say nothing of the owners. We urge any capital gains reform to apply to all assets — currently owned assets as well as those that are later acquired.

The Contract's capital gains reforms would apply to individually held and corporately held assets.

We see no justifiable tax policy reason for excluding a class of taxpayers and we therefore support this aspect of the Contract With America.

The Contract's capital gains reforms importantly maintain real estate's historical depreciation recapture treatment.

The current depreciation recapture rules, in place for over 30 years, are consistent with sound tax policy. These rules, which determine the portion of gain-on-sale taxed at the ordinary income versus the capital gains rate, recognize that buildings are long-lived assets that deteriorate over time, and they appropriately allow recaptured real economic depreciation deductions to be taxed as capital gain rather than ordinary income, which they clearly do not represent. As a consequence, these rules prevent taxpayers from converting ordinary-income deprecation deductions in excess of economic depreciation into capital gain upon a real property sale or disposition. Replacing this current system with one that taxed all recaptured depreciation deductions as ordinary income, as is sometimes suggested, would deny the fact that buildings and their internal systems do in fact depreciate. In addition to having no policy justification, a full recapture system also would have the net result of increasing taxes on any real estate sale at or slightly above original cost. We support the Contract With America depreciation recapture system, it is correct long term policy, and we urge its inclusion as part of any overall capital gains tax reform.

In a nutshell, the Contract With America capital gains reforms are the most thoughtful and effective capital gains proposal we've seen in many years; they represent sensible change and, with technical modifications to the indexation provision, we urge their swift enactment.

Depreciation

National Realty Committee views the inclusion of the Neutral Cost Recovery System in the Contract With America as a significant and positive step. We agree that the current depreciation system should be reviewed and modified to better reflect the true economic useful lives of assets. Indexation of depreciation deductions for inflation is one approach to partially achieving this goal.

But for depreciable real estate, the most egregious flaw in the current system, and the one that should be addressed most immediately, concerns the depreciation system for leasehold improvements.

Simply stated, leasehold, or tenant, improvements are the internal building components that are typically reconfigured, changed or somehow improved on a regular basis to meet the needs of new and existing tenants. Internal walls, ceilings, partitions, plumbing, lighting and finish — these are all elements that might be part of improvements made within a building shell to accommodate a tenant's requirements and therefore ensure that a tenant leases space.

The problem with respect to the tax code is that today's depreciation rules don't differentiate between the life of a tenant improvement — which typically corresponds with a tenant's lease-term — and the life of the overall building structure. Current rules subject both the building shell and all its internal improvements to a 39-year depreciation schedule, even though tenant improvements, in most cases, have no useful life beyond the average lease-term of seven to ten years. Correcting this mismatch between income and expense should be a priority.

Compounding this problem is significant ambiguity in the marketplace today concerning whether a real estate owner may "close out" and deduct currently any unrecovered costs remaining at the time a leasehold improvement is destroyed. It seems almost absurd, but the current rules are in some cases being interpreted to deny the ability of a building owner to "close out" its investment for tax purposes even though the improvement has been scrapped, demolished or otherwise permanently retired from service. Theoretically, in 30 years a building owner could have had 6 different 5-year

tenants, each requiring different improvements to accommodate their individual business needs. Because of the current confusion, the owner may be required to depreciate improvements that in fact no longer exist. In addition to more closely matching income from the improvement with its costs, this close out issue needs to be addressed.

As a result of today's flawed depreciation rules, the after-tax cost of reconfiguring, or "building out", space to accommodate new tenants is artificially high. This is because owners are unable to fully deduct the economic costs expended on leasehold improvements over the period in which the improvements actually generate income.

In addition, the current policy hinders urban reinvestment and construction job opportunities as improvements are delayed or not undertaken at all. And a widespread shift to more energy-efficient, environmentally sound building elements is discouraged because of their typically higher expense.

To address this issue, the cost of leasehold improvements should be recoverable over the improvements' useful lives . . . such as the lease-term or some other time period necessarily much shorter than today's 39-year requirement.

Equally important, it should be clarified that owners are permitted to fully deduct and close out any unrecovered leasehold improvement expenses remaining at the time a leasehold improvement is demolished.

We are pleased that several members of this Committee, including Congressmen Shaw and Rangel, have expressed concern with this aspect of the current depreciation system. We look forward to working with them, with you, Mr. Chairman, and with this Committee, toward corrective action in this important area.

Longer term, NRC believes the current one-size-fits-all real estate depreciation system should be examined and reformed to recognize the true economic lives of buildings and all their various component parts. We aren't, after all, talking about an undifferentiated commodity, but assets of a range of different varieties, shapes and sizes, uses and useful lives. Our current depreciation system needs greater flexibility to more accurately account for this diverse asset class.

Conclusion

National Realty Committee is encouraged by the tax proposals contained in the Contract With America — capital gains and depreciation reform — and we're pleased to join you down the path toward a more rational, reasonable, growth-oriented federal tax code.

Thank you.

Mr. HERGER. Thank you for your testimony, Mr. Didion.

Our next panelist is a constituent of our esteemed colleague from Washington, Jennifer Dunn.

Jennifer, would you mind introducing Mr. Freeman?

Ms. DUNN. Thank you very much, Mr. Chairman, and colleagues on the committee. It is a personal pleasure for me to introduce to my colleagues, Kemper Freeman, a long-time friend and a school classmate of mine. He comes before the committee as the president of the International Council of Shopping Centers and as owner of a regional shopping center in Bellevue, Wash., which is in my district.

Mr. Freeman is no stranger to leadership, to advocacy or to legislation. He has been a leader ever since I knew him at Bellevue High School. Like his father and grandfather before him, he has been an articulate and outspoken leader in the Northwest business community.

Beyond that, he has also served with great distinction in Washington State's Legislature. As you will see, he brings particular knowledge and insight to some of the most pertinent tax issues before our committee.

And it is my great pleasure and privilege to introduce to you a gentleman I know as a leader, an expert, a friend, and what I have been told, a pretty adept Harley-Davidson driver, Kemper Freeman.

STATEMENT OF KEMPER FREEMAN, JR., PRESIDENT, INTERNATIONAL COUNCIL OF SHOPPING CENTERS, AND PRESIDENT, KEMPER DEVELOPMENT CO., BELLEVUE, WASH.

Mr. FREEMAN. Thank you, Jennifer. I think I should thank you for letting me be here. I wish my mother could have heard all of that.

Mr. Chairman, and distinguished members of this committee, it is indeed an honor to join you today and speak on behalf of the ICSC in favoring your Job Creation and Wage Enhancement Act of H.R. 9. As Congressman Dunn said, I am Kemper Freeman, owner and manager of Bellevue Square and Bellevue Place, president of Kemper Development in a city near Seattle in the other Washington.

It is my pleasure this year to serve as chairman and president of the ICSC, which is an industrial organization of the nearly 39,000 shopping centers, mostly small shopping centers, and our organization is made up of approximately 27,000 members.

We are here today specifically to address the capital gains issue, and I would like to give some testimony on that.

I believe it is time that we break the myth that capital gains tax reduction is only for the benefit of the rich. It is simply not true. I can explain that by pointing out, in our industry, the capital is the first thing in. That buildings, jobs, and tax base come along sometimes over many years after the original capital is put in. And only when and if the project becomes successful, successful enough so that the capital has become more valuable, only then does the person who put up the original money get to take out more than they put in. We are the first money in. We are the last to get paid.

And the fact is, all America wins when the capital gains tax is reduced.

We also believe that in this bill there are several other things that will be corrected, and the myth of inflationary gains right now are taxed by the full rate of capital gains. And investments sometimes take years to come out of a project and, oftentimes, the entire gain is simply the inflation that took place while that capital was tied up, and in every case, a large portion of the gain is inflationary.

And this bill, as I understand it, would correct that. Also, the lock-in effect of capital, because this rate is so high now, now one with any common sense would take capital out of a project, suffer up to a third of its being destroyed by the existing tax, only to reinvest in the next project. And this makes us less competitive and less able to get at the capital to deploy it where it best should be and that is, the most viable projects.

You have seen in our industry that many of us have been forced to borrow heavily rather than take equity from one place and move it to another because of the severe penalty. The ICSC strongly supports the capital gains legislation that we are talking about today. And this legislation presents the best opportunity for the Nation's economy unlocking real estate investment to spur economic growth and jobs.

Cutting the capital gains tax rate and the resulting economic growth will significantly lower the cost of capital for the Nation's real estate investors, and for that we are deeply appreciative.

The inflation indexing will eliminate the taxing and fictional element of property values. Shopping centers are one of the largest employers in the United States, with direct employment of over 10 million jobs, representing approximately 9 percent of all the people who work in America, work in these centers, and with your help, there will be more investment and simply more jobs.

While we support this bill and are deeply thankful for your help in moving it along, we do want to offer an amendment as to the net lease, a technical correction. Most of our industry deals with net leases and I think the net lease provision is in there to try and correct some other problem, but our industry is sort of the dolphin in the net, and we really shouldn't be caught in that net.

The ICSC strongly supports this capital gains bill, and all America will love you for passing it.

Thank you.

[The prepared statement follows:]

Testimony
of the
International Council of Shopping Centers
on
The Capital Formation and Job Creation Act of 1995 (H.R. 56)
Presented to
The Committee on Ways and Means
U.S. House of Representatives
By
Kemper Freeman, Jr.
President
Kemper Development Company

January 26, 1995

I. Introduction

I am Kemper Freeman, President of Kemper Development Company located in Bellevue, Washington. I am also the elected President of the International Council of Shopping Centers (ICSC) and I am appearing today on behalf of ICSC. My testimony today will focus on the capital gains provisions contained in The Job Creation and Wage Enhancement Act of 1995 which have also been introduced separately as The Capital Formation and Job Creation Act of 1995 (H.R. 56).

The International Council of Shopping Centers (ICSC) is the trade association of the shopping center industry. Its 27,000 members represent owners, developers, retailers, lenders, and all others having a professional interest in the shopping center industry. Its 24,500 U.S. members represent almost all of the 39,000 shopping centers in the United States. In 1993 these centers accounted for $830.2 billion in retail sales, over 55% of all non-automotive retail sales. In addition, shopping centers employed 10 million people, about nine percent of non-farm jobs in the United States.

II. Capital Gains Tax Treatment

A. Current Law

Prior to 1987, assets such as corporate stocks and bonds, land and depreciable property used in a trade or business were accorded special "capital gain" treatment on disposition, which resulted in a lower rate than the ordinary income tax rate. Since 1987, the capital gains of individuals have been taxed at ordinary income rates up to a maximum of 28 percent.

B. Background

From 1921 to 1987, non-corporate capital gains were taxed at reduced rates. From 1942 to 1987, land and depreciable real property used in a trade or business ("section 1231 assets") were accorded net capital gain and ordinary loss treatment. From 1921 to 1942, a maximum 12.5 percent tax rate was prescribed for capital gains. From 1942 to 1986, the basic structure of the capital gains tax was an exclusion of a portion of the gain from income (50 percent from 1946 to 1978, and 60 percent from 1978 to 1986) with a tax rate lower than the ordinary income rate applied to the non-excluded portion of the capital gain.

The Tax Reform Act of 1986 repealed the capital gains tax preference for all capital assets and Section 1231 property and all capital gains of individuals were taxed at the same rates as ordinary income subject to a maximum rate of 28%. However, rules regarding capital gains were left in the Internal Revenue Code in case a capital gains differential was reinstated. As part of the 1990 budget summit agreement, a top rate of 31 percent for individuals was instituted for ordinary income, but the top rate for capital gains was maintained at 28 percent. In 1993, the top rate for ordinary income of individuals again was raised, while the top rate for capital gains was maintained at 28 percent.

Corporate capital gains are governed by somewhat different rules with a current maximum rate for capital gains of 35%.

III. Reasons For Capital Gains Tax Reduction

ICSC believes that a significantly lower tax on capital gains from capital and other assets such as real estate must be reinstated to encourage economic growth, to improve long-term productivity, and to make the nation more competitive (most other nations do not tax, or impose a very low tax, on capital gains). In addition, the reduction of the taxation of capital gains will reduce impediments to the efficient functioning of the economy and improve the fairness of the tax system. Among the reasons for lowering the tax on capital gains are the following:

A. Economic

It is vital to the strength of the U.S. economy that the tax system facilitate the growth of new business and job formation, product and process innovation, and development of new and emerging technologies.

Investments in depreciable real property materially improve the growth and productivity of the economy and are important to our competitive position in the world.

Buildings that are energy efficient, that facilitate modern communications and information processing, and that are safe and comfortable encourage the effective and efficient performance of workers in them. Investments in modern office buildings assist the work of knowledge-based workers. Investments in industrial space, warehouses, and shopping centers and other retail facilities make the entire production-distribution system more efficient. Multi-use facilities integrate residential units, commercial office space, hotels and retail outlets all in one combined facility, bringing broad segments of the economy together in one location, and making it easier for each segment to access the services of another.

The development of high technology office, manufacturing, warehouse, and retail facilities help create value that is passed on to tenants who share their productivity gains from occupying efficiently designed space with their customers and clients.

Obtaining the investment necessary to develop these modern commercial facilities requires the creation and long-term commitment of capital and will be positively effected by a reduction in the taxation of capital gains.

B. Inflationary Gains

Because of inflation, building values would need to increase over time in order to maintain a constant value. Even at low rates of inflation, each year that passes increases the distortion between original and nominal values, especially for assets held for long periods of time, such as real estate. Thus, owners who sell capital assets at a nominal profit pay tax on a "fictional" element of capital gain represented by inflation and may be paying a tax on capital.

Therefore, capital gains from capital and other assets such as real estate should be taxed at a lower rate than ordinary income to compensate for this problem.

C. Lock-in of Investments

Another reason supporting a reduced tax rate for capital gains is to avoid "locking in" investments.

The "penalty" of paying ordinary rates on the gain from the sale of property "locks-in" real estate and other investments and impairs their free alienability. This prevents real property and other assets from being employed in their highest and best use, which is vital to the functioning of an efficient economy.

The investment in real estate in the U.S. is such a large percentage of total private domestic investment that any decrease in the efficiency of its allocation can have significant aggregate economic effects.

Real estate provides some of the best examples of the problems associated with "lock-in". For example, "lock-in" may prevent the disposition of a family-owned property upon retirement or a taxpayer's reallocation of his assets to a more efficient use. There is a direct negative effect on growth, jobs, and prosperity, from the higher rates of tax on gain which tend to discourage the natural economic evolution

of the changing use of real properties. For example, old industrial loft space may be sold and then converted to residential units or retail uses, thus freeing up capital to build new industrial space and provide rehabilitated space for new uses.

Thus, the disincentive to dispositions of real property because of the relatively high rates of tax (federal, state, and local) on gain, and the consequent reduction in the funds available for reinvestment in another structure, is quite strong in some circumstances for owner-operators. The disincentive may be even stronger for lessors, whose decisions on the disposition of their property are more independent of the particular situation of any individual business and more based upon aggregate financial incentives and disincentives.

Reducing the tax on sales of existing and new assets would make it economic to sell property subject to the lock-in effect now and in the future. Increased sales of property will create greater economic activity, improve the efficiency of the economy, and increase federal revenues -- a tax is only paid when property is sold or transferred.

D. Bunching

Still another reason for reducing the tax on capital gains is the "bunching" problem.

"Bunching" occurs when gain, both real and inflationary, that has accumulated over several years is taxed in one year. This pushes the income of the taxpayer, including the income that otherwise would have been taxed at a lower tax rate, into a higher tax bracket in that year.

The "bunching" problem typically is more severe the longer the holding period because more years of accumulated gain are taxed in one year. Investments in real estate typically are held for longer periods than many other investments. Therefore, bunching generally is a more serious problem for real estate than for other assets.

In addition, the "bunching" problem is more widespread the greater the number of investors who would be in a lower tax bracket except for a sale with significant gain. Investments in real estate are more evenly distributed by income class, and therefore by tax bracket, than investments in other assets. Therefore, "bunching" may be a more widespread problem for real estate than for other assets.

IV. The Capital Formation and Job Creation Act of 1995

A. Provisions

The Capital Formation and Job Creation Act of 1995, H.R. 56, addresses the problems discussed above through its provisions, including these that follow:

- a deduction from gross income of fifty percent of net capital gain (thereby reducing the capital gain tax rate to one-half the rate on ordinary income) and a reduction in the impact of the phase-out of the personal exemption and the limitation on itemized deductions;
- the flow through to individuals and corporations of the fifty percent deduction from pass-through entities, such as partnerships, REITs, S corporations, etc.;
- the exemption of the fifty percent deduction of net capital gain from the alternative minimum tax;
- the indexation of the "adjusted basis" of capital and certain other assets to eliminate purely inflationary gains; and
- a provision to treat the loss on the sale of a home as a capital loss.

The 50% capital gains deduction and the home sale capital loss provision would apply to sales on or after January 1, 1995. The capital gains indexation would apply to inflation (and sales of capital assets) occurring after December 31, 1994.

B. ICSC Support

ICSC believes that the provisions of H.R. 56 are consistent with the principles for action on capital gains enunciated and supported by ICSC and its members over the years and supports its enactment. ICSC urges the Committee and the Congress to act promptly in enacting H.R. 56 as a means of encouraging the growth of jobs and the economy.

C. Issue of Concern

However, ICSC does have concern that the provision in the legislation that excludes net lease property[1] from the assets eligible for indexation may have a serious negative impact on shopping centers and believes that it needs to be reviewed by the Committee as to its purpose and scope.

ICSC is concerned that this exclusion and the definition of net lease property on which it is based may be inappropriate in the context of shopping center and other leases. This is particularly so regarding shopping centers because of reasons related to the history and unique nature of the shopping center industry.

A shopping center is a special type of commercial real estate that involves a unique interdependence and synergy between and among the shopping center and its tenants. Shopping center tenants pay to be located in a setting where they cooperate and compete with other retailers because of the high volume of customers attracted to the center by the combination of retailers and the facilities and amenities of the shopping center.

The shopping center landlord designs the "tenant mix" of the center to maximize the customer traffic to be drawn from the center's "market area" by leasing to those retail stores that in combination will be most attractive to the potential customers in the market area. The shopping center landlord creates the desired tenant mix by choosing retail tenants based on their nature or "use", their quality, and their contribution to tenant mix and by entering into leases which set forth and limit the uses to be made of the premises and the conditions and terms of operation within the center. Rents reflect the desirability and uniqueness of the tenant's use in relation to the tenant mix and vary among tenants on this basis.

Often, the shopping center landlord's rental income is directly tied to the success of the shopping center through "percentage rents", i.e., rent based on a set base amount and an additional percentage of the lessee's gross sales. The shopping center tenants join together and pay common area maintenance fees and other fees to provide for the maintenance, operation, and advertising of the shopping center in cooperation with the landlord who bears the costs of managing and operating the center. In addition, many tenants control, operate, and maintain their own HVAC systems independent of that of the shopping center and pay the costs associated with heating, cooling, lighting, and maintaining their space. The terms of these leases generally vary from 5 to 20 years and usually contain one or more options to renew.

While these leases facilitate the creation and operation of shopping centers and have contributed to the growth, modernization, and increased efficiency of the retail sector of the U.S. economy, in some instances they may meet the definition of "net lease property" in H.R. 56 and may not be eligible for indexation under its provisions.

ICSC believes that it would be inappropriate and unfair to deny indexation to the large number of shopping center leases that may qualify as net lease property under the definition in H.R. 56 and urges the Committee to examine this provision of the legislation.

V. Conclusion

ICSC strongly supports the provisions of the Job Creation and Wage Enhancement Act of 1995, and urges the Committee and the Congress to promptly pass the legislation.

In addition, ICSC asks that the Committee examine the net lease property provision and clarify its application, particularly as to shopping center leases.

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[1]In the legislation, the term "net lease property" means leased property where -- (A) the term of the lease (taking into account options to renew) is 50 percent or more of the useful life of the property: and

(B) for the period of the lease, the sum of the deductions with respect to such property which are allowable to the lessor solely by reason of section 162 (other than rents and reimbursed amounts with respect to such property) is 15 percent or less of the rental income produced by such property.

Mr. HERGER. Thank you very much Mr. Freeman.

And our final panelist, Mr. Johnson, please.

STATEMENT OF CALVIN H. JOHNSON, PROFESSOR OF LAW, UNIVERSITY OF TEXAS, AUSTIN, TEX.

Mr. CALVIN JOHNSON. I am Calvin Johnson from the University of Texas Law School. I teach tax and accounting at Texas.

My statement is on three errors in the neutral cost recovery system proposal and I propose to follow along fairly closely on the first 2 pages of that statement. You can both hear and read me simultaneously, if you would like.

Title II of the Contract With America would allow taxpayers to elect a complicated new depreciation system NCRS. The logic of the system is that taxpayers should be given tax savings worth the value of expensing, which means that one gets to deduct one's investment immediately as soon as the equipment is set up for use, although no resources have been lost.

The NCRS proposal involves a number of serious errors. Left uncorrected, the errors make NCRS an irresponsible or ideological proposal. In the political excitement of the moment, it is too easy to let professional standards go by the way, but politics needs calm deliberation and dispassionate analysis. We need to slow down and correct these errors or we will regret at leisure. The mistakes are too important to be lost.

The first error relates to tax shelters. The first error of the NCRS proposal is that it creates negative tax or subsidies more valuable than just freeing investment from tax. It does this first by combining expensing with interest deductions, and second, by combining expensing with lower capital gains rates.

The proposal, for instance, allows both the expensing of the investment and also an interest deduction on the debt that makes the investment possible. Given the expensing, the interest deduction is a mistake. Expensing, plus interest, gives a negative tax that is better than zero by about the value of the deduction of interest. The negative tax subsidy will cause waste of capital because it makes investments that are not acceptable in terms of their real pretax economics look acceptable to a taxpayer after tax.

The negative tax, moreover, is rate dependent giving more subsidy to high-bracket taxpayers than to low. A rate dependent subsidy is a terrible idea. It drives young entrepreneurs, startup companies and ailing companies out of the market simply because they have too low a tax bracket. A rate dependent tax bracket will also leave high-bracket investors with windfalls that they do not turn over to investment.

Separately, the NCRS proposal also needs to define NCRS property as not eligible for advantageous capital gains rates. Real estate needs to have "full" recapture and more. Deduction of inputs against ordinary income combined with favorable capital gains rates for outputs creates a separate rate dependent negative tax better than zero.

It is the combination of expensing and the interest deduction and the combination of expensing and the capital gains rates that are the killer issues. The combination is what needs to be corrected. Household ammonia is a pretty good cleaner. Chlorine bleach is a

pretty good cleaner, too. But pour them in together in the bathtub and you will blow out your bathtub. The NCRS proposal didn't check its combinations.

The second error of NCRS is that it assumes without support, that savings will respond powerfully to expensing. Without a powerful savings response, the proposal just shifts the burden of tax off of taxpayers who have capital and on to taxpayers who have little or no capital. That shift will do the country harm.

We had our experiment with expensing in the 1981 enactment of ACRS. We need to learn from that experiment. ACRS was a supply side depreciation system, like NCRS, providing for expensing for machinery and equipment. The data from the experiment is in; ACRS failed. The 1981 act gave the largest incentives to capital in the history of income tax, and yet, savings declined after the act for good and solid reasons.

The consensus of the economics profession across the political spectrum from right, to middle, to left, is that the data gives no support to findings of high positive response or significant elasticity in response of savings to tax rate reductions. Proponents of ACRS were surprised. Congress cut back on ACRS in 1982, 1984, and 1986 because the incentives were too generous and did not work. We need to learn from our mistakes. ACRS failed. We cannot afford it again.

The third error of the NCRS proposal is in scoring the proposal as a revenue raiser, when it should be scored as a revenue loser more costly than expensing. NCRS is scored as a revenue raiser because it switches from 200 to 150 percent declining balance depreciation in its underlying structure. But NCRS then gives generous interest deductions, the "NCR ratio," intended to give NCRS a value like expensing.

But, because of the 5-year window convention, most of the interest costs of the NCR ratio are pushed beyond the 5-year window and ignored.

Scoring NCRS as a revenue raiser is dishonest accounting that hides the true cost. NCRS is intended to be the equivalent to expensing and its cost needs to be scored as equal to the cost of expensing.

If this kind of misleading accounting were done in the private sector to sell securities or consumer goods, the promoter should be indicted.

These three errors are explained in greater detail in my statement in full.

I thank you very much.

[The prepared statement follows:]

Statement, Three Errors in the "Neutral Cost Recovery System" Proposal

Professor Calvin H. Johnson*

Title II of the Contract-With-America bill, HR. 9, would allow taxpayers to elect a complicated new depreciation system, the neutral cost recovery system ("NCRS"), for basis in machinery and equipment. The logic of the system is that taxpayers should be given tax savings worth the value of "expensing" for tangible personal property with a current tax life of 10 years or less. "Expensing" means deducting the basis of one's investment immediately, as soon as the equipment is set up for use, although no resources have yet been lost. Under the NCRS proposal, the taxpayer in fact takes deductions over the tax life of the property, but NCRS then gives interest and inflation adjustments to compensate for the delay since the investment's start.

The NCRS proposal involves a number of serious errors, judged under neutral, professional standards. Left uncorrected, the errors make NCRS an irresponsible or ideological proposal. In the political excitement of the moment, it is too easy to let professional standards go by the way, but politics needs calm deliberation and dispassionate analysis. We need to slow down and correct these errors now or we will repent at leisure. The mistakes are, however, core errors so that correction might well kill the whole NCRS proposal.

(1) Tax Shelters. The first error of the NCRS proposal is creating negative taxes or subsidies by combining expensing with an interest deduction and with lower capital gains rates. The proposal, for instance, allows both expensing of the investment and also an interest deduction on debt that makes the investment possible. Given the expensing, the interest deduction is a mistake. Expensing and interest deduction gives a negative tax, better than zero tax by the value of deducting interest. The negative-tax subsidy will cause waste of capital by making investments that are not acceptable, in terms of their real pretax economics, look acceptable to the taxpayer after tax.

The negative tax is tax-rate dependent, moreover, giving more subsidy to high bracket taxpayers than to low. A bracket-dependent subsidy drives young entrepreneurs, start up companies and ailing companies out of the market, simply because they have too low a tax bracket. A bracket-dependent subsidy also leaves high bracket investors with windfalls they do not turn over to investment.

Separately, the NCRS proposal combines expensing with advantageous capital gain rates. Given expensing, favorable capital gains rates applied to any gain creates a separate rate-dependent, negative tax.

It is the combination of expensing and the interest deduction or capital gains rates that is the killer issue. Household ammonia is a pretty good cleaner, for instance, and chlorine bleach is a pretty good cleaner too, but pour them in together to clean the bathtub and you will blow out the bathtub. The NCRS proposal did not check its combinations.

2. Savings don't respond to incentives. The second error of NCRS is that it assumes, without support, that savings will respond significantly to expensing. Without a significant savings response, NCRS just shifts the burden of tax or deficit from taxpayers with capital to taxpayers with little or no capital. That shift will do the country harm.

We have had our experiment with expensing in the enactment of the Accelerated Cost Recovery System, "ACRS," in 1981. ACRS was, like NCRS, intended to allow expensing equivalence for machinery and equipment. The results of the experiment are in. ACRS failed. The 1981 Act gave the largest tax incentives for capital in the history of the income tax and savings declined. The consensus of the economics profession across the political spectrum is that the data gives no support for a significant positive response of savings to tax rate reductions. The proponents of ACRS were surprised. Congress cut back on ACRS in 1982, 1984 and 1986 because the incentives were too generous. We need to learn from our mistakes.

3. Revenue Estimates. The third error in the NCRS proposal is in scoring the proposal as a revenue raiser. NCRS is equivalent to expensing in intent and impact and scored like expensing, NCRS loses roughly $300 billion over five years. NCRS is scored as a revenue raiser because it switches from 200% to 150% declining balance depreciation in its underlying structure. But NCRS then gives interest and inflation adjustments, in the "NCR ratio," that compensates for the delay after expensing. Because of the 5-year window convention, however, most of the costs of the NCR ratio are pushed beyond the 5 year window and ignored.

Scoring NCRS as a revenue raiser is dishonest accounting that hides the true cost and impact on the deficit. If this kind of accounting were done in the private sector to sell securities or consumer goods, the promoter should be indicted.

Statement in detail: Three Errors Explained

1a. Negative Tax: Interest Deduction[1]

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[1] This section is based on Johnson, *Tax Shelter Gain: The Mismatch of Debt and Supply-Side Depreciation*, 61 TEX. L. REV. 1013 (1983), which has more extensive arguments on some issues.

NCRS permits expensing of the cost of the investment and also permits the taxpayer to deduct interest on debt financing that makes the investment possible. The combination of expensing and interest deduction means that there is a "negative tax" or subsidy on the investment, that is, treatment better than mere tax exemption or zero tax. The subsidy is generally worth the value of deducting interest.

Algebraic description. The negative tax or subsidy can be shown with simple algebra. Assume taxpayer Q borrows amount "B" paying interest of "i" to make an investment A in equipment that will return profit at return rate "r" annually. Assume first that interest, "i," and profit, "r," are equal, so that in absence of tax, investment A is a break-even investment. Every year for the life of the equipment, A makes $B*r$ profit and pays $B*i$ interest. $B*r-B*i=0$.

Adding tax, with both expensing and an interest deduction, will improve Q's return. With expensing of investments, taxpayer Q can expand the amount invested in A, relying on tax savings generated by the investment (at tax rate "t") to reduce its cost. With expensing, borrowing of B will allow Q to invest amount X such that $X-t*X = B$. Rearranging the algebraic terms, it follows that the amount invested X in investment A under expensing will be $B/(1-t)$. The expensing allows Q to get pretax return rate r on augmented investment, $B/(1-t)$, whereas Q pays interest only on borrowed B itself. The pretax position every year is

$$[B/(1-t)]*r - B*i \quad (1).$$

The pretax position in expression (1) is subject to tax at rate t, so that Q's after tax annual income is

$$[B/(1-t)]*r - B*i - t\{[B/(1-t)]*r - B*i\}, \quad (2).$$

which is equivalent to

$$(1-t)\{[B/(1-t)]*r - B*i\} \quad \text{or}$$

$$B*r-B*i + B*i*t. \quad (3).$$

When return rates and interest rates are the same, $B*r$ and $B*i$ cancel out and expression (3) becomes

$$B*i*t \quad (4).$$

Expression $B*i*t$ is an after tax positive value or subsidy equal to the tax saved by deducting interest of i on borrowing B for an investment in A that would have no net value ($r=i$) in absence of tax.

The subsidy, $B*i*t$, will allow taxpayers to accept real returns from investments that are materially below the prevailing cost of borrowed capital.

Setting after-tax annual return, expression (3), equal to zero :

$$B*r-B*i + B*i*t = 0 \quad (5).$$

Rearranging the terms and factoring out B:

$$r = i(1-t) \quad (6).$$

Hence with the subsidy, an investor will accept a pretax or real loss on the investment, which however will cover the cost. Going backwards to check, we can substitute low return $i(1-t)$ in expression (3) so that there is a pretax loss:

$$B*i*(1-t)-B*i \quad \text{or}$$

$$-B*i*t \quad (7)$$

But the tax subsidy $B*i*t$ (in bold in (8) below) will turn the pretax loss in an investment able to meet its cost of capital:

$$-B*i*t + \mathbf{B*i*t} = 0 \quad (8)$$

Ordinary use of NCRS with debt would be a paradigm tax shelter. A tax shelter is an investment that is worth more after tax than before tax because of negative tax from artificial accounting losses. A tax shelter saves the investor tax that would otherwise be paid on consumed amounts or other outside income. Within the parlance of HR 9, "neutral" means free from tax and, under that criterion, NCRS is not neutral because it goes beyond zero tax. To get back to zero tax, interest deductions must be disallowed or something equivalent, that offsets the $B*i*t$ subsidy.

The subsidy ($B*i*t$) will allow taxpayers in competition to bid up the price of investment A so that the return, r, stated as a percentage of investment, will drop below the prevailing interest rate, i, to $i(1-t)$. For instance, where pretax interest rates are at 7%, then the return to the highest bracket investors from the NCRS qualified investment needs only be 7%(1-41%) or 4%.

A tax system that allows investors to profit privately from investments that return less than the prevailing interest rates wastes capital. We saw the waste in the tax shelters prevailing before the 1986 Tax Reform Act. Investors put their money into legal, but economically silly investments such as see-through office buildings, garden apartments that were constructed and then promptly

torn down, jojoba beans in Costa Rica, twaddling record masters and the like. We have too little capital to waste it so.

The waste will be most significant for situations outside of the passive activity restrictions, that is, for corporate investors and for investors who actively participate in the business making the investment, but the negative tax will have effect even within the limitations imposed by passive activity rules.[2] The proposal would limit NCRS deductions to the amount of the investor's business taxable income, but that limitation does not prevent use of the subsidy to zero out all business real income. Where the negative tax is available, the waste from returns below prevailing interest rates is as inevitable as apples falling.

Rate-dependent. The subsidy, $B*i*t$, also critically depends upon the investor's tax rate at which the value of expense and interest deductions are computed. High tax bracket investors, with the highest values for t, will get the largest subsidy -- perversely because they are considered to be the best bearers of tax. Lower bracket competitors such as start up companies, young entrepreneurs with fresh ideas and ailing companies temporarily in trouble will get lesser or no subsidies and will be driven out of the market. The following chart shows the interest cost, less the $B*i*t$ subsidy, equaling the required pretax return r, for various tax brackets:

Tax bracket (t) of investor	Interest cost (i)- 7%	less subsidy ($i*t$) on 7% interest	equals required real return (r)
41%	7%	2.9%	4.1%
34%	7%	2.4%	4.6%
28%	7%	2.0%	5.0%
15%	7%	1.05%	5.95%
0	7%	0	7%

As the chart shows, it is the highest bracket investors who can accept the lowest returns under the subsidy and will pay the most for any given property. For example when interest rates are 7%, a 41% bracket investor needs only a 4% return from the investment and a start up company facing no tax will need a 7% return. All other things being equal, high bracket investors will bid up the price of the investments, driving down r, and driving out lower bracket investors.

The $B*i*t$ subsidy would discriminate not only for rich against poor, but also, along geographical lines, in favor, of high income tax states. States with high rate income taxes, such as California and New York, that have tax systems that trace federal taxable income would give a higher subsidy than low rate states such as Texas and Nebraska. California and New York residents can thus outbid residents in low tax states in the auction for NCRS-qualified property. The geographical discrimination arises perversively because the negative tax subsidy depends upon the tax rate (the t in the $B*i*t$ subsidy) and is higher when the tax rate is higher.

Where the price for NCRS property settles will depend upon market factors, especially on how many alternative ways there are to avoid tax. The price will settle giving a return r at one effective tax rate, that of the marginal or last investor necessary to make all NCRS property sell. The required r (and price) will depend in the market upon the supply (basis that can be made to qualify within NCRS) and the demand (income that can not be sheltered from tax by cheaper means) for tax shelter. Because of the cornucopia of other tax advantaged plans that swamp the market,[3] we should expect the marginal rate to be less than the 34% statutory tax rate applied to large corporations.

Wherever the market settles, investors in a higher-than-the-marginal tax bracket will get a windfall that they do not turn over to investments. For example if the market settles with a pretax return of 5%, investors in the 41% and 34% bracket will get windfall returns in excess of their cost of capital The 41% bracket investor will get 5% after tax whereas 4% would be a sufficient return to meet their cost of capital. The extra 1% windfall is a variety of waste.

Investors at or above the marginal rate will also become the exclusive owners of NCRS property. Unless they have some material nontax advantages, investors in tax brackets less than the marginal return rate will be excluded from the market because the return rate r is too low. Assuming again the market settles with a pretax return of 5%, then 15% and tax exempt or tax loss entities will not be able to afford the cost of capital and will not be able to buy the machinery.

It is difficult to see how the negative tax subsidy, $B*i*t$, can be anything other than an error. The rhetoric behind NCRS argues for zero effective tax rates, but not for a negative tax

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[2] Section 469 of the Code provides that deductions from any passive activity may be used only against taxable income from all passive activities. Widely held corporations and active participants in a business are exempt from the limitations. Even for non-exempt taxpayers, deductions representing artificial accounting losses can be used against consumed amounts or other cash income. The passive activity rules are also under constant political assault, in part, because they represent such bad theory. There is nothing wrong with being passive nor with being active nor with the combination. The assumption behind the exemptions that businessmen and public corporations would not use artificial deductions is also nonsense.

[3] Harvey Galper & Gene Steuerle, *Tax Incentives for Savings*, 3 STATISTICS OF INCOME BULL., 1, 4 (Spring 1984) estimate that 80% of the assets held in wealth of individuals has an effective tax rate of zero, which implies that no high bracket taxpayer would accept very much lower r from NCRS investments.

subsidy. If we were going to give a subsidy for investment as a budget item with a known cost, we would not give the subsidy to the nonmeritorious drivel like jojoba beans and record masters that have qualified for the shelter subsidy in the past. We would also not distribute the subsidy in a way that would drive start up competitors and temporarily losing companies out of the market and we would not give the greatest subsidy to the richest first, in the exact negation of the pattern by which the tax burden is distributed, when Congress thinks about distribution issues and reaches a fair compromise.

The negative tax for debt financed NCRS investments is not justified by consumption tax arguments. Expensing has been supported by the consumption tax argument that an income tax is a double tax on capital,[4] but the debt-financed investment is missing the starting step of the double tax.. One can not defend the negative tax as a subsidy for capital formation since neither borrowing cash nor promising to pay for property in the future is capital formed, but instead is anti-capital or use of capital. Consumption tax theorists would correct the error of the negative tax by disallowing the interest deduction, taxing borrowed amounts or some equivalent measure.[5]

Interest on debt is in theory taxed to the other side, and if debtor and creditor were in the same bracket and paid tax as interest is deducted, there would be just zero tax. But investors arrange themselves into clienteles under which high bracket investors incur debt and pension funds or low bracket investors supply debt, so that only trivial tax is collected on interest. The market for interest, in any event, gives little or no premium to cover tax. Even if the creditors did pay tax on interest and pass it back to borrowers, that would raise the interest rates, but still leave a tax-dependent subsidy on the debtor's side, that would give windfall to some and exclude others just because of their tax bracket.[6] The combination of expensing and interest deduction is a mistake.

Remedy The remedy to bring tax up to zero is to disallow deduction of interest on debt, up to an amount of debt equaling the consolidated group's NCRS investment. It is neither administrable nor fair to attempt to "trace" debt to specific uses. Money is fungible. Financing from any source goes into a common pool from which the company needs are withdrawn. Debt incurred for any purpose will allow the taxpayer to increase NCRS basis, even if the occasion for the debt was not NCRS investment. Two taxpayers with identical balance sheets should pay the same tax, without regard to the order or occasion of their borrowing.[7] The necessary remedy follows IRC §263A(f) (construction interest) and identifies interest on the taxpayer's first debt as nondeductible. In theory interest should be disallowed on an amount of debt equal to the current value of NCRS. A less complete solution would be to identify the target debt according to the basis of NCRS property under a slow, economic depreciation schedule.

1b. Negative Tax: Capital Gain. Negative tax subsidies also arise on NCRS property because some part of the return from sale of the property would be eligible for lower-rate capital gains tax. As a matter of well established tax theory, expensing of an investment is equivalent to zero tax on the return from the investment. With expensing, taxes do not reduce the pretax percentage return the investor gets.[8] When expensing of the investment is combined with advantageous capital gain, tax *increases* the taxpayer's return from the investment.

Illustrations: Expensing. Expensing does not reduce the taxpayer's return. Assume for instance an investment with $100 input and $131.08 revenue in four years. In absence of tax, the investment has a return ("internal rate of return")[9] like compound annual interest at 7%, because $100 will grow to equal $131.08 in four years at 7% compounded annually:

$$\$100 * (1+7\%)^4 = \$131.08 \qquad (9)$$

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[4] See, e.g., Norman Ture (later Assistant Secretary of the Treasury for Tax Policy urging ACRS), *Statement*, 1 GENERAL TAX REFORM: PANEL DISCUSSIONS BEF. COMM. ON WAYS & MEANS, 93d Cong., 1st Sess. 160,162 (1973)(benefits for depreciation just reduce the double tax on savings)

[5] David Bradford, *The Economics of Tax Policy Toward Savings*, in THE GOVERNMENT AND CAPITAL FORMATION 42-50 (George Von Furstenberg ed. 1980)(disallowing interest). Other advocates of consumption tax would cure negative tax by including borrowing in taxable income. DEP'T. OF TREASURY, BLUEPRINTS FOR BASIC TAX REFORM 124 (1975); Nicholas Kaldor, *Comment*, in WHAT SHOULD BE TAXED: INCOME OR EXPENDITURES? 151 (Joe Pechman ed. 1980).

[6] See discussion, Johnson, *Tax Shelter Gain*, 61 TEX. L. REV. 1013, at 1039-1049 (1983)

[7] See William Klein, 1962 WISC. L. REV. 608, 611-612.

[8] The thesis that expensing is the same as no effective tax on the percentage income from an investment is one of the base theorems of modern tax economics. See, e.g., See, e.g. Cary Brown, Business-Income Taxation and Investment Incentives, in INCOME, EMPLOYMENT AND PUBLIC POLICY: ESSAYS IN HONOR OF ALVIN H. HANSEN 300 (1948); DEP'T OF THE TREASURY, BLUEPRINTS FOR BASIC TAX REFORM 123-24 (1977).

[9] "Internal Rate of Return" is the interest-like return on an investment, used as yardstick of worth. It needs to be modified to avoid some pitfalls, not however present here. See, e.g. Higgins, FINANCIAL MANAGEMENT: THEORY AND PRACTICE 47 (1977).

Rearranging equation (9), 7% is also the discount rate that will make the present value of the revenue on termination equal the present value of the cost:

$$-\$100 + \$131.08/(1+7\%)^4 = 0. \qquad (10)$$

Expensing the $100 input immediately means that the taxpayer gets a tax savings (here assumed to be at 40% tax rates) which reduces its cost (by 40%). When tax is imposed on the revenue at the same tax rate, the net result is that the taxpayer's return is not reduced by tax:

$$-\$100(1-40\%) + \$131.08(1-40\%)/(1+7\%)^4 = 0. \qquad (11)$$

Expression (11) is an illustration of the thesis that expensing is like a zero tax on the percentage return. The investment gives 7% return both before and after tax.

No recapture. The most dramatic negative tax occurs for investments like timber, business intangibles and R&D where there is no recapture and the entire return can qualify as capital gain. Assume no recapture and capital gains tax rates of 20% (half the assumed ordinary tax rate). All of the $131.08 received at the end of the investment is then capital gain, reduced by 1-20% to $104.86. The investment now has an annual return of 15% because 15% is the discount rate that makes the net present value equal zero:

$$-\$100(1-40\%) + \$131.08*(1-20\%)/(1+15\%)^4 = 0. \qquad (12)$$

Expensing of the input combined with capital gain for the output has *increased* the return from a pretax 7% to a post-tax 15%.

Expensing plus capital gain would also allow inferior investments to compete with better ones, post tax. Assume an investment that is a guaranteed money loser, requiring an input of $100 and giving a return of only $88.31. Nonetheless the investment gives 4.2% return after tax, which equals 7%(1-40%) or exactly what a 40% bracket taxpayer will get at the given prevailing interest rates on normally taxed bonds or CDs:

$$-\$100(1-40\%) + \$88.31*(1-20\%)/[1+7\%(1-40\%)]^4 = 0 \qquad (13)$$

Without recapture, expensing will cause wasted capital by turning investments that lose money on their economic merits ($100 to $88.31) into investments that are acceptable to taxpayers who get the subsidy.

Some capital gain. Traditional "full" recapture remedies have been limited to making only gain up to the original cost basis ($100) ordinary income and the NCRS proposal does not increase recapture. Under such recapture, for the 7% investment of $100 in and $131.08 out, the revenue output up to $100 would be subject to ordinary tax of 40% at termination, but the extra $31.08 "gain" would be subject to tax at 20%. The regime *increases* the return from 7% pretax to 9% after tax:

$$-\$100(1-40\%) + [\$100*(1-40\%)+\$31.08(1-20\%)]/(1+9.05\%)^4 = 0 \qquad (14)$$

A tax regime that increases the taxpayer's return after tax will also waste capital because it will make inferior investments acceptable after tax. The following investment gives only a 3.2% return before tax, because it grows only from $100 to $113.42 in four years.[10] But to a 40% bracket taxpayer, the 3.2% return will look as good as the prevailing 7% return:

$$-\$100(1-40\%) + [\$100*(1-40\%)+\$13.41(1-20\%)]/[1+7\%(1-40\%)]^4 = 0 \qquad (15)$$

A tax regime that makes a pretax 3.2% investments look as good as a pretax 7% investment will cause waste of capital.

To prevent negative tax, all gain from NCRS property must be ordinary income.[11] An incomplete solution, which would prevent some but not all negative tax, would be to provide that recaptured depreciation deductions are increased by 3.5% interest compounded, just as the NCR ratio increases the depreciation deduction by 3.5% interest.

2. The Failure of Expensing Incentives.

The second error in the NCRS proposal is its assumption that savings will increase significantly in response to expensing. The underlying purpose of NCRS is to provide an incentive for the formation of capital. The increased capital is to increase productivity and economic growth and to create more jobs. Unless savings responds significantly to the exemption, however, expensing of investment will just shift the burden of tax or deficit from taxpayers who have capital to taxpayers with little or no capital. Without increased savings, there will be no added capital to justify the shift in burdens downward, nor will there be added growth, increased productivity or

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10 $\$100 * (1.032)^4 = \$113.42$

11 NCRS property, however, must continue to be subject to the limitation on capital losses, which have a different rationale. See, e.g., Johnson, *Deferring Losses with an Expanded §1211*, 48 TAX L. REV. 719 (1993)

new jobs. Shifting the burden of tax or deficit downward onto the low capital taxpayers, who start with a lower standard of living, will do the country harm.

The assumption that savings will respond significantly to expensing has no support in the economic literature or the underlying economic data. If economics is a science, it is a science because it is empirical, that is, it tries to disprove its assumptions on the basis of the evidence. We need to look at the record.

We have had our grand experiment with allowing expensing of machinery and equipment and the results of the experiment are in. In 1981, in the enthusiasm at the start of the Reagan Administration, Congress adopted a tax system for depreciable property, the Accelerated Cost Recovery System ("ACRS"), intended like NCRS, to give the equivalent of expensing for machinery and equipment. ACRS reached for expensing-equivalence by giving an immediate 10% investment tax credit, whereas NCRS would reach expensing by giving an interest-like augmentation to deductions. ACRS in 1981 even went considerably beyond expensing in value because the computation of expensing-equivalence ACRS used an interest rate that was materially higher than the real interest rate the government must pay.[12] The purpose of ACRS, like that of NCRS, was to give incentive to capital formation, i e, to savings.[13]

Proponents of ACRS in 1981 argued that savings would respond dramatically to the new incentive. ACRS was part of the "supply-side economics revolution" which sought to shift the focus of public policy away from fiscal stimulus, through government spending and deficits, and onto incentives for the production of goods.[14] Some proponents argued that the economic response to tax cuts might be large enough to make the 1981 tax cuts self-financing. The Laffer Curve, for instance, showed a range where economic response to tax cuts would be so extraordinary that the government revenue would rise by participating in the new higher level of economic activity.[15] More moderate advocates doubted a response that was self financing, but they did assume a high response,[16] arguing that the "elasticity of savings in response to the real after-tax rate of return was relatively large and elastic."[17]

Judged on its own terms, ACRS was a failure. Savings rates declined, notwithstanding the most dramatic cut in tax rates on capital in history. Personal savings, for instance, dropped from 7.9% of disposable personal income in 1980 to 6.4% of disposable personal income in 1985, to 4.2 % of disposable income in 1990.[18] Supply-side economics renounces deficit stimulus,[19] but the

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12 ACRS, as adopted in 1981, was equivalent to expensing for corporations (46% bracket) at a 24% pretax interest rate. See Johnson, *Tax Shelter Gain*, 61 TEX. L. REV. 1013, 1022 n. 46(1983) (equating expensing and ACRS at 13.1% after tax which translates into 24% pretax interest at 46% tax rate). Even long term federal bonds in 1981 gave only 13-14% interest. COUNCIL OF ECONOMIC ADVISERS, ECONOMIC REPORT OF THE PRESIDENT 1993, at 428.

13 See Pamela Gann, *Neutral Taxation of Capital Income: An Achievable Goal?* LAW & CONTEMP. PROBS., Autumn 1985, at 77,97-108(giving overview of arguments for capital formation).

14 See Paul Craig Roberts, *Supply-Side Economics*, in 4 NEW PALSGRAFFS ECONOMIC DICTIONARY 615 (1987).

15 Jude Wanniski, *Taxes, Revenues and the 'Laffer Curve"*, PUBLIC INTEREST, Winter 1978, at 3 *reprinted in* Arthur Laffer & Jan Seymour (ed.), ECONOMICS OF THE TAX REVOLT 7 (1979). See also Arthur Laffer, *Statement*, THE ECONOMICS OF THE PRESIDENT'S PROPOSED ENERGY POLICIES: HEARINGS BEFORE THE JOINT ECONOMIC COMMITTEE, 99th Cong., 1st Sess. 16, 18 (1977)("[I]t is not only conceivable but entirely possible that [the proposed 2.8 billion tax !] will lead to reduced overall revenue... .").

16 Don Fullerton, *On the Possibility of An Inverse Relationship Between Tax Rates and Government Revenues*, 19 J. OF PUB. ECON. 3 (1981), concentrating on labor responses, found it possible but unlikely that total revenues would increase. Donald Keifer (Library of Congress, Congressional Research Services), *An Economic Analysis of the Kemp/Roth Tax Cut bill H.R. 8333, CONG. REC.* Aug. 2, 1978, H7777-7787, using privately developed economic models with an aggressive supply-side orientation, nonetheless, projected nothing close to elasticity of one percent saving increase per one percent tax decrease. Paul Craig Roberts, an important supply-side advocate argues that self-financing was never the goal, but he made the argument only after it was clear that self-financing did not happen. *Supply-Side Economics, supra* note 14.

17 Mai Nguyen Woo (Research Associate IRET), *Taxation, Savings, and Labor Supply: Theory and Evidence of Distortions* in ESSAYS IN SUPPLY SIDE ECONOMICS 117, 131 (David G. Raboy ed. 1982). Similarly Michael Boskin, who became Reagan's Chairman of the Council of Economic Advisor's found a significant positive response (0.4 elasticity) by savings to after tax interest, 5 *Taxation, Saving, and the Rate of Interest*, 86 J. OF POL. ECON. S3 (1978), but see Lans Bovenberg, *Tax Policy and National Saving in the United States: A Survey*, 42 NAT. TAX J. 123129 (1989)("others have found it difficult to reproduce his results."); Robert Hall (Hoover Institute), *infra* note 23 (findings that consumers save when expected interest rises are in error) and other sources cited, *infra* notes 18-27.

18 DEPT. OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES, 1994 No. 695 (drawing from BEA, National Income and Product Accounts). Personal savings remained low at 4.0% of disposable personal income in 1993.

19 See, e.g., Paul Craig Roberts, *Supply-Side Economics, supra* note 14, at 615.

annual deficit, projected to disappear in the last federal budget before the 1981 Act,[20] in fact grew in size from $74 billion in 1980 to $220 billion. by 1986.[21] Proponents of ACRS were surprised, even shocked. Norman Ture, one of the primary architects of ACRS as a Treasury official in 1981 was quoted as saying that the drop in savings is "not only a disturbing result, ... it is very surprising."[22]

On terms not allowed by Reaganomics, the deficit created by ACRS caused a fiscal stimulus to the economy. The fiscal stimulus of deficit spending created economic activity and made every one riding upward feel good. The high deficits, however, were the target or enemy of supply-side depreciation, not its purpose. President Reagan had promised that "we are putting the false prosperity of overspending, easy credit, depreciating money and financial excesses behind us.[23] Thus the benefits of the ACRS deficits can not count to its credit.

The conclusion that investable savings did not increase elastically in reaction to the 1981 incentives is a strong consensus shared by the economics profession across the political spectrum. Robert Hall of the conservative Hoover Institute, for instance, has concluded that consumers do not defer consumption in response to expected interest returns and that apparent findings to the contrary were in error.[24] Joel Slemrod of the respected National Bureau of Economic Research and the University of Michigan and the editor-in-chief of the National Tax Journal tells us that the economic research from the 1980s has concluded that savings are unresponsive to lower tax.[25] Tanzi and Sheshinski of the International Monetary Fund have found that there was no important increase in U.S. savings rates after ACRS.[26] Jonathan Skinner and Daniel Feenberg of the National Bureau of Economic Research report that the consensus in the economic literature is that any positive response of savings to interest rate increase is "fragile and fleeting." Long-term, since the 1970's, they find, savings have reacted negatively to increase in after tax returns.[27] Barry Bosworth and Gary Burtless of the Brookings Institution show the decline of different kinds of private savings throughout the 1980s and advise that "government policy-makers should act under the presumption that income tax incentives for saving are likely to fail."[28]

Tax incentives do have a powerful influence on the timing, form and channelling of investment, but those effects do more harm than good. Taxpayers, for instance, delay or anticipate sales to take advantage of shifts in capital gains rates.[29] Taxpayers will also rapidly change the legal or financial forms by which investment is undertaken. In 1986, for instance, Congress changed the relation of corporate and individual tax rates S Corporations became better investment vehicles than regular C corporations.[30] Corporations responded dramatically, scrambling to make S elections.[31] Finally, taxpayers will move around fixed capital already in existence to achieve tax

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20 OFFICE OF MANAGEMENT AND BUDGET ("OMB"), U.S. BUDGET, FISCAL YEAR 1982, M3 (1981)(projection for 1984)

21 DEPT. OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES, 1994 Table No. 505

22 Kilborn, *Americans Saving Less Now Than Before the 1981 Act*, NEW YORK TIMES, Sept. 6, 1983 at A1, col. 3.

23 Budget Message of the President, US.BUDGET, FISCAL YEAR 1983 at M5. See also Paul Craig Roberts, *Supply-Side Economics, supra* note 14, at 615.

24 Robert Hall (Hoover Institute) *Intertemporal Substitution in Consumption*, 96 J. OF POL. ECON. 339, 350 (1988)

25 Joel Slemrod, *Do Taxes Matter? Lessons from the 1980's*, 82 AM. ECON. REV. 250, 251-252 (1992)

26 Tanzi & Sheshinski, *Fund Study Suggest Answer to the U.S. Savings Puzzle*, 13 IMF SURV. 353, 366-67 (1984).

27 Jonathan Skinner & Daniel Feenberg, *The Impact of the 1986 Tax Reform Act on Personal Saving*, NBER WORKING PAPER NO. 3257 at 10-17 (1990)

28 Bosworth and Burtless, *Effects of Tax Reform on Labor Supply, Investment and Saving*, 6 J. OF ECON. PERSPECTIVES 3, 14-23 (1992).

29 Alan J. Auerbach, *Capital Gains Taxation in the United States: Realizations, Revenue, and Rhetoric*, BROOKINGS PAPERS ON ECONOMIC ACTIVITY, 1988- 2, 595, 627(change in capital gains rates in 1986 had a strong impact on the timing of sale); Fredland, Gray and Sunley, *The Six Month Holding Period for Capital Gains: An Empirical Analysis of its Effect on the Timing of Gains*, 21 NAT. TAX J. 467, 471 (1968)(investors sell property in the month after meeting the holding period requirements for capital gain at a rate that was eight times the rate of sales in the month before qualifying for the preferential rates).

30 The terminal value of a $1 investment in a partnership, sub S corporation or C corporation debt is $[1+R(1-t_p)]^n$ and the terminal value of a $1 investment in equity of a corporation, terminated by a capital gain transaction. is $[1+R(1-t_c)]^n - cg*([1+R(1-t_c)]^n-1)$, where R is the prevailing pretax return on capital, n is the years until termination of the investment and t_p t_c, and cg are the maximum tax rates on individuals, corporations and capital gain respectively. Myron Scholes & Mark Wolfsen, TAX AND BUSINESS STRATEGY 57-59 (1992) Prior to 1986 with R=10%, n = 25, t_p = 50%, t_c = 46%, and cg = 20%, the partnership, debt or subS would give $2.65 per dollar invested and the C corporation stock would give $3.18. After 1986, with t_p = 33%, t_c = 34%, cg = 28% and R and n the same, the partnership form would give income of $5.05 and the C corporation stock would give $3.83.

31 Robert Leonard, *A Pragmatic View of Corporate Integration*, 35 TAX NOTES 889, 895-90 (1987)(In first 2 weeks of 1987 there were 220,000 subchapter S elections, compared with 70,000 elections for all of 1985).

savings When IRA's and Keogh plans were liberalized in 1981, taxpayers reacted far more dramatically than expected, but apparently without however increasing their total savings.[32] Movement in the form or direction of savings does not increase over-all capital and will usually cause waste by inducing the use of the fixed savings in inferior investments. Tax incentives can affect channelling, short-term shuffling and financial manipulations, but they will not cause capital formation nor improve the efficiency of its use. The hard thing to do is to increase real savings and underlying savings did not respond to the 1981 incentives.

Explaining negative and sluggish reactions. The results from the data that underlying savings react sluggishly or negatively to tax cuts is plausible in terms of normal economic behavior, even if it seems implausible at first. Savings drop when taxes go down, first, because of "target savers" who quit saving earlier when their after-tax return rate increase. Assume, for instance, that Saver A needs $150,000 for tuition payments in 10 years for his child. When after-tax return rates are 12% after-tax, A must set aside $8,548 a year for 10 years. Reduce A's return to 3% after tax and A will need $13,085 per year. Take away the difference (9%) in tax and watch A get really desperate and also increase savings by $4,500 per year per child to meet his targets. Taxpayers who are saving for a car or downpayment on a house or retirement security are similarly target savers who will *contract* savings rates when after tax returns on saving go up and increase savings when tax rates go down..

Decreased taxes decrease savings, secondly, by reason of what has been called the "mail-box effect,"[33] that is, taxpayers consume a high proportion of cash received. Under traditional theory -- the permanent income theory—, rational, far-sighted consumers should average their resources evenly over their life times. They should not increase consumption simply because more cash is realized, unless the cash also signals a real increase in wealth or the permanent flow of income.[34] Under the model, cash is no reason to increase consumption.[35] But econometricians are finding increasing evidence that consumers are not very far sighted in their savings behavior. Consumption is closely related to receipts, averaged over a time horizon of just a few years, and it is more volatile than allowed by life-cycle model. Consumers keep only enough savings to buffer uncertain incomes in the next few years and they consume the rest. [36] Under these findings, a tax cut increases consumption because it increases the cash that consumers have in hand.

The sluggish response of capital formation to tax incentives also occurs because so much of savings goes forward even when real interest rates are negative. Much saving is done to create a buffer or to average out consumption. Money that you have for subsistence in case of trouble is very much more valuable than money spent on luxuries during good times. It is thus rational to save money for a rainy day, even if the return rates are negative. Pharaoh had a dream that Joseph said meant Egypt would have 7 fat years and then 7 drought years. Joseph said save. Mice ate the grain so that it shrank by 10%-15% per year, so that the real rate of interest on stored grain was a negative 10-15%. Still, Joseph was no dummy. The rationality of saving, even in the face of expected negative interest rates also explains, for instance, why in high-inflation Latin American countries, the wealthy often save in dollars. Dollars give no interest coupon and dollars do lose value, although not the rate of the local currency. Saving goes on.

The rationality of saving, even in the face of negative interest rates, suggests that much of positive after-tax interest rates that savers in fact receive is "rent," that is, an amount in excess of

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32 Eric Engen, William Gale & John Karl Scholz, *Do Saving Incentives Work?* BROOKINGS PAPERS ON ECONOMIC ACTIVITY 1994-1, 85, 150.

33 Douglas Bernheim, Introduction in NATIONAL SAVINGS AND ECONOMIC PERFORMANCE 1,5 (Douglas. Bernhein and John Shoven ed. 1991).

34 A rational far-sighted consumer should smooth his consumption so that his expected lifetime wealth is consumed at steady, average rate over his whole life. Wide variations in amount consumed per year will not maximize utility of the dollars spent. Franco Modigliani, *The Life-cycle Hypothesis of Saving, the Demand for Wealth and the Supply of Capital*, 33 SOCIAL RESEARCH 160 (1966).

35 Auerbach & Hassett, *Corporate Savings and Shareholder Consumption, In* NATIONAL SAVINGS AND ECONOMIC PERFORMANCE 75 (Douglas. Bernhein & John. Shoven ed. 1991)

36 Barry Bosworth, Gary Burtless & John Sabelhaus, *The Decline in Saving: Evidence from Household Surveys*, BROOKINGS PAPERS ON ECON. ACTIVITY, 1991-1, 226 (summarizing the research);. Christopher Carroll and Larry Summers, *Consumption Growth Parallels Income Growth: Some New Evidence*, NBER WORKING PAPER, No. 3090 (1989)(permanent income or life-cycle hypothesis is inconsistent with the grossest features of the data on actual consumption patterns); Flavin, *The Adjustment of Consumption to Changing Expectations about Future Income*, 89 J. OF POL. ECON. 974, 1006 (1981)(data rejection of the permanent income or life-cycle hypothesis is significant); Campbell and Mankiw, *Permanent Income, Current Income, and Consumption*, NBER WORKING PAPER NO. 2436, 32 (1987)(estimating that 40-50% of income is received by individuals who consume according to current income rather than according to wealth or permanent income.)

the strike price necessary to induce the savings. The interest can be reduced by tax to the negative range, even by increasing tax on capital, without much effect on such savings.[37]

3. Revenue Estimates

The third error in the NCRS proposal is in scoring the proposal as gaining revenue for the government. NCRS is intended to be equivalent to expensing in net present value terms and cost to the government. It is misleading accounting to score NCRS with a revenue estimate loss less than what would be scored for expensing. Scored honestly, I estimate that NCRS will lose over $300 billion over the five year budget window.

Under the Budget Act, revenue estimates are prepared for tax proposals by the staff of the Joint Committee on Taxation to analyze how a tax proposal will affect federal deficits.[38] The federal deficits are large enough now that no one would wish them larger. Revenue estimates limit how much can be given away by competing tax proposals.

In substance, the NCRS proposal treats the federal government as owing an obligation at the time and amount determined by expensing and requires the government to pay interest on the obligation by increasing annual deductions. In fact, NCRS gives taxpayers deductions over the tax life of the property under the pattern of 150% declining balance method of depreciation,[39] but the proposal increases the annual deductions by a compound interest factor, the "NCR ratio," to compensate the taxpayer for the delay since the property was placed in service. The NCR ratio augments the annual deduction to cover both inflation, now at 3.2%, and an after-inflation 3.5% interest amount. The two adjustments mean an annual interest factor of 3.5%+3.2% or 6.7%, or slightly higher than the current 6% federal interest costs on short-term federal obligations, in which the obligee is similarly protected from rises in inflation.

Since NCRS treats the government as owing an interest-bearing debt equivalent to expensing, the revenue cost from NCRS should be scored as the equivalent of the revenue loss from expensing. In analyzing the distributional impact of the burden of proposed tax changes, the staff of the Joint Committee on Taxation has adopted a principle to maintain consistency in the measurement of "tax proposals that are expected to have equivalent economic effects on the taxpayer."[40] It is, for instance, possible to create a zero effective rate on pension fund investments either by excluding contributions from tax or by excluding distributions from tax and the present value of either alternative would be the same. The Staff analyzes both as having the same economic impact, although in the former case the tax benefits are front-end loaded and in the latter they are back-end loaded. That principle applied to revenue estimating would mean that NCRS would be scored the same as its intended equivalent, expensing. Using available data, I estimate that NCRS would lose over $300 billion during the next five years if NCRS were scored as an expensing-equivalent.[41]

Because of an artificial five-year convention in revenue estimating,[42] however, NCRS is in fact scored as if it were a revenue raiser. Current law allows depreciation deduction under the 200% declining balance method and switching to 150% declining balance means more undiscounted revenue for 5 years, even with the augmentation by the NCR ratio. Most of the costs

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37 The premium return or "rent" on savings means, by definition, that the rent or premium could be taxed away without changing the amount saved. The maximum revenue from capital (as shown for instance in the Laffer Curve) should be at a point in which after-tax interest is negative. Labor income, by contrast, could never be taxed into the negative range without suppressing the income in full. The rationality of savings even in the face of negative returns suggests that there might be efficiency gains possible by shifting taxes from labor and onto capital

38 See Joint Committee on Taxation, *Discussion of Revenue Estimation Methodology and Process* (JCS 14-92)(Aug. 13, 1992).

39 The 150% declining balance method of depreciation first computes what fraction of basis would be allowed in the first year if basis were allowed in equal portions in each year of the tax life. (e.g. $1/n$, where n is the tax life). It then increase the fraction by 150%to 1.5/n. The fraction $1.5/n$ is multiplied by the remaining or adjusted basis from the end of the prior year to determines the depreciation deduction for the current year. A constant percentage of an every decreasing adjusted basis would never allow the taxpayer to recover the entire basis, so the taxpayer is allowed to deducting remaining basis in equal amounts over the remaining years when that amount is bigger ($1.5/n \leq 1/m$ where m is remaining years of the tax life).

40 STAFF OF THE JT. COMM. ON TAXATION, METHODOLOGY AND ISSUES MEASURING CHANGES IN THE DISTRIBUTION OF TAX BURDENS 4 (JCS 7-93)(July 14, 1993).

41 I reach an estimate of revenue loss of roughly $330 billion composed of $775 billion revenue cost from expensing, less $445 billion loss from depreciation under current IRC §168. My estimates assumes $3.1 trillion investment in NCRS eligible property in 1995-1999, assuming Producer Durable Equipment of $528 billion in 1994 extrapolated forward at 5.4% annual growth. BUREAU OF ECONOMIC ANALYSIS, SURVEY OF CURRENT BUSINESS 3 (Nov. 1994)) and a 25% average tax rate for users. My rough estimates can not be expected to correspond to Joint Committee, Congressional Budget Office or Treasury figures, which start from a different data base that better decribes NCRS investment..

42 The 5 year window is a mandate of the Congressional Budget Act (Joint Committee on Taxation, *supra* note 38 at 3), but that mandate does make the accounting any less misleading or the costs less hidden.

of the NCR-ratio interest factor occur beyond the five year window. Revenue costs that occur after five years are ignored.

Scoring NCRS as a revenue raiser is misleading, dishonest accounting that hides the true cost. NCRS will not decrease the deficit or federal debt, as it is scored. NCRS will increase the federal debt by the roughly $300 billion over five years. A public policy is responsible only if it measures the costs of a proposal and compares the costs fairly and forthrightly with the benefits. If the costs are hidden or ignored, then the costs and benefits can not responsibly be compared. The hiding of costs by pushing costs to beyond the five year window will distort decision-making. Unfortunately, the first victim to be misled will be Congress itself.

Mr. HERGER. Thank you, Mr. Johnson.

Mr. Kachadurian, if you could elaborate a bit more, if you would, on how the capital gains provisions in the Contract With America will help ease the exit tax problem you described in your testimony.

Mr. KACHADURIAN. Mr. Chairman, the exit tax comes about when there are certainly at least very low or, even in some cases, negative capital accounts carried by partnerships that own real estate. We see this quite a lot when we are trying to acquire real estate and the seller or owner of that real estate has a capital account whereby in order to first pay off the existing loan, and then also settle up on a basis that is at least zero, and sometimes negative because of previous losses that have been taken, the property effectively cannot be sold because there is not cash available from the sale to pay the taxes. So the property is frozen, in effect.

And we have seen property after property that is frozen without money or capital being reinvested in that property to improve the property and so the rent roll tends to suffer. I think, in many cases, as we have been told, the only alternative is really death to the owner of that property where the basis can finally be stepped up, which we don't think is a solution to creating better real estate and better income streams.

Mr. HERGER. Mr. Didion, in your testimony you discussed the cost recovery rules for leasehold improvements. If the committee were to consider alternatives to the neutral cost recovery proposal, as some have suggested today, would changes to the treatment of leasehold improvements be appropriate?

Mr. DIDION. Mr. Chairman, we believe that would be absolutely appropriate. We think leasehold improvements need to have a change in the tax treatment in terms of the life of the improvements, and we believe that that change will in fact incent the job creation and urban reinvestment, so we believe there are lots of benefits to it.

Mr. HERGER. Thank you very much.

Mr. McDermott will inquire.

Mr. Payne.

Mr. PAYNE. Thank you very much, Mr. Chairman. I must tell you that as you all were testifying, I was thinking that in 1986 when I was a real estate professional and was testifying before the Senate Finance Committee about the 1986 Tax Act, many of the things that you are talking about and saying here today were things that we expressed concern about in 1986. So I feel to some extent that the chickens have come home to roost, I suppose.

I did want just to pursue one element, and that is the element of unlocking of capital gains, and there are differences of opinion about how much of that might occur if in fact there is a capital gains reduction. If each of you might share with this committee either data that you have or any anecdotal information that you might have, it may be certainly helpful as we think about this particular element of assessing the impact of the capital gains tax, and I would start maybe with Mr. Woods.

Mr. WOODS. Well, one of the things, Congressman Payne, is that certainly, as I mentioned in the report, there are literally—no, I was going to say thousands, but tens of thousands of small investors out there that have been frozen into property because they just

aren't willing to or they aren't able to pay the tax that they would have to pay to get out of it.

With this bill, with the passage of this bill and cutting that rate in half, I think that you would see many, many more properties on the market that people just are refusing to put on the market right now. So it is a situation where, yeah, you are going to get half the tax revenue that you would get if they sold today, but in reality they are not going to sell today, so the government really ends up with 50 percent more than they would have otherwise, but it is 100 percent more than they would get if they didn't change the tax laws.

Mr. PAYNE. And you would say today that compared to——

Mr. WOODS. Anytime since the tax changes of 1986 that you were speaking of.

Mr. PAYNE. That there would be more potential for unlocking than anytime since 1986?

Mr. WOODS. That is right. You have a vast sum of properties that have just been locked up tighter than a drum since the elimination, the slow elimination of capital gains in the late eighties.

Mr PAYNE. Mr. Kachadurian.

Mr. KACHADURIAN. Mr. Payne, I couldn't agree more with Mr. Woods. I think he probably said everything I would have said, and the answer to Mr. Herger's question that I gave before really summed up my feelings in that there is a lockup of these same properties that we see that aren't being sold, the transactions aren't occurring, and second, the unlocking of these transactions will stimulate job growth because as these properties are sold and capital flow begins to increase, we will see the same carpenters, laborers, appliancemakers improving, in our case, apartment units that are in need of improvements, and as these units are improved, the rent rolls improve, and these buildings come back to the same place they were when they were built.

Mr. PAYNE. Thank you.

Mr. Didion.

Mr. DIDION. Congressman, I agree with both the previous speakers on this.

Mr. PAYNE. Mr. Freeman.

Mr. FREEMAN. Congressman Payne, I think our strongest international competitors, such as Japan and Germany, both see fit to not even have a capital gains tax or a very small one.

That is simply to bolster the advantages of capital seeking its highest and best use. Clearly in our country now we are seeing sales and movement of capital not taking place because up to a third of the capital is going to disappear due to this tax upon sale, and it takes a pretty good alternative investment to talk you into taking that kind of a licking and reinvest the remaining two-thirds into that. It is such a differential in return in order to motivate you to move that people just don't do it.

Mr. PAYNE. Not only a differential, but, as Mr. Kachadurian pointed out, there are probably assets in shopping centers that are frozen because of the current situation and the negative basis that people might have to deal with. Consequently, they couldn't get enough cash to pay both their debt and to be able to pay their taxes in order to sell some of these marginal properties.

Is that a fair statement?

Mr. FREEMAN. I think so. As you know from being in the business yourself, a loan today requires equity, and that is probably a much healthier way for us to restructure, too, and this is capital that is equity and it is hard to find sometimes because of this lock-in.

Mr. PAYNE. Mr. Johnson.

Mr. CALVIN JOHNSON. I know a man who sold some stock to buy his daughter a horse, and that is what capital gain is about. Capital gain is given to people who pull their money out of investments and put it into consumption.

The real estate industry already has rollover privileges in 1031 like kind exchanges and the ability to release property from one use to another. If you sell, paying substantial tax, you are not selling to reinvest.

There is an economic theory called the efficient market thesis that said that you cannot make money selling investment A in order to buy investment B. You can't make money selling Yugos to buy Lexuses. You can't make money by selling junk investments to buy good investments.

Why? Because the smart market has already taken account of relative quality in the pricing. You will have to sell the junk for a cheap price and have to buy the good for a high price. Nobody sells to reinvest once they have to lose a big part of their capital.

The more tax you have involved in any sale transaction, the more money at stake, the more money we are really talking about, the more I can state with confidence that that person is selling in order to consume, not in order to reinvest.

The economists are also finding a mailbox effect that shows that people consume cash that you give them in hand.

Mr. PAYNE. Let me just say my experience in the industry I think runs more closely to the first four than the last respondent. Thank you.

Mr. HERGER. Thank you very much.

Mr. McCrery will inquire.

Mr. MCCRERY. Before I inquire, does anybody else on the panel wish to respond to Mr. Johnson's comments?

Mr. KACHADURIAN. Mr. McCrery, I would just say that personally and on behalf of our firm, we have reinvested proceeds from selling one property virtually on the same block after selling one property on the same block and reinvesting it in another, and that is, to improve the second property, we have brought our management expertise, improved property A to a point where we thought that property is at its fullest potential, reinvested the proceeds in property B to improve that property, so in our case we have reinvested that equity.

Mr. MCCRERY. Do you have to pay tax on that capital?

Mr. KACHADURIAN. Well, in certain cases, we are all cash investors, in certain cases, it is debt, it just depends on a particular case in point, but if there is a gain, yes, we pay a tax.

Mr. MCCRERY. Thank you. Mr. Woods, I appreciate your bringing up the possible expansion of the American dream savings account to allow parents and grandparents to make withdrawals for first-time purchase of a home for their children or grandchildren.

I think that would be an excellent improvement of the proposal, and, as you say, would encourage home construction and home buying. Just on the chance, Mr. Johnson, let me ask you, do you have any thoughts on the current tax treatment of leasehold improvements? Do you think it is fair today as it is in the Tax Code?

Mr. CALVIN JOHNSON. There is no question that if the tax life is too long, it should be shortened. Our goal is to describe the taxpayer's true investment, and if there has been an anomaly under which his adjusted basis is below fair market value, then we ought to do something, although I think there is a lot of self-help, taxpayers sell and get that adjustment, but basis should equal real investment, and if the basis is too high, higher than your real savings account equivalent investment, then correction needs to be done.

Mr. MCCRERY. Good. Thank you.

Mr. Didion, you mentioned a couple of avenues to correct the current tax treatment of leasehold improvements. If you can't get the life of the lease as the term for depreciation, what would you think would be a fair term in the code if you had to just put in a static term for depreciation?

Mr. DIDION. We would put in a term of 10 years. The average lease term that tends to be written in across-the-board commercial leases is probably closer to 7 years, but that is a little too fast, I think, and a 10-year term when you look at all types of improvements seems to make sense to us.

Mr. MCCRERY. Anybody else have any idea on that or is that pretty much the thinking of the industry?

Mr. FREEMAN. Shopping centers, on an average, go through a major remodel about every 10 years, certain types of stores, restaurants, food stores, maybe it is as little as 5 years. Others are longer, but I think 10 years would be appropriate.

Mr. MCCRERY. OK.

Thank you, Mr. Chairman.

Mr. HERGER. Thank you, Mr. McCrery.

Ms. Dunn.

Ms. DUNN. Thank you very much, Mr. Chairman. I was interested, Mr. Woods, in your example of the number of folks whose incomes are $25,000 to $50,000 a year who would find some positive things to say about a decrease in the capital gains tax, and I am wondering, sometimes we are accused politically of having that change that we recommend in our Contract With America affect only the wealthy people.

How do we sell the fact, what examples do we use that it affects people all over this country?

Mr. WOODS. I think you are absolutely right. To be honest, I was surprised, too, when I saw that statistic because that is not a statistic that I knew about before, just a few days ago, and when I saw that 20 percent of all the families in this country own income property with an income between $25,000 and $50,000, I was really surprised because I wouldn't have guessed anywhere close to that.

When you go up a little bit more and you are talking about between $50,000 and $100,000, it is certainly still not people that anybody would categorize as rolling in money, you talk about 30 percent, so there is a 50-percent increase from that next click up

of income, so it really, I guess it is the people that you don't think about, the people that own the two-family house, the people that own the three-family house, and those are the ones we think, investors sometimes think about shopping centers and apartment buildings, but we forget the husbands and wives with two kids and a dog that own a three-family house, and maybe they are going to live in it for their entire life, but they are investors, just like everybody else.

Ms. DUNN. Thank you.

Mr. Freeman, other real estate groups have spoken in favor of changes in the depreciation schedule for leasehold improvements. Has ICS taken a position on this?

Mr. FREEMAN. We would certainly like to see it shortened. Thirty-nine years is a very long time, and major improvements in our industry average at least every 10 years and various parts of it half that, so current schedules are exceptionally long, more than double or triple what we see as normal in the industry.

Ms. DUNN. Good. Thank you. Mr. Woods—Mr. Chairman, I am moving on to another topic just briefly, but I want to take advantage of Mr. Woods' background and the background of any of the rest of you in asking you about the flat tax proposal that Congressman Armey has proposed.

I have heard from people in my district, some of whom are realtors, some concern and others say that, no, the fact that mortgage interest deductions would not be allowed under the flat tax still won't influence the industry because people like to own their own homes and their own property.

Could you comment on whether this is a good thing or a bad thing for your industry.

Mr. WOODS. I could comment whether it is a good thing or a bad thing if you could tell me how we are going to work the parameters and exactly how we are going to do it.

You know, there are real questions about it, there are questions I am sure amongst everybody that speaks about a flat tax. It has to do with how are we going to control it and if we put together a flat tax and we pass a flat tax and we have support for it and then it is changed 2 or 5 or 10 years down the road to something entirely different, well, then, you would have to say, no, we would be probably violently opposed to it, but if there were some safeguards that could be put into it so we knew that we were going to have a flat tax and the flat tax was going to remain flat, well, then, I think you would have to look at that in a whole different light, and you would have to examine the impact that it would have.

Buying a piece of property and owning a piece of property, it is a multifaceted investment. I mean, you have interest rates and you have the benefits. One of the benefits that you have always had is the fact that there is mortgage interest deductibility, and to give something up that has been in our Tax Code ever since we have had a Tax Code like that, you would really have to make sure that the controls are in there, so it can't be a stocking horse for something else, and we give that up as an industry and as all the homeowners, the 65 percent of the population that owns homes, and then we find out 5 years from now we have given it up for nothing.

Ms. DUNN. Does anybody else wish to comment on that question? Thank you, Mr. Chairman.

Mr. HERGER. Thank you.

Mr. Rangel will inquire.

Mr. RANGEL. Thank you, Mr. Chairman. Certainly I would have to agree with you that we have to revisit the tax laws to make certain that we remain competitive and to generate more jobs and more revenues for the United States.

Now, the President and Chairman Greenspan would have me to believe that this economy is really pumping, that we have reduced the deficit, that factory capacity is topped out, that interest rates and inflation are down, that millions of jobs have been added, and that it is his concern that it has been the deficit reduction that has dramatically caused this healthy attitude. And of course, as he indicated in his State of the Union speech, that many Members that voted for that tax increase in order to reduce the deficit are not here. So, he feels very strongly about that. And, as you might suspect, many of the proposals that are being supported here, especially capital gains, there is a lot of concern by Treasury and other economists that the figures may look good the first 5 years, but they become really much worse in the next few years.

Knowing that you all agree that we have to have a balanced budget and that we can't load the deficit and that we would have to have cuts to do all of these things, how would you answer the President that it ain't broke, so don't fix it?

How about Mr. Freeman because I want all of America to love me and I want to do the right thing. I would rather have all America's love than the President's. So how would you say—he has really impressed himself and the Federal Reserve Board that America is now moving, and he doesn't want anything or anybody to stop that movement, and I think all of you have to agree that we are doing a heck of a lot better for whatever reasons in the last 2 years, right? Right, right, right, right. Not good at elections, but the economy is recovering, right? Probably it was something that Reagan thought about, but anyway——

Now what are we going to do, Mr. Freeman?

Mr. FREEMAN. Congressman Rangel, I am really going to sleep well tonight knowing that everything is in such good shape.

Mr. RANGEL. No, no, you have to tell the President through me about where he is wrong and you have got to tell this guy Greenspan how he is wrong. I mean, he is so excited about how well he is doing, he wanted us to sign $40 billion guarantees to foreigners, so you know he is excited about how strong we are, how strong the economy is.

Now, you know, I have witnesses to many of the things that you are proposing. Unfortunately, you know, the mandated balanced budget, that is all right, but I want answers, what would you say if the President is saying you are right, but give me a break, not now.

Mr. FREEMAN. I am going to give an answer, and believe me I am not trying to be a smart aleck, but the rest of America has to balance its budget every day, and Congress needs to do it, too. I don't know how else to answer it.

Mr. RANGEL. That is not a smart aleck. The President would say I am doing that, and you are asking me to do something that would cause me to do things that are more painful.

The economy is moving, and he is not complaining about balancing the budget, he is way ahead of you in terms of reducing the deficit, so that is not an issue.

The issue is he is saying that the economy doesn't need this jump start that you want to give it, and I am not arguing with you because you have been introduced by one of the most esteemed members of the committee, so I respect her judgment, and your connection with a higher authority, but tell me, what would I tell my President?

Mr. FREEMAN. It is time to do it, and we have to do it.

Mr. RANGEL. Anybody want to help him before the red light comes on?

Mr. KACHADURIAN. Mr. Rangel, I would again add that there are transactions that are not occurring with the present capital gains tax. Freeing up those transactions and freeing up that capital will produce more revenues for the Treasury and lower the cost of capital.

Mr. RANGEL. No one challenges—well, I am not going to challenge you for the first 5 years, but when you get out to the next 10 years, there seems to be a lot of storm out there about the dramatic shortfall.

Do you challenge that?

Mr. KACHADURIAN. Well, I am personally not that involved and knowledgeable about the discussions about after 5 years.

Mr. RANGEL. OK. Listen, I am all right.

Thank you, Mr. Chairman.

Mr. HERGER. Thank you, Mr. Rangel.

Mr. Christensen will inquire.

Mr. CHRISTENSEN. Well, I am batting 1,000, Mr. Chairman.

You know, I have heard testimony again today from a panel of individuals in the private sector, working, representing various interests, and then comes along an academician or a government bureaucrat who is against the capital gains tax reduction or neutral cost recovery or anything that is going to give more power back to the small businessowner and the American family.

I am going to give you the benefit of the doubt, Mr. Johnson. Let's say we didn't do a couple of the things in our proposal here. Let's just say we did the capital gains tax reduction, would you still be opposed to the bill?

Mr. CALVIN JOHNSON. I think capital gains reduction unlocks lots of capital for consumption. You have a very strong mailbox effect under which you give people big cash and they consume it. Real estate has lots of opportunities to roll over their investment if they wanted to keep money invested. That is not where the demand is coming from.

Mr. CHRISTENSEN. Mr. Johnson, capital gains does not apply only to real estate.

Mr. CALVIN JOHNSON. I am sorry, I don't understand.

Mr. CHRISTENSEN. There are a lot of things that we can do.

Mr. Didion, Mr. Freeman, would you like to respond? I wanted to follow up on Mr. Payne's questioning also. Are there other things

that we could talk about as far as what Mr. Johnson is referring to?

Mr. DIDION. I guess I am in just fundamental disagreement with Mr. Johnson in his view that the sale of an asset in fact changes the character of the incentive to invest the money that derives from that sale. My sense is he is talking about apples and oranges, and I just don't fundamentally agree with him.

Mr. CHRISTENSEN. Mr. Freeman.

Mr. FREEMAN. I agree.

Mr. CHRISTENSEN. Mr. Kachadurian.

Mr. KACHADURIAN. I agree.

Mr. CHRISTENSEN. Mr. Woods.

Mr. WOODS. I agree also.

Mr. CHRISTENSEN. I just wanted to make sure there wasn't something I was missing.

Thank you.

Mr. HERGER. Thank you, Mr. Christensen.

Mr. Ramstad.

Mr. RAMSTAD. Thank you, Mr. Chairman.

I am going to be brief. I apologize to the panel for getting here late, but I was able to figure out which one is the professor, with all respect, Professor Johnson.

Representing the world's largest shopping center, the Mall of America, I am pleased to see you here today, Mr. Freeman. I think you are too humble. I think you present a very articulate defense of the reasons for capital gains tax reduction and the effect on the macroeconomy, so I am going to send your testimony to the White House to answer the question that was addressed to you today. I think you very effectively, as you put it, break the myth that the capital gains reduction is somehow a tax break for the rich as well.

But I want to ask you another question. In your testimony you mentioned the exclusion of net lease property from capital gains indexing. Could you elaborate on this? You didn't get much time. It was toward the end of your testimony.

Mr. FREEMAN. Thank you, Congressman. I would like to—that is the one—we are very happy with this bill, mind you, we are not trying to be critical, but there is one part of it.

In the past 20 years during the time this net lease provision somehow found its way into the capital gains law, our industry has changed from what used to be basically a gross lease to a net lease, and so—when I refer to us being caught as the dolphin in the net, when this provision was drafted, our industry didn't do it this way, and we, believe me, we are not passive investors, this is not something that we just do as a hobby.

For most of us, this is our work, and these leases are net, the rent is listed separately from the other expenses, and they are basically in that lease, so if we were not to make some technical correction here, it would preclude us from the advantages of capital gain that we so badly need.

Mr. RAMSTAD. Thank you for that clarification. I want to thank all of the witnesses. I also want to thank you as long as the green light is still on, Mr. Freeman, your organization in particular has been very helpful, particularly Jim Hale, my good friend from Min-

neapolis and Judy Black, in providing input. I really appreciate that. As a new member of the committee, it has been very helpful.

Thank you very much.

Mr. FREEMAN. Thank you.

Mr. HERGER. Thank you, Mr. Ramstad.

We do have a vote going on. We will recess for 15 minutes, and, at that time, we will call up our next panel. Thank you very much.

Mr. RANGEL. Could I ask the professor one question before we go?

Mr. HERGER. Yes.

Mr. RANGEL. Professor, I did not know by the title you had that you were teaching economics, and certainly I normally yield to those people that are out there doing it rather than those who study and teach it, but if the capital gains tax reduction actually passes, do you personally stand an opportunity to have any gain in terms of income?

Mr. JOHNSON. Yeah.

Mr. RANGEL. So you really are testifying against your own self-interest there?

Mr. JOHNSON. Yes. We are system loyal, that is what teachers do.

Mr. RANGEL. Thank you very much, Professor.

Mr. HERGER. Again, I thank our panelists for your testimony, very helpful. We do have a vote on now. We will recess for 15 minutes and return for our final panel.

Thank you.

[Recess.]

Mr. ENGLISH [presiding]. Thank you very much. Calling the meeting to order.

I am happy to reconvene this hearing of the House Ways and Means Committee and entertain comments from our final panel.

Serving on that panel are Michael Callahan, executive vice president and chief financial officer of the FMC Corp. on behalf of the Chicago Coalition for the Reform of AMT, welcome; Wayne E. Chambers, member, board of directors of the Association of Progressive Rental Organizations in Austin, Tex., welcome; Alan E. Ross, chairman of the board of directors of the Semiconductor Industry Association and president, telecommunications, Rockwell International Corp. of Newport Beach, Calif., welcome; and Thomas B. Rumfelt, owner and chief executive officer, Risk and Insurance Brokerage Corp., Lake Wales, Fla., welcome.

What I will do is give you an opportunity to each speak for 5 minutes. If you have any additional testimony, you can submit it for the record, and then we will have members of the panel submit questions to you. Thank you.

Mr. Callahan.

STATEMENT OF MICHAEL CALLAHAN, EXECUTIVE VICE PRESIDENT AND CHIEF FINANCIAL OFFICER, FMC CORP., ON BEHALF OF THE CHICAGO COALITION FOR THE REFORM OF AMT

Mr. CALLAHAN. Thank you, Congressman. Mr. Chairman and members of the committee, not many here at this late hour of the day, wish there were more, the Chicago Coalition for the Reform

of AMT appreciates this opportunity to express its views to the committee on the important subject of capital cost recovery within the context of the Job Creation and Wage Enhancement Act.

My name is Mike Callahan, and I am executive vice president and chief financial officer of the FMC Corp., a diversified manufacturer with headquarters in Chicago.

However, I am speaking on behalf of the coalition, which you mentioned, which consists of eight Illinois-based companies with their headquarters in and around Chicago, such as the Amoco Oil Co., United Airlines, Chicago Bridge & Iron, and a number of others, although obviously their operations are spread throughout all of the United States.

We agree with the committee that the subjects of future investment by business, capital formation, and the rates of capital recovery for tax purposes are all very important to capital formation and the creation of jobs. As you know, the Tax Code has had a significant impact on the potential return on future investments made by businesses.

Our coalition is concerned that the existing alternative minimum tax system, as it is currently in effect today, has a negative effect on project investment returns. As a result, American capital investment behavior has been negatively affected, and in reality American business has become less competitive.

Now, earlier in the week you heard testimony by the American Council of Capital Formation and others that it would attest to these general macroeconomic aspects of the current system. We are really very pleased by your committee's proposals that they address these issues, and we would really like to make some very specific and simple comments in the time that you have given us today.

First, our coalition specifically supports your efforts to eliminate the economic distortions caused by the capital cost recovery provisions of the Tax Code for both regular and AMT taxpayers to encourage new investment in plant and equipment and the creation of new jobs through the enactment of the NCRS.

In addition, it must be realized that for AMT taxpayers, such as the members of this coalition, the intended benefits of the NCRS can only be fully realized if fundamental corrections are made to the AMT capital cost recovery system.

Even with the changes made in this area by the NCRS proposal, AMT taxpayers must wait on average twice as long for the recovery of their capital versus regular taxpayers. Thus eliminating the current law, AMT capital cost recovery system with this built-in disincentive to investment should be a priority for Congress and this committee to both increase investment and promote job creation.

Therefore, this coalition would propose that for taxpayers which elect NCRS, the AMT and the regular tax capital cost recovery system should be made the same to in effect level the playingfield for all taxpayers.

Second, if for any reason the NCRS initiative should not move forward, this coalition would urge this committee to look for a more narrow targeted solution to meet substantially the same objective. Specifically we would propose that the most beneficial change which can be made would be to reform the AMT system in the following ways:

One, the AMT depreciation system should be conformed to the existing system available to regular taxpayers for all future, not past investments. This part of the proposal is pretty straightforward for the same reasons mentioned above. Two, all long-term AMT taxpayers should be allowed to utilize their built-up AMT tax credits to reduce current and future year AMT tax, but not below the amount payable under the regular tax system. This proposal would provide relief across the entire spectrum of AMT taxpayers who may never receive the benefits of these credits, which was not really the intent of the law back in 1986.

Why do we make these recommendations at this time? Each member of the companies of our coalition is significantly affected by AMT. At the time of the enactment of that law, it was really assumed that the companies would be subject to the AMT for, say, 1 or 2 years when profits were low and use of credits or deductions happened to also be high. Thus the AMT would result in a temporary prepayment of tax with credits to be used in future years.

In practice, the AMT system has not worked as planned for many taxpayers, and that has been pretty well documented by a number of studies, since many taxpayers pay AMT every year and cannot claim AMT credits as contemplated. FMC, my company, is an example of just such a company, having been subject to AMT in each year since the AMT system became in effect.

If you look at the credits building today and going forward that we would not have for investment, this is money that really could have gone for investments and is really not going to go into the system simply because of the nonuse of the AMT credits. Therefore, this proposal would return the operation of the AMT to that of a temporary prepayment of tax and help mitigate this investment disincentive which the AMT currently imposes on all AMT taxpayers.

Mr. ENGLISH. Mr. Callahan, would you like to complete your remarks, then summarize, and I will go to Mr. Chambers.

Mr. CALLAHAN. Thank you, sir. In closing, the coalition again wants to applaud the direction of your committee. We are encouraged that we are seeing some meaningful change. I think consistent and stable change is what would create an environment to give us the confidence to invest on a sustainable basis, and we would like very much to work with you in your proposal as we go forward.

[The prepared statement follows:]

Committee on Ways and Means
1100 Longworth House Office Building
Testimony for the Written Record of Mr. Michael Callahan,
Executive Vice-President, FMC Corporation, speaking on behalf of
the Chicago Coalition for the Reform of AMT
Thursday, 26 January 1995

Mr. Chairman and other members of the committee, the Chicago Coalition for the Reform of AMT appreciates this opportunity to express its views to the committee on the important subject of capital cost recovery within the context of the Job Creation and Wage Enhancement Act. My name is Mike Callahan and I am Executive Vice-President and Chief Financial Officer of FMC Corporation, a diversified manufacturer with headquarters in Chicago. I am speaking on behalf of the Coalition which consists of eight Illinois based companies with their headquarters in and around Chicago.

As you know, the tax Code has a significant effect on both the potential return on future capital investments made by business, and the ability of business to make such investments. Following the enactment of the alternative minimum tax system, businesses that have been routinely subject to the AMT have been affected in a number of ways: capital intensive businesses had their capital recovery periods lengthened and the rates of recovery slowed; businesses with foreign operations which pay foreign taxes saw their ability to claim foreign tax credits subjected to a further limitation; businesses which export goods and help mitigate the still growing trade deficit saw their foreign sales corporation export incentives eliminated; and businesses lost their ability under the AMT system to use credits designed to encourage certain taxpayer behaviors, such as the creation of jobs and the investment in research and development.

By having a negative effect on the investment returns of projects and on business sales subject to the AMT rules, American business investment behavior also has been negatively affected; and as a result, American business has become less competitive. This is especially true for American manufacturing and service businesses that require significant investments in capital, and which also provide relatively high paying jobs to the American economy. Moreover, based on a study by the Treasury's Office of Tax Analysis, the AMT affects many more taxpayers than originally envisioned. In any given year, AMT will be paid by at least one out of every six companies with assets over $50 Million. AMT is a significant tax! Therefore, our coalition encourages this Committee to reverse these barriers to future business investment.

Our coalition specifically supports efforts to eliminate the economic distortions caused by the capital cost recovery provisions of the tax code, and to encourage new investment in plant and equipment and the creation of new jobs through enactment of the NCRS. The coalition shares some of the concerns about the NCRS system previously expressed by others: Is there a need to slow the rate of capital recovery from 200% to 150% declining balance? Is there a more direct method of achieving the economic equivalent of a current deduction for capital costs so that the complexities associated with the NCRS system might be avoided? Is there a risk that the system could become mandatory rather than elective, thereby imposing the 150% recovery rate on all new investments? Is there a risk that the system could be altered or repealed before the benefits are realized? But the coalition believes that on balance, the direction of the NCRS proposal is both appropriate and beneficial. In addition, it must be realized that for AMT taxpayers such as the members of this coalition, the intended benefits of the NCRS can only be fully realized if fundamental corrections are made to the AMT capital cost recovery system. For taxpayers permanently paying AMT, the AMT capital cost recovery system is one of the slowest in the industrialized world. Even with the changes made by the NCRS proposal, AMT taxpayers must wait for the relief over the longer AMT recovery periods rather than the shorter periods available to regular taxpayers. Thus, eliminating the current law

AMT capital cost recovery system which acts as a disincentive to investment should be a priority for Congress and this Committee to fully achieve the intended increase in investment and to promote job creation. This coalition would propose that the AMT and regular tax capital cost recovery systems be conformed for taxpayers which elect the NCRS system. When the same depreciation rules apply to all taxpayers the investment incentives contemplated by the NCRS are achieved for all taxpayers and administration is simplified.

If, for any reason the NCRS initiative should not move forward, whether for political or budgetary reasons, this coalition would urge this committee to look for a more narrow, targeted solution to meet the same objective. Our coalition would propose that the most beneficial change which can be made would be to reform the AMT system in the following ways. First, the AMT depreciation system should be conformed to the existing system available to regular taxpayers, for all future investments. This part of the proposal is relatively straightforward. **In addition**, all long-term AMT taxpayers should be allowed to utilize their built-up AMT credits to reduce current and future years' AMT tax, but not below the amount payable under the regular tax system. This proposal would provide relief across the entire spectrum of AMT taxpayers, as described earlier. Either a dual tracking system for use of the AMT credits against future AMT and regular tax, or a system similar to that currently used to track investment tax credit carryovers for use against AMT could be used to achieve the intended result.

Each member company of our coalition is significantly affected by AMT, which was enacted in 1986 to prevent otherwise profitable companies from escaping taxation altogether through the use of deductions, credits or exclusions. At the time of enactment, it was assumed that companies would be subject to the AMT for one or two years when profits were low and use of credits or deductions happened also to be high. It was assumed that the AMT paid in those years would be used to reduce the regular tax in subsequent more profitable years through the credit mechanism enacted as part of the AMT system. Thus, the AMT would result in a temporary prepayment of tax. In practice, the AMT system has not worked as planned for many taxpayers, since many taxpayers pay AMT every year and cannot claim the AMT as credits as contemplated. Therefore, this proposal would return the operation of the AMT to that of a temporary prepayment of tax and help mitigate the investment disincentive which the AMT currently imposes on all AMT taxpayers.

In closing, the Coalition again wants to applaud the direction which the Committee is taking. We are encouraged that meaningful change may at last be at hand. Our Coalition wants to encourage the Committee to adopt provisions which can be sustained for the foreseeable future. Constant change in areas that affect business investment should be minimized; capital cost recovery provisions should be both favorable and stable to promote the certainty of result for the future which promotes investment, and is critical for job creation and the American economy. Permanently reforming the AMT system would be a very significant step to achieving all of these objectives.

Our Coalition has developed draft statutory language to achieve the objectives I have outlined and would be pleased to share it with the Committee if this would be helpful.

Mr. ENGLISH. Thank you, Mr. Callahan.
Mr. Chambers.

STATEMENT OF WAYNE E. CHAMBERS, MEMBER, BOARD OF DIRECTORS, ASSOCIATION OF PROGRESSIVE RENTAL ORGANIZATIONS, AUSTIN, TEX.

Mr. CHAMBERS. Thank you, Mr. Chairman. Mr. Chairman and distinguished members of the committee, perhaps my difficulties are a little bit more simplified than what we have heard today. I am a small businessman operating a company called Dow Rentals out of Houston, Tex.

I represent a majority of dealers who like myself rent household durable goods to consumers on a short-term basis. My industry has a major problem with the way the current depreciation laws are being applied. If a reasonable solution is not reached to bring about equity in the application of the depreciation laws, it will have a crippling effect on my business and those of the rental purchase industry.

I am here today to talk about these depreciation laws and suggest a couple of simple solutions. In my stores we rent televisions, VCRs, appliances, furniture, and other items for the home, usually on a week at a time or a month at a time basis. Most customers rent for a while and simply return the property. This usually happens after 3 to 4 months. Customers return the merchandise because their needs change or their financial circumstances change. Also customers can terminate the agreement at any time and have no obligation to make additional payments, or customers can renew the agreement for a stated number of periods, at which time title to the property is transferred to the customer.

Meanwhile, as a dealer, I am responsible for bearing the expense of keeping the merchandise in good condition. Statistics show that only 25 to 30 percent of the rental agreements result in the customer obtaining title to the property. Additionally, the average revenue generated by the products for a rental company is approximately 21 to 24 months. An average of three to four customers will rent the merchandise before it exits the store's inventory.

Because of the use and the abuse of the property during its rental life, it becomes economically unrentable within a 21- to 24-month period.

A word about our industry. I represent an industry that has approximately 7,500 store locations nationwide. We employ in excess of 50,000 people, and we do approximately $4.5 billion annually in revenues. Interestingly enough, in our industry 80 percent of the companies are generally called mom and pops who are owner-operators with five stores or less.

I also am a member of the board of directors of the Association of Progressive Rental Organizations which represents a majority of these businesses. So you ask what is my problem. After 6 years of litigation, a recent tax court decision mandates a cost recovery of rental property over 5 years under MACRS, even though the revenue stream of rental merchandise rarely exceeds 2 years. This creates an enormous distortion of income and the related tax liabilities.

The industry itself has generally used an income forecasting method as a form of depreciation on this rental merchandise matching the revenues with the cost of doing business. In my way of thinking, Mr. Chairman, depreciation should match revenues and the expenses that are utilized to obtain those revenues, and 5-year MACRS, as an example, simply doesn't do that.

What it means is that it makes me, as a small businessman, pay taxes on income that has not yet been received. An example might be if a new item of rental property is rented on January 1 in year one, after three or four customers have rented the merchandise, it completes its rental life on June 30 of year two.

Income forecasting, for example, recognizes two-thirds of the income and two-thirds of depreciation in year one and one-third of each in year two. Five-year MACRS recovers 20 percent of the cost in year one and 80 percent of the cost in year two, overstating the tax liability in the first year and understating it in the second year.

Some of the dealers in my business simply do not have the capacity to pay the accelerated tax liability. I propose a simple solution in our case. We would need for Congress to enact legislation clarifying the Tax Codes by authorizing the application of the income forecast method of depreciation for the rental purchase transaction used in this industry or alternatively, enacting legislation authorizing the depreciation of rental purchase property over a 3-year recovery period under MACRS.

This would provide a better match for revenues and expenses. It would also make it consistent with the statutes that already exist in 38 States, recognizing the rental purchase agreement as a valid lease and confirm them as a true lease for tax purposes.

Mr. Chairman, thank you for this opportunity to express the views of this industry.

[The prepared statement follows:]

STATEMENT OF WAYNE E. CHAMBERS
of the
ASSOCIATION OF PROGRESSIVE RENTAL ORGANIZATIONS
before the
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

January 26, 1995

Mr. Chairman and distinguished Members of the Committee:

My name is Wayne Chambers. I own and operate a rental-purchase business. I am also a director of the Association of Progressive Rental Organizations ("A•PRO"), which is a nonprofit national trade association representing the rental-purchase industry. The rental-purchase industry is comprised of hundreds of businesses that rent household durable goods to consumers on a short term basis. A•PRO represents nearly 500 of the businesses in the industry, most of which are small companies.

I am pleased to present to this Committee A•PRO's and my views regarding the principles of neutral cost recovery set forth in H.R. 9, the "*Job Creation and Wage Enhancement Act*." In particular, I want to discuss a cost recovery problem currently faced by the rental-purchase industry that should be addressed in connection with the proposed legislation.

By indexing depreciation against inflation, the proposed legislation promises to reduce the economic costs of the deferral of depreciation deductions. The economic costs to the rental-purchase industry of the deferral of depreciation deductions may well eliminate jobs and could even put some companies out of business. Inflation, however, is only one factor contributing to such economic costs. For the rental-purchase industry, unjustified economic costs of much greater magnitude are created by an IRS interpretation of tax rules (upheld in one case by the Tax Court) that would mandate cost recovery of rented property over five years (or longer). Under the IRS interpretation, rental-purchase property would be depreciable over a five year class life, even though the income stream generated by that property rarely exceeds two years. This postponement of cost recovery deductions cannot be justified on any theory of matching income with related deductions.

Description of Rental-purchase Industry

The rental-purchase industry is a young industry comprised of more than 7,500 stores throughout the 50 states that currently employ approximately 50,000 persons and are estimated to generate more than $4.5 billion of revenue per year. The typical rental-purchase dealer is a small company or sole proprietorship that has very limited capacity to

finance its inventory with borrowed funds. Most of them have virtually no capacity to finance the additional tax liability attributable to the postponement of cost recovery deductions.

Rental-purchase businesses rent household durable goods -- such as furniture, TVs, stereos, VCRs, refrigerators, washers and dryers -- to consumers on a short term basis. Virtually all of the industry's customers are individuals who obtain the property for personal household use. While customers enter rental-purchase transactions for a broad variety of reasons, many customers enter the transactions becaue (i) they have only a temporary need for the property, (ii) they want no continuing payment obligations, or (iii) for a variety of reasons, they are not sufficiently creditworthy to purchase the item on a credit sale basis. Thus, the rental-purchase industry occupies an important niche among suppliers of household goods.

Rental-purchase transactions are designed to provide flexibility to customers by permitting them to obtain immediate use of the property on a week-to-week or month-to-month basis without incurring financial obligations beyond the one-week or one-month term of the agreement. Because the customer has no obligation to continue making rental payments, rental-purchase dealers do not conduct credit checks or require a deposit. The customer makes one rental payment on the date he enters a rental-purchase agreement and has no obligation to make any additional payments. The typical rental-purchase agreement has an initial term of one week or one month. Although a customer has the option to renew the agreement for an additional term of one week or one month, the customer has no obligation to renew the agreement. The customer can elect at any time to return the property (or have the dealer pick up the property) without any further obligation.

If the customer elects to renew a rental agreement for an item of property for the maximum number of rental periods stated in the agreement, title to the property is transferred to the customer. The maximum number of renewal periods stated in the agreement usually covers a period of 12 to 24 months, depending on the type, age and condition of the property. The customer also can purchase the property before the end of the maximum number of rental periods by paying an amount stated in the agreement. The purchase option price generally equals a stated percentage (usually ranging from 50% to 80%) of the payments that would be made during the remainder of all possible renewal periods stated in the agreement.

Industry experience shows that only 25 to 30 percent of all rental-purchase agreements result in the customer ultimately obtaining title to the property. On average, a customer will make rental payments and maintain possession of an item of rental property for approximately 12 to 14 weeks after which the customer returns the property to the dealer. An item of property typically is rented to three or four different customers before a customer obtains title or the dealer abandons the property. Moreover, rental-purchase dealers often experience theft of 10 percent or more of their inventory per year.

Rental Income Stream

The average stream of income from an item of rental property is approximately 21 to 24 months. After an item of property has been rented to two or three different customers and subsequently returned to the store, obsolescence and wear and tear force the rental-purchase dealer to reduce the rental amount and/or the maximum possible number of renewal periods. As a result, the third or fourth customer is more likely to renew the rental-purchase agreement enough times to acquire ownership of the used property. Moreover, because renters tend to treat property with less care than owners, the used property often becomes unrentable and must be abandoned by the rental-purchase dealer. Thus, because of customer payouts and the destruction or theft of rental-purchase property, on the average a dealer's income stream from an item of property does not exceed two years.

Cost Recovery

Income Forecast. Members of the industry generally have depreciated rental-purchase property using the income forecast method.[1] Under this method, a rental-purchase dealer's depreciation deductions are closely matched with the income stream generated by the rental property. Using the income forecast method, the annual depreciation deduction is determined by multiplying (i) the adjusted basis of an item of property by (ii) a fraction, the numerator of which equals the amount of rent received during the year under all agreements relating to such property, and the denominator of which equals the total estimated rent that will be received over the remaining life of the property. For example, if rent in the amount of $50 is received during the year from an item of property, and the item of property had been expected to generate a total of $150 over its remaining life, then the depreciation deduction for the year using the income forecast method equals one-third (50/150) of the adjusted basis of the property.

Five-Year MACRS. Late last year, the U.S. Tax Court held that a particular rental-purchase dealer could not use the income forecast method. ABC Rentals of San Antonio Inc. v. Commissioner, T.C. Memo 1994-601 (December 7, 1994). Despite its finding that the rental property on average remained in the taxpayer's inventory only 21.6 months, the Tax Court indicated that the rental-purchase dealer was required to depreciate its rental property under Section 168 of the Code using a MACRS class life of five years.[2] The Tax

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[1] Section 168(f)(1) of the Internal Revenue Code allows a taxpayer to elect out of the Modified Accelerated Cost Recovery System ("MACRS") depreciation rules and properly use a method not expressed in terms of years. The income forecast method is such a method.

[2] For purposes of computing the alternative minimum tax, such rent-to-own property generally would be depreciable using a MACRS class life of nine years.

Court held that the income-forecast method could be used only for property that is "similar in character" to motion picture and television films and sound recordings.

Economic Harm from Deferral of Depreciation

If rental-purchase property is required to be depreciated using a five-year class life there will be a significant mismatch between the income stream generated by an item of rental property and the costs of producing that income. Such a mismatch will result in income from that property being taxed more quickly than it should be, to the economic disadvantage of the dealer. While the income stream from an item of rental property in general is spread over a 21 to 24 month period, the use of a five-year recovery period under MACRS defers most of a dealer's cost recovery until the last year the dealer uses the item of property in its rental inventory. The postponement of the rental-purchase dealer's cost recovery deduction is a significant economic loss based on the time value of money. The loss reduces the dollar amount available to a rental-purchase dealer to reinvest in new rental inventory items. The economic harm is particularly acute because most rental-purchase dealers are small companies or sole proprietorships that have very limited capacity to finance their inventory with borrowed funds. Thus, the postponement of cost recovery deductions will effectively reduce the volume of their business.

As an illustration, assume that a dealer acquires an item of rental property and places it in service on January 1 of Year One and depreciates the property using five-year MACRS (using the applicable half-year convention and the double declining balance method). Assume that a customer ultimately obtains title to the property as of June 30 of Year Two. In this example, 66⅔% of the dealer's rental income from the property is recognized in Year One, and 33⅓% of the rental income is recognized in Year Two. Using five-year MACRS, the dealer recovers only 20% of the costs of the property in Year One as a depreciation deduction, and recovers 80% of the costs in Year Two.[3]

	Percentage of Income	Percentage of Cost Recovered Using Income Forecast	Percentage of Cost Recovered Under 5-Year MACRS
Year One	66 2/3%	66 2/3%	20%
Year Two	33 1/3%	33 1/3%	80%

[3] To the extent the dealer places property in service later in Year One, the mismatch is less dramatic, but nonetheless significant.

This mismatch between the timing of a dealer's income and cost recovery deductions causes an economic distortion. The dealer's taxable income and tax liability during the first year of the life of an item of rental property are unfairly overstated. Although the dealer's taxable income and tax liability during subsequent years is understated, the dealer bears the economic burden of the time value of the front-loaded tax liability.

Recommendation

A•PRO urges Congress to enact legislation expressly authorizing the application of the income forecast method for depreciating rental-purchase property. The tax law should reflect the actual business conditions in, and practices of, the industry. To require the MACRS depreciation period of five years results in a mismatching of revenue and costs in the rental-purchase industry. By reflecting depreciation for the periods that the property is actually leased, the income forecast method properly matches costs and revenue and more clearly reflects income.

Alternative Recommendation

In the alternative, A•PRO urges Congress to enact legislation authorizing the depreciation of rental-purchase property over a three-year class life under MACRS. Although three-year MACRS would not match a rental dealer's income with its depreciation costs as closely as the income forecast method, a three-year class life would provide a closer match (and a clearer reflection of income) than a five-year class life under MACRS.

* * *

Legislation expressly providing for depreciation of rental-purchase property under the income forecast method (or over a three-year class life) would reduce the economic costs to the rental-purchase industry of the unjustified deferral of cost recovery deductions until the end of a rental dealer's income stream. Moreover, consistent with statues in 38 states recognizing rental-purchase agreements as valid leases, such legislation would expressly confirm that rental-purchase agreements are true leases for tax purposes. Without such legislation, the economic costs to the rental-purchase industry of the unjustified postponement of cost recovery deductions will unnecessarily paralyze these small businesses, causing some to close.

Thank you for the opportunity to present my statement on this important issue.

Mr. McCrery [presiding]. Thank you, Mr. Chambers.
Mr. Ross.

STATEMENT OF ALAN E. ROSS, CHAIRMAN, BOARD OF DIRECTORS, SEMICONDUCTOR INDUSTRY ASSOCIATION; AND PRESIDENT, TELECOMMUNICATIONS, ROCKWELL INTERNATIONAL CORP.; ACCOMPANIED BY JOHN J. SALMON, COUNSEL

Mr. Ross. My name is Alan Ross, I am chairman of the board of directors of the Semiconductor Industry Association and president of the telecommunications group of Rockwell International Corp.

I am accompanied today by John Salmon of the law firm of Dewey Ballantine, who is the SIA counsel. I am here on behalf of the Semiconductor Industry Association to discuss the proposed neutral cost recovery system's impact on semiconductor manufacturing equipment and the need for economically accurate cost recovery rules.

Semiconductors are the crude oil of the information age, driving technological advances in computers, telecommunications, and consumer electronics, and changing our society in ways ranging from telecommuting to electronic banking to promoting citizen access to legislation through the Internet.

Semiconductors are at the heart of the $500 billion U.S. electronics industry that employs 2.3 million Americans. The U.S. semiconductor industry alone provides over 200,000 American jobs and has recently regained its position as the world's leading producer of silicon chips.

It is a highly dynamic industry based on an ever evolving technology that demands continuing changes to our manufacturing infrastructure. This rapid pace of technological change results in equipment that becomes obsolete technologically and economically soon after being placed into service, but U.S. tax rules depreciate semiconductor manufacturing equipment over 5 years, a period significantly longer than the equipment's true economic life.

As a result, the U.S. semiconductor industry is at a competitive disadvantage with foreign firms whose cost recovery rules far more accurately reflect realities of the marketplace. The Job Creation and Wage Enhancement Act aims to stimulate economic growth and capital investment by reflecting the true cost of investment in depreciable assets. Indexing depreciation deductions will significantly affect investment in longer term assets.

However, the proposed system will provide little positive cash flow impact for short-lived assets. These assets will be subject to a reduction in the current law declining balance method but will not benefit significantly from indexing.

The problem is compounded for semiconductor manufacturing equipment because its statutory class life set by Congress in 1986 now is clearly longer than its economic life. To encourage capital investment in semiconductors, the SIA urges Congress and the administration to reduce the depreciable life of semiconductor manufacturing equipment from 5 years to 3 years.

The case for an adjustment in the depreciable life of semiconductor manufacturing equipment is clear, and we think compelling.

First, the technological life of semiconductor manufacturing equipment is shorter than the current law's 5 year classification. Two recent reputable economic studies have demonstrated that two-thirds of the economic life of semiconductor manufacturing equipment is exhausted in the first 24 months of use, and the full economic life of such equipment is less than 4 years, thus qualifying it for a 3 year class life under tax depreciation rules.

Second, more accurate cost recovery is necessary to offset the tax advantages enjoyed by foreign competitors. For example, Japanese firms enjoy a wide range of tax incentives for investment in semiconductor manufacturing equipment. As a result of these incentives, Japanese companies can write off up to 88 percent of their investment in new equipment in the first year, whereas U.S. companies can write off only 20 percent.

This neutral cost recovery proposal not only fails to address this unfair advantage, it would actually reduce first-year depreciation of semiconductor equipment to 15 percent. As such, several of our members have already indicated that they would not even elect to use the new system if it is enacted.

Third, faster depreciation is needed to continue to strengthen the global position of U.S. semiconductor equipment manufacturers. In 1980 all 10 of the leading semiconductor equipment manufacturers were U.S. companies. By 1989 four of the top five producers were Japanese.

However, U.S. firms have managed to regain their position in the highly competitive environment by undertaking a strong commitment to new capital investment. In 1992 the National Advisory Committee on Semiconductors, a government industry panel established by Congress to develop a national semiconductor strategy found that setting semiconductor manufacturing equipment's depreciable life at 3 years would have the most significant impact on the industry, increasing semiconductor industry capital investment by 11 percent per year.

In recent years Members of Congress of both parties, including Speaker Gingrich, Majority Leader Armey, Democratic Leader Gephardt, and many members of this committee have cosponsored bills to align the depreciable life of semiconductor equipment with economic reality.

We urge the Congress to act now to ensure that the industry is able to meet its future capital needs and maintain its leadership in promoting U.S. economic growth.

Thank you very much.

[The prepared statement follows:]

TESTIMONY OF ALAN E. ROSS
SEMICONDUCTOR INDUSTRY ASSOCIATION

My name is Alan Ross. I am Chairman of the Board of Directors of the Semiconductor Industry Association (SIA) and President, Telecommunications, of Rockwell International Corporation. I am accompanied by John J. Salmon of the law firm of Dewey Ballantine, SIA's counsel. The Semiconductor Industry Association is pleased to have this opportunity to testify before the Committee on Ways and Means about the need for more economically accurate cost recovery rules. In particular, I am here to discuss the proposed neutral cost recovery system's impact on short-lived assets such as semiconductor manufacturing equipment.

SIA is an association of U.S.-based semiconductor manufacturers that account for ninety percent of all U.S. semiconductor production. SIA was formed in 1977 to address public policy issues impacting the industry's ability to remain internationally competitive. Semiconductors are the enabling technology for the $ 500 billion U.S. electronics industry that employs over 2.3 million Americans. The U.S. semiconductor industry alone provides over 200,000 American jobs and is once again the world's leader in this most critical of technologies. We have regained our position in a highly competitive environment through strong commitments to research and new capital investment. The semiconductor industry is a dynamic industry using ever evolving technology that demands large changes to manufacturing infrastructure on an ongoing basis. It is anticipated that, globally, the semiconductor industry will invest more than $ 120 billion during the remainder of this decade to develop new fabrication facilities needed to keep pace with the rapidly changing nature of semiconductor technology.

This rapid pace of technological change results in equipment that becomes obsolete, technologically and economically, soon after being placed into service. Nevertheless, U.S. tax rules depreciate semiconductor manufacturing equipment over five years, a period that two recent studies and normal business practice demonstrate is significantly longer than the equipment's true economic life. This inability to depreciate such property over a period that reflects its actual useful life places the U.S. semiconductor industry at a competitive disadvantage versus foreign competitors who receive substantially more advantageous depreciation. In recent years, Members of Congress of both parties, including Speaker Gingrich, Majority Leader Armey, Democratic Leader Gephardt, and many members of this Committee, recognizing the need to correct semiconductor manufacturing equipment's depreciable life rules, sponsored bills aligning depreciable life with economic reality.

The Job Creation and Wage Enhancement Act ("the Act") aims to stimulate economic growth and capital investment and to accurately assess the true costs of investment in depreciable assets. Increasing depreciation deductions to account for inflation and, for certain assets, for the time value of money, will significantly impact investment in longer-term assets, particularly those with class lives accurately reflecting their economic usefulness. However, the proposed system will have relatively little impact on short-life assets because these assets will be subject to a reduction in the declining balance method yet, will not benefit significantly from indexing. The problem is exacerbated for semiconductor manufacturing equipment because its class life is longer than economic reality. The proposed neutral cost recovery system, therefore, would not sufficiently improve the U.S. semiconductor industry's competitive position in relation to its primary foreign competitor, Japan, or adequately stimulate the industry's level of capital investment. SIA urges Congress and the Administration to encourage capital investment in semiconductors by changing the depreciable life of semiconductor manufacturing equipment from five to three years. This change will correct the existing system's failure to allow semiconductor manufacturing companies to recover the real cost of their capital investments.

BACKGROUND

A vibrant, world-class semiconductor industry is universally acknowledged as vital to America's national security and economic growth. Semiconductors are the "crude oil" of the information age -- driving technological advances in computers, telecommunications, and consumer electronics. Semiconductor technology is the heart of a growing $ 1 trillion world electronics industry that employs 2.3 million Americans. In 1994, the global semiconductor industry had sales of $ 100 billion. Semiconductors are essential for defense capabilities, playing an important role in 18 of the 21 defense-critical technologies identified by the Department of Defense.1/

The semiconductor industry's pace of technological change is astounding. The number of transistors on a computer chip increased from 10 in the early 1960's to 10 million today. By the year 2,000, the U.S. industry hopes to place over 10 billion transistors on a single chip. This chip could store the equivalent of a 20-volume encyclopedia, or provide all of the computing power of one of today's leading-edge supercomputers.

This technology was invented in the United States. However, the U.S. industry's position as world leader steadily eroded during the 1980's. From 1982 to 1990, the U.S. industry's world market share declined from 56.7 percent to 39.8 percent, while Japan's share rose from 32.5 percent to 47.1 percent. Although, in 1993, the United States passed the Japanese in world market share, this position is tenuous with new investment needed to maintain and improve this mark. The earlier decline in market share occurred for a number of reasons:

- The U.S. industry has been injured by competing nation's unfair trading practices, including illegal "dumping" of their products in the U.S. market and denial of foreign market access. For example, Japanese dumping of DRAMs in the mid-1980's forced six of the eight U.S. DRAM manufacturers out of the market.

- Other governments made their semiconductor industries a national priority, "targeting" the industry by funding R&D consortia, extending low-interest loans, and providing favorable tax depreciation treatment and other tax incentives. Our primary competitor, Japan, for example, allows first year depreciation of up to 88 percent of semiconductor equipment's original acquisition cost to be written off in the first year compared to only 20 percent allowed for U.S. firms.2/

- The U.S. lost many industries which use semiconductors, such as the consumer electronics industry.

- Between 1984 and 1989, Japanese firms invested $ 12 billion more in plant and equipment and R&D than U.S. firms.

U.S. and Japanese capital spending rates are particularly important, since there is a high correlation between investment and market share. The difference in depreciation rates between

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1/ See Department of Defense, *Critical Technologies Plan*, (Washington, D.C.: May 1991); and National Critical Technologies Panel, *Report of the National Critical Technologies Panel*, (Washington, D.C.: March 1991).

2/ Technecon Analytical Research, Inc., *Analysis of the Relative Economic Benefits of Tax Depreciation Policies for Semiconductor Equipment and Facilities in the United States and Japan*, 1991.

the United States and Japan negatively impacts U.S. capital spending and consequently lowers U.S. market share and competitiveness.

In 1992, The National Advisory Committee on Semiconductors (NACS), a government-industry panel established by Congress to develop a national semiconductor strategy, found that shortening semiconductor manufacturing equipment's depreciable life to three years would have the most significant impact on the industry's capital expenditure level by increasing semiconductor industry capital investment by 11 percent.

SIA strongly supports NACS's conclusions and recommendations. While the Act's other changes in tax policy would enhance U.S. capital formation, the NACS study and SIA's analysis of the current proposals indicate that a reduction in semiconductor manufacturing equipment's depreciable life would have a greater impact on increasing semiconductor industry capital investment.

THE SEMICONDUCTOR INDUSTRY NEEDS A DEPRECIATION PERIOD THAT ACCURATELY REFLECTS THE ECONOMIC LIFE OF ITS MANUFACTURING EQUIPMENT

The case for an adjustment in the depreciable life of semiconductor manufacturing is clear and compelling.

1. The technological life of semiconductor manufacturing equipment is shorter than the current law's five year classification. The semiconductor industry's rapid pace of technological change results in equipment that becomes obsolete, technologically and economically, soon after it is placed into service. In fact, in the first year of use alone, a substantial amount of the true economic life of this equipment is consumed. Two recent economic studies by American Appraisal Associates, and Lane, Westly Inc. show that the economic life of semiconductor manufacturing equipment is 3.75 and 3.27 years respectively. Because the current law's tax depreciation rules classify property with an economic life of less than four years as "three year property," semiconductor manufacturing equipment should be classified as three year property.3/

Historical trends indicate that every three years a new generation of semiconductors is released. These chips, on average, increase four times in performance and capacity over the previous generation. The introduction every three years of new generations of semiconductors results in rapid obsolescence because more advanced manufacturing equipment is required for volume production of state-of-the-art integrated circuits. This fact clearly indicates that a change in depreciation is necessary if the United States intends to maintain a world-class semiconductor industry.

2. Faster depreciation is necessary to offset the tax advantages enjoyed by foreign competition. Japanese firms enjoy a wide range of tax incentives for investment in semiconductor manufacturing and equipment. Japan provides for substantially more generous depreciation of semiconductor manufacturing equipment, allowing firms to accelerate depreciation if equipment is operated more than eight hours per day -- a significant advantage

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3/ American Appraisal Associates, *Depreciation Rates Report for Semiconductor Manufacturing Equipment*, January, 1992. Lane, Westly Inc., *Estimating The Proper Depreciation Lifetime for Semiconductor Manufacturing Equipment*, January, 1995. Under current law, assets with useful lives less than four years are treated as "three year property" and depreciated accordingly. This result will not change under the neutral cost recovery proposal.

given that most wafer fabrication facilities operate twenty-four hours per day. Additional accelerated depreciation is provided to companies that locate in certain geographical areas. As a result of these incentives, Japanese companies can write off up to 88 percent of their investment in new equipment in the first year, whereas U.S. companies can write off only 20 percent. The neutral cost recovery proposal fails to address this unfair advantage held by foreign competitors. Ironically, under the neutral cost recovery proposal, first year depreciation of semiconductor equipment will actually be reduced by 25 percent, so that only 15 percent of the asset can be written off in the first year.

3. **Faster depreciation is needed to continue to strengthen the global position of U.S. semiconductor equipment manufacturers.** The U.S. semiconductor equipment industry's market share eroded rapidly in the 1980's. In 1980, all ten of the leading semiconductor equipment manufacturers were U.S. companies. By 1989, four of the top five producers were Japanese. U.S. firms have regained their position in a highly competitive environment by undertaking a strong commitment to new capital investment. Continued investment on a large scale basis, however, is needed if the domestic industry is to maintain its position. Faster depreciation would increase U.S. capital spending, which would stimulate demand for semiconductor manufacturing equipment and strengthen the U.S. semiconductor manufacturing industry.

4. **Allowing firms to accurately recover capital investment costs is critical in industries characterized by rising capital costs and product prices that fall rapidly after introduction.** In 1992, the U.S. semiconductor industry devoted 14 percent of sales per year to capital spending and another 12 percent of sales to R&D. The cost of a new fabrication facility is currently more than $ 1 billion, and is rapidly approaching $ 2 billion. While prices for manufacturing facilities continue to rise, prices for semiconductor products drop sharply soon after they are introduced. From 1978 to 1989, the price per bit for DRAMs decreased at a compound annual rate of 26 percent.4/ This means that the window in which firms can hope to recover their investments is extremely small.

5. **The information highway is paved with semiconductors.** Semiconductors are at the core of all aspects of the information highway -- the computers, televisions, and phones as well as the satellites and switching systems connecting them. Supporting these pervasive electronics products is expected to help double worldwide semiconductor industry sales between now and the end of the century -- from $ 100 billion in 1994 to $ 200 billion in the year 2,000. To support a doubling of sales will require a doubling of plant and equipment. To double the worldwide industry's net fixed assets will require cumulative investments of about $ 120 billion in the remainder of this decade. U.S. tax depreciation rules will be one factor determining whether firms will build new plants in the U.S. or overseas.

Each billion dollar semiconductor fabrication facility requires 1,900 people to construct the building and about 2,000 people to make the manufacturing equipment in the building. Once operating, the facility supports 750 to 1,000 manufacturing jobs. The 214,000 U.S. semiconductor jobs and 38,500 semiconductor manufacturing equipment jobs are the base supporting the 2.3 million Americans employed by the U.S. electronics industry -- more than the U.S. automotive, steel and aerospace industries combined. U.S. tax depreciation rules that reflect the short economic life of semiconductor manufacturing equipment will help

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4/ From 1978 to 1989, the price per bit for DRAMs decreased by a factor of 37.8 -- from 48.39 millicents per bit to 1.28 millicents per bit.

insure that the 214,000 U.S. semiconductor employees have the tools they need to do their part in building the information highway.

6. The Job Creation and Wage Enhancement Act does not address the needs of high-technology industries. The neutral cost recovery proposal correctly attempts to remove inaccuracies in the existing system which limit companies' ability to recover the true cost of their capital investments. The proposal's indexing for inflation and a standard discount rate allow companies to recover the cost of inflation and the time value of money.

In spite of its intention to stimulate economic growth the proposal will not sufficiently improve the U.S. semiconductor industry's general competitive position or capital investment level. Although the proposal provides incentives for investing in assets with long lives, relatively short-lived assets, such as semiconductor manufacturing equipment, receive little economic benefit as the advantage of indexing over only a few years is offset by the loss of the 200 percent declining balance methodology. Industry analysis demonstrates that firms with long-lived assets will receive a substantially greater increase in their ability to recover cost than firms with short-lived assets. Under NCRS, the present value of the benefit of depreciation deductions for an investment in a twenty-year asset (discounted at 7 percent) will increase 24.3 percent, while increasing 6 percent for a similar investment in a three-year asset. Under the proposal, semiconductor manufacturers will remain unable to recover the real cost of their capital investment. The proposal therefore fails to achieve its goals of stimulating capital investment and economic growth in the semiconductor industry.

CONCLUSION

The United States must adopt capital formation policies which reflect the economic realities of the semiconductor industry and international competition. Adjusting the depreciable life from five to three years will more accurately reflect the rapid pace of technological change in the semiconductor industry. The resulting increase in capital investment will bolster the semiconductor industry and the semiconductor manufacturing equipment industry, thereby strengthening U.S. electronics firms. Such a change will reduce the gap between U.S. and Japanese capital spending in semiconductors, which is attributable to the wide range of incentives that the Japanese government extends to their industry. If the United States fails to correct the existing inaccuracy in capital investment cost recovery, the U.S. semiconductor industry will have great difficulty in making the large capital expenditures needed to stay at the forefront of technological innovation.

Microelectronics technology has had an enormous and pervasive impact on our quality of life and on the productivity of new and existing industries. There is every reason to believe that the pace of technological change will continue to accelerate. If America is not to be left behind, we must act now to ensure that the U.S. semiconductor industry is able to meet its future, large-scale capital investment needs. Congress and the Administration have expressed a true commitment to promoting U.S. high-technology industries. It is now time for Congress to act on that commitment by correcting the inaccuracies in the existing cost recovery system.

Mr. McCrery. Thank you, Mr. Ross.
Mr. Rumfelt.

STATEMENT OF THOMAS B. RUMFELT, FOUNDER, OWNER AND CHIEF EXECUTIVE OFFICER, RISK & INSURANCE BROKERAGE CORP., LAKE WALES, FLA.; AND NATIONAL CHAIRMAN, NATIONAL BUSINESS OWNERS ASSOCIATION

Mr. Rumfelt. Thank you, Mr. Chairman.

Mr. Chairman and members of the committee, my name is Thomas B. Rumfelt, and I am founder, owner and CEO of Risk & Insurance Brokerage Corp., a small business headquartered in Lake Wales, Fla. R&IB is a full-lines property and casualty insurance agency. I am appearing at the request of the National Business Owners Association and currently serve as its national chairman.

Thank you, Mr. Chairman, for holding this hearing to find new ways to help America's small businessmen and -women, nearly 22 million strong, that are the driving force of our economy today. Although they represent slightly more than 10 percent of our population, it is small businessowners who are creating businesses, providing new jobs, and keeping local communities and big cities prosperous. They are our best hope for a future—a future of growth and opportunity for everyone.

What is it about small businessowners that sets them apart, that makes them so successful?

The fact that truly distinguishes them is their firm belief in the future. It is their optimism about the future and the opportunities it holds that prompts them to invest. They know that investment today will bring rewards tomorrow.

Too often, small businesses experience difficulties in getting ahead. Banks are often reluctant or unwilling to loan money. And government does not always extend a helping hand. Its policies are one of the greatest obstacles small businessowners face. In fact, tax policies are a disincentive for savings and investment—the sources of capital entrepreneurs need to start and expand companies. For example, the current tax treatment of capital gains hurts investments as well as small businessowners who spur growth and the many millions who benefit from it.

That is why it is important that this committee do something about the tax policies that inhibit growth. These policies punish both those who are willing to save and invest and those who help create businesses and the jobs and growth that our Nation needs. As any successful small businessowner will tell you, it is investment that drives business growth and productivity.

In 1989, I started my own company, R&IB. When we opened our doors, we had two employees—I was one—and we rented a small executive suite. I made a commitment to invest my personal savings from the beginning. I searched for the best talent, and I invested in training and technology to help our employees be their best. I invested in anything that would give our team an advantage, and it paid off. Five years later, I am pleased to say that my company has grown to 110 employees in our own commercial space. We now have several offices and our growth continues.

One secret of this success is a commitment to continued investment. Our future growth will continue to come from investment. Without it, I cannot envision our company remaining as successful and as profitable as it has been the years since its creation.

I know small businessowners can do more with a dollar than most other businesses because they have to. It is time that Congress remove the obstacles to investment in small business that pays for itself many times over. The cost recovery provisions are a good start to help small businessowners recoup more of the dollars they invest in plant, equipment, and technology. As a small businessowner, I endorse this proposal.

I can see how this provision will help promote business investment, improve productivity, which will also mean higher wages for employees. It is wrong to suggest that investment helps only the individual who makes it. Whenever my company invests in computers, in a building, or any other asset, many benefit from that investment.

I am pleased to see a proposed increase in spending of $7,500 that will bring the writeoff total to $25,000. This is an important change and one that will encourage investment. All of these proposals, if enacted, will result in jobs for Americans and products for the world. Incentives that encourage savings and investment are the very ones that promote economic growth.

I appreciate this opportunity to offer my views on the important tax and investment incentives contained in the Job Creation and Wage Enhancement Act.

Thank you.

[The prepared statement follows:]

TESTIMONY OF THOMAS B. RUMFELT
NATIONAL BUSINESS OWNERS ASSOCIATION, INC.

Mr. Chairman, Mr. Gibbons, and Members of the Committee, my name is Thomas B. Rumfelt, and I am the founder, owner, and chief executive officer of Risk and Insurance Brokerage Corporation, a small business headquartered in Lake Wales, Florida. R&IB is a full-lines property and casualty insurance agency with operations in several states. I am accompanied by Mr. J. Drew Hiatt, Executive Vice President and Director of Government Affairs of the National Business Owners Association.

I appreciate very much the opportunity to appear before this Committee to offer a small business owner's perspective on specific tax and investment provisions contained in the Job Creation and Wage Enhancement Act.

Thank you, Mr. Chairman, for holding this hearing to find new ways to help America's small business men and women -- nearly 22 million strong -- who are the driving force in our nation's economy today. Although they represent slightly more than 10 percent of our population, it is entrepreneurs who are creating the businesses, providing the new jobs, and keeping local communities and big cities alive and prosperous. They are our best hope for a better future -- a future full of growth and opportunity for everyone.

If one thing is certain, it is that small business -- and small business owners -- have to be one of the most-studied subjects in all history. It seems that everyone wants to know the secret of their success. Many have pointed to their ability to endure and wait out hard times. Some have focused on their capacity for developing ideas and bringing new products to the marketplace. Others have sought to explain their success by noting their remarkable determination and tenacity. Still others have said that the secret to their success lies in their hard work, in their self-confidence, and in their strong faith. I think there is a little bit of truth in all these explanations. But many Americans share the traits and talents that make small business owners successful. Having good ideas is not unique to small business owners alone and neither is the ability to work hard. Other Americans have good ideas and work hard as well.

What is it about small business owners that sets them apart, that makes them more successful in many cases than other business owners? The detractors of small business and those who deride their contributions and achievements over the years would say the success of small business is more luck than hard work, more luck than talent -- more luck than anything else. But I believe it is all the things I have mentioned. The one single factor that comes to my mind that truly distinguishes small business owners and makes them successful is their firm belief in the future. It is their buoyant optimism.

It is this optimism about the future and the opportunities it holds that prompts small business owners to invest for the future. This is why they invest in new ideas and businesses. They know that investment today will bring rewards tomorrow. And they are not the only ones who benefit from investment -- those around them benefit as well and often in equal measure.

Small business owners understand the value of investment and its potential and power to create business, jobs, higher wages, and economic growth. For them, it is easy to see how an idea fueled by investment can create unlimited opportunities. They are smart about the investment decisions they make, even though not all of their investments pan out they way they would like, but they know that investment brings rewards and they are willing to risk now to reap rewards later. Small business owners, like farmers, understand the law of the harvest -- we reap what we sow. Farmers would never dare not to sow the seeds of the crops they hope to harvest next fall. Likewise, small business owners know that an investment today, if it is a good one, will pay off tomorrow.

Over the years, small business owners have, more times than not, had to help themselves to get ahead. Banks have often been reluctant or unwilling to loan them money, refusing to bet on a promising idea and a practical dreamer. This has deterred some from pursuing their dreams, but it has not deterred the rest -- the bold risk-takers -- who have bet everything on themselves and their dreams and their ability to achieve them. It is government, more times than not, that has not extended a helping hand to small business owners as they have sought to invest in new companies to create jobs and growth for themselves and their communities. Government policies, including tax policies, have been one of the greatest obstacles in the path of small business owners. In fact, tax policies have acted as a disincentive for savings and investment -- the sources of capital entrepreneurs need to start and expand companies. For example, the current tax treatment of capital gains has hurt investment as well as the small business owners who spur growth and the many millions who benefit from it.

That is why it is important that this Committee do something about the tax policies that have inhibited growth. These policies have punished both those who are willing to save and invest and those who help create businesses and the jobs and growth our nation needs.

Like many small business owners, ambition, determination, and hard work have carried me far. I have been helped by my own faith and the blessings that come from it. And, I might add, I have had my share of good luck and fortune along the way. But as any smart small business owner will tell you, it is investment that drives business growth and productivity. In 1989, I started my company -- R&IB -- a full-lines insurance brokerage company. When we opened our doors in July we had five employees and rented a small executive suite. Since money was tight I had to finance my company's operations from its cash flow. This same cash flow also provided the investment funds we needed to grow.

I made a commitment to invest from the beginning. Then I searched for the best talent I could find, and I invested in the technology that our employees needed to work faster, smarter and better than our competitors. Soon I moved our company from rented rooms into newly acquired space so that we would have room to expand and provide quality service to our customers. I increased training for employees to keep giving them the skills they needed to succeed in their jobs. In fact, I invested in anything that would give us an advantage.

Some five years later, I am pleased to say my company has grown from five employees in rented space to more than 110 employees in our own commercial space. We now have several offices, and our growth continues.

What has been the secret of this success? Well, to agree with several critics, I would admit that luck has played a role. But more than that so has hard work, determination, tenacity, customer service, and many other factors. The decisive factor that has helped to fuel our growth has been a continuing commitment to investment. Our future growth will also continue to depend on and come from investment. Without it, I cannot envision that our company will long remain as successful and as profitable as it has been in the years since its creation.

Many other small business owners could recount similar success stories. They have been fortunate enough to finance their own growth through cash flow or from the generosity of friends and family, through personal savings, or from bank loans. But many others have been unable to attract the investment they need. Others have been taxed with such a heavy hand that it has diminished the return on investment. I believe small business owners can do more with a dollar than most other businesses can do with three. Isn't it time that Congress begin to remove the impediments to savings and investment and the obstacles to investment in small businesses that pay for themselves many times over?

I believe that the neutral cost recovery provisions are a good start to help small business owners recover more of the dollars that they invest in plants, equipment, and technology. These investments help build strong and prosperous companies that employ local residents. Because inflation is not taken into consideration and is not figured as part of the write-offs, small business owners are unable to recover the real value of their investments. Inflation always chips away at this value. Another problem is that the write-off does not take into account the time value of money. This also reduces the present value of an investment. As a small business owner, I endorse the neutral cost recovery proposal because I believe that there is a fundamental issue of fairness at stake here. I believe these provisions will help to correct an inequity in the current tax treatment of write-offs as they relate to recovery of the full value of investments in depreciable assets.

From my perspective as a small business owner, I can see how this new recovery provision will help spur additional business investment and could lead to new advances and improvements in productivity. This will also mean higher wages for employees. It is wrong to suggest that an investment helps only the individual who makes it. In my years of experience, whenever my company invested in computer equipment, in a building or in any other asset, many benefited from that investment. I believe these recovery provisions will indeed spur economic growth, and new job creation through increased investment.

Over the years, many small business owners have taken advantage of the expensing write-off. This has been a benefit to many small business owners. But in many cases, the write-off has not been as helpful as many intended it to be. I am pleased to see that the Committee has proposed that this expensing provision be increased $7,500, up to $25,000, on

the first $200,000 in investment. This is an important change and, one that, I believe, will help promote investment at the local level and increase economic growth and job creation.

By passing the proposals we have discussed today, this Committee can help small business owners to start and expand companies. Their efforts will result in jobs for Americans and products for the world. The incentives that will encourage savings and investment are the very ones that will promote economic growth.

I'm a simple businessman, but I take pride in the fact that I employ a lot of people and many families depend on a business I started from scratch. I've met thousands of small business owners across this great country who have also created this American dream, and thousands who want this same opportunity for themselves.

Won't you help them by helping to create this opportunity? I know they will help others and eventually help support this great country. Won't you give them increased incentives and breaks that I could have used and know that they can? Small business owners are optimistic about the future, and if we can help them invest in their dreams, we will all benefit.

With 700,000 new businesses started each year in this country there are men and women in every state brimming with new ideas and energy to make new companies work. I saw a film last year that touched my heart, and obviously millions of others. It was Forest Gump, and even though he was possibly not as bright as everyone else around him, with hard work and diligence, and yes, some lucky breaks, maybe even breaks created by Providence, he created a business that helped support many families. Yes, it is a film fantasy, but it is a fantasy that comes true every day in this country. It is the American dream of starting and owning a business, and I think that is one of the reasons that this film touched so many hearts. I ask you to help keep this American dream going.

I appreciate this opportunity to offer my views on the important tax and investment incentives contained in the Job Creation and Wage Enhancement Act.

Mr. McCRERY. Thank you, Mr. Rumfelt.

I thank all of you gentlemen for your excellent testimony and bearing with us through a long day of hearings.

Mr. Hancock, would you like to inquire?

Mr. HANCOCK. Thank you, Mr. Chairman.

Mr. Chambers, I was not here for your testimony, but I am specifically interested in the rent-to-purchase industry. That primarily is small business individuals. Is there a national company, a large organization engaged in that business? Is there a franchise operation? Have they started franchising this type of business?

Mr. CHAMBERS. Yes, Congressman. The industry itself is comprised primarily of mom and pops, what we classify as owner-operators. About 80 percent of the businesses are that way of the 7,500 stores that we have. There is one larger group that operates. It is commonly called Rent-a-Center, and that is probably the largest group that we have.

Mr. HANCOCK. You don't happen to know how many stores they operate?

Mr. CHAMBERS. Not off the top of my head. I would assume it is somewhere in the thousand-store range.

Mr. HANCOCK. I understand that there has been a little bit of a problem showing up all of a sudden about whether a rent-to-own is actually a lease-purchase, or whether it is a sale. And Internal Revenue, as I understand, in some instances, has decided that when you sign a lease, that that is a sale and that the entire value of that lease is income and that you should pay income taxes on it.

Mr. CHAMBERS. Yes, sir, that is correct. We feel it is a lease primarily because it has a terminability clause and no obligation on the part of the customer. The Service, for example, has decided that if a piece of merchandise is rented, let's say, on December 25, and the tax year ends on December 31, and the customer makes a $15 payment, what they want us to do is accrue all the future income associated with that agreement back into the current tax period and tax it accordingly. That puts a tremendous burden, tax burden on the taxpayers, one of which most of the companies involved in our industry would not be able to fund and survive.

Mr. HANCOCK. OK. Let me understand this. I want to be sure this gets in the record. You sign, let's say, a 5-year contract on merchandise, and let's say, it is $50 a month, which would be a total of $3,000 that they will pay you over a 5-year period in rentals if, in fact, they pay the full 5 years.

You sign the contract for a Christmas present, and on December 24, let's say in 1994 you signed this, you would be required to declare in that year the full $3,000 as income, even though all you had been paid is $50?

Mr. CHAMBERS. Yes, sir, that is correct. And taxed upon that amount.

Mr. HANCOCK. Now, 6 months from now there is no overhead expense or anything else. That would be pure profit, except finance charge.

Mr. CHAMBERS. They allow us to deduct the cost of the merchandise—which is minimal.

Mr. HANCOCK. If they want to handle it that way, could they carry it one step further and deduct the cost of the merchandise from the profit rather than make you capitalize it?

Mr. CHAMBERS. That is correct.

Mr. HANCOCK. Are they doing the entire rental business that way now or are they just doing it in specific cases?

Mr. CHAMBERS. Well, Congressman, over the last 2 or 3 years, there has been a heightened audit activity upon our particular business. And most of the audit activity, I would say probably somewhere in the range of 80 to 90 percent of the audit activity, deals with the issue that you are speaking of. And as they audit the dealers throughout the country, they are, in fact, making them or asking them, to recognize all future revenues back into the current period and tax it accordingly. And in a lot of cases, they are assessing penalties and interest because they feel as though the taxes were not paid appropriately the first time.

Mr. HANCOCK. That is going to put some of those operations out of business.

Mr. CHAMBERS. I would venture to say someone like myself it would definitely put out of business. I am a small businessman within the industry, and I would say it would put probably 80 to 90 percent of the small businessmen in the industry out of business because banks will loan us money to buy merchandise to create revenues but they will not loan us money to pay taxes on income not yet received.

Mr. HANCOCK. We know what happened to the banking industry when they started having to book high-income loans that defaulted. We know what happened to that industry a few years ago. Well, thank you very much. I would like to talk with you further or to your organization or whoever is representing you, about how we can work something out in the regulations to at least be fair on the basis of a cash business. You haven't received the money, therefore, you have not made the profit. You have a paper profit and that is all.

Mr. CHAMBERS. That is it, yes, sir. The future money that we would hope to receive is still out there. We have that one payment that you spoke about.

Mr. HANCOCK. And I understand according to history, you are going to have 10 percent of those customers just vanish with the merchandise.

Mr. CHAMBERS. That is correct. Over a period of, roughly, 12 months, somewhere in the neighborhood of 10 percent of the merchandise will be lost, stolen, poorly used and abused, and come back in an unrentable situation.

Mr. HANCOCK. And under these laws, you would have paid income tax on it, even though you cannot find those people.

Mr. MCCRERY. Thank you, Mr. Hancock.

I think you made the point. And there are several of us here who would like to help you get that straightened out.

Ms. Dunn.

Ms. DUNN. Thank you.

Mr. Chambers, I would like to ask you another question. How would your industry, the rental-purchase industry be affected if we were to adopt in H.R. 9, the neutral cost recovery provisions that

we are talking about, without adopting the cost recovery rules for the rental-purchase business?

Mr. CHAMBERS. Congresswoman Dunn, the H.R. 9, the adoption of H.R. 9 would not exactly help us in terms of as it relates to NCRS. We are looking at H.R. 9 being a place where if we are going to talk about depreciation law and the equitable administration of the depreciation laws, particularly for our industry, this is the place that we need to talk about them.

As a layman and a businessman, I am not an attorney or CPA, I am only a businessman, the only place I have, in my experience with the IRS and with the courts out there, the only place left for me to come, is to a forum as this is say, as a small businessman, I need help. I don't know where else to go to get the help.

Ms. DUNN. As a layman to a businessman, the reverse probably, why do customers choose to engage in a rental-purchase transaction, rather than a retail sales transaction?

Mr. CHAMBERS. Really for three simple reasons: For the convenience of it. If they come into our locations, they can generally have the merchandise the same day.

Second, most of our customers come to us because they don't want to have a continuing obligation placed upon them.

And third, customers come to us because we don't do credit checks and we don't extend credit. A lot of these customers come to us because for some reason or another we are not the judge of that. They may be uncreditworthy and they can't go to a retail operation and get the proper financing in order to get the goods.

Ms. DUNN. Thank you.

Thank you, Mr. Chairman.

Mr. MCCRERY. Thank you, Ms. Dunn.

Mr. Collins.

Mr. COLLINS. Thank you, Mr. Chairman.

Mr. Callahan, can you explain how the alternative minimum tax system works against the normal business cycle or why is the alternative minimum tax particularly troublesome during recessionary times?

Mr. CALLAHAN. I heard the first part, you may have to restate the second part. If you look at the mechanics of the AMT over the business cycle and you look at the add-backs that lead you into AMT and the tax itself when you are in the low end of the business cycle and profits are down, the add-backs that lead you to the calculation of paying an AMT don't change and go down with your profitability. So you can find yourself in the bottom of the business cycle, paying almost the same AMT because of the add-backs and preference items that get you to that calculation. And, therefore, you are not stimulated in the bottom of the cycle to invest your way out. It is a bit of a trap on the bottom.

Mr. COLLINS. The situation would be even worse in recessionary times.

Mr. CALLAHAN. Yes, and I am speaking of recession——

Mr. COLLINS. Your cash flow goes down, but your tax liability stays level.

Mr. CALLAHAN. Yes, sir.

Mr. COLLINS. What are the advantages of simply conforming the alternative minimum tax depreciation system to the current system

used for regular taxpayers rather than conforming the system to the proposed neutral cost recovery system?

Mr. CALLAHAN. Well, probably the biggest of those is to put us all on the same basis. If you look in the industries we compete in, we can find ourselves against a competitor in the same industry, where they would be a regular taxpayer with the 5-year depreciation and we would be an AMT taxpayer with almost twice the length of that recovery period, 9, 9½ years, within the same industry by two corporations. You can have two recovery periods of A versus B competing in the same industry.

So, the biggest single reason to put the two together is to have a level playingfield in the same industry; and second, it would make it simpler in terms of running two separate depreciation systems, the regular and the AMT system, both from a corporate point of view—figure it out, what to pay, and also from the IRS point of view. Recent studies have been pretty clear in their comments and with their documentation of the cost of collection under such a complex system. Both of those depreciation systems just add to the complexity of the whole tax system; but the biggest reason is to put all taxpayers on the same tax basis.

Mr. COLLINS. Thank you, sir.

Mr. Rumfelt, some have expressed that the neutral cost recovery system would really cause some complexity to the depreciation schedules. Is the neutral cost recovery system really worth it? Is it too complex?

Mr. RUMFELT. I think for the benefit of small business, that right now it is the opportunity that is on the table. And it is something or other that is being proposed, and certainly has advantage for most small businessowners, to some degree.

And, of course, there is some criticism with regards to the method of which this is calculated as being complicated and cumbersome, but I also have to rely on the wisdom of our congressional representation to simplify this so that small business can understand it and CPAs can deal with the issue.

I am not certain that is enough clarification, but I think the issue at hand is certainly a starting point. I think it is something that we can build upon and it is certainly going to have a positive impact on the 22 million small businessowners throughout America.

Mr. COLLINS. Well, as you say, it is a starting point.

We have had a lot of testimony today dealing with alternative minimum tax, and I am very pleased to hear some colleagues from the other side of the aisle speak very favorably about making some changes to alternative minimum tax, which I think would be very beneficial to the business world and also to jobs.

I thank each of you for being here.

Mr. MCCRERY. Mr. Christensen.

Mr. CHRISTENSEN. Thank you.

Mr. Ross, in your testimony you touched on the fast-changing semiconductor world and how quickly things become obsolete. Can you describe for the committee the decline in value of the semiconductor, how quickly it is changing, and how would this neutral cost recovery system affect your association?

Mr. ROSS. I hear several questions in that question, but I think there are two very important responses. The semiconductor industry is, as has been stated, a very fast-moving industry. And the example that I like to use—one that is common knowledge to most of us—is the microprocessor. In the past 5 years, we have all become accustomed to the term 286, and 386 and 486, and now the Pentium. These products have all arisen, and except for the Pentium and the 486, have died within a 3- or 4-year period.

We have seen product cycles where 10 years ago a 286 was in production for 4 years. The Pentium will be in volume production for less than 2 years. The cycle is shrinking.

Now, these products are infinitely more complex today than they were 5 or 10 years ago. The functionality on the integrated circuit has increased by order of magnitude factors of 10 every 2 or 3 years, and as a result, the equipment required to produce them has had to keep pace with this increase in functionality.

Now semiconductor products typically come into the market selling for a fairly high price. However, competitive pressures force the reduction in the average selling price, the ASP, as we refer to it in our industry, by 10 or 15 percent per year. That is sort of bad news, but the good news is that the American semiconductor community has learned how to reduce cost at a faster rate than the ASP deteriorates every year.

The neutral cost recovery system impact is on the semiconducting manufacturing equipment, the effect of which is twofold: First, it has the effect of eliminating the double-declining balance depreciation method. And if enacted may have the actual result of reducing the current level of 20 percent per year depreciation to 15 percent. So we are going in the wrong direction here in terms of the global competitive reality that we face.

We are competing with companies who in some cases are depreciating equipment over a 1 to 1½ year period.

Mr. CHRISTENSEN. When Speaker Gingrich and Majority Leader Armey introduced the bill in the previous years, I was not around here. I am new to Congress and to this committee. How did that do on vote totals? Do you know?

Mr. ROSS. I personally do not know. Counsel advises me that it has never been formally considered for a vote.

Mr. CHRISTENSEN. It was locked up in committee, maybe? And do you know what committee that was in?

Mr. ROSS. Ways and Means.

Mr. CHRISTENSEN. Ways and Means? Amazing. I wonder if there is anything we can do to get it out.

We thank you for your testimony.

Mr. ROSS. The questions were excellent.

Thank you for the opportunity to address them.

Mr. MCCRERY. Mr. Coyne—this is the last—thank you.

Mr. Chambers, one quick question. With respect to the item that Mr. Hancock was asking you about with respect to the interpretation by IRS that the lease agreement really amounts to a sale and you have to pay taxes on the full amount of the object that you are leasing. Has that always been the case?

Mr. CHAMBERS. No, that has not always been the case. That has surfaced since 1986 when they changed the Tax Code and did away

with the installment sales accounting provision. It has surfaced more readily in the last 3 to 4 years, however. It has become the number one topic, the audits, as they do the audits on the industry.

Mr. MCCRERY. So this is a problem that is just now coming to the fore.

Mr. CHAMBERS. A fairly new problem and a very significant problem.

Mr. MCCRERY. Thank you all gentlemen for your excellent testimony. We appreciate very much your being with us today.

[Whereupon, at 4:37 p.m., the hearing was adjourned, to reconvene at 10 a.m., Tuesday, January 31, 1995.]

SAVINGS AND INVESTMENT

TUESDAY, JANUARY 31, 1995

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, D.C.

The committee met, pursuant to call, at 10 a.m., in room 1100, Longworth House Office Building, Hon. Bill Archer (chairman of the committee) presiding.

Chairman ARCHER. If we could ask our guests to take seats. Today's hearing will consider the portion of the Contract With America concerning the American dream savings account. We all realize that in the last several years, our savings rate in the United States has been entirely too low. The low savings rate adversely affects our standard of living, as well as business' ability to compete in the global marketplace.

The Contract With America has several tax incentives intended to stimulate savings, investment and growth. One of those incentives is the American dream savings account. It is unique and innovative in the way that it uses the current IRA provisions. It appeals to a broad range of taxpayers by granting preferential treatment for distributions that are used for such desirable purposes as educating one's family, purchasing a first home, or meeting emergency medical needs.

By granting tax benefits to distributions that are for worthy purposes, it encourages a broad spectrum of taxpayers to use the dream savings account. The American dream savings account also encourages owners of existing IRAs to transfer their current IRA account balances to the American dream savings account by granting these transfers special tax treatment.

One criticism has been that the dream savings account is backended; that is, the tax benefit is delayed until the funds are withdrawn. In contrast, the current IRA, which would continue to be available, is called frontloaded because the tax benefit is granted when the contribution is made. However, in a recent Boston Globe article, my good friends and noted economists Martin and Kathleen Feldstein noted that the American dream savings account can produce as much benefit as the traditional frontloaded IRA. I hope that some of our witnesses today will comment on this aspect of this new approach. I ask unanimous consent to make the Feldsteins' article a part of the record.

[The following was subsequently received:]

Opinion

Good news for savers

MARTIN FELDSTEIN AND KATHLEEN FELDSTEIN

THERE IS GOOD NEWS FOR SAVERS IN the Republican Contract with America. A key promise of the contract is for a new and better kind of individual retirement account (IRA) called the American Dream Savings Account. Since President Clinton has now signaled his willingness to support these new IRAs, it seems a sure bet to pass in the early months of the new Congress.

The increased saving that the American Dream program is likely to generate in the years ahead means that the new accounts will be good for economic growth as well as for individual savers.

The favorable tax treatment of savings made IRAs popular and led to their rapid growth after Congress authorized them in 1974. But the Tax Reform Act of 1986 sharply limited eligibility by excluding taxpayers with incomes over $50,000 (or $35,000 for single taxpayers) who participate in a pension at work.

The new legislation will give every employee the opportunity to have an ADS account that is actually a better deal than the traditional IRA. And those who are currently eligible for a traditional IRA will be able to have both the traditional IRA and a new ADS account as well.

The new ADS accounts are more appealing than traditional IRAs because funds can be withdrawn without penalty for spending on first-time home purchases, higher education and medical care. There is, however, a difference in the timing of tax savings that causes some skeptics to doubt whether the new ADS accounts will be as popular as the traditional IRAs. Unlike the immediate tax saving that results from a deposit in a traditional IRA, the tax savings in the ADS is "backloaded" and not immediately visible. The two methods are nevertheless really equivalent dollar for dollar in their value to a taxpayer. Moreover, the backloaded ADS accounts actually provide the opportunity to save a larger percentage of pretax income on favorable terms.

To understand why, let's look first at the rules of the two plans and then at an example of how they would work in practice. Under the traditional IRA, an eligible individual can deposit up to $2,000 a year and get an immediate tax break by not having to pay income taxes on the amount that is deposited in the IRA. The earnings on those savings in the form of interest, dividends and capital gains accumulate free of tax. When the funds are withdrawn, the taxpayer pays income taxes on the initial deposit as well as on all the accumulated earnings.

In contrast, the ADS account offers no immediate tax break but the accumulated funds in the account are free of all tax when they are withdrawn. The maximum individual contribution would again be $2,000, but it would have first been counted in taxable income.

To see why the two methods are really dollar-for-dollar equivalent, let's look at an example. Consider a 45-year-old employee with a marginal tax rate of 28 percent who decides to put $1,000 into a traditional IRA. If that saving is invested in a long-term bond yielding 8 percent and accumulates until the employee withdraws the funds at age 75, the initial $1,000 grows to an amazing $10,062. If the funds are withdrawn at that point, the employee will pay a 28 percent tax on the total accumulated savings, or $2,817. That leaves the employee with $7,245, on an initial investment of $1,000.

But the employee didn't really give up the chance to spend $1,000 at the time of the initial deposit. If that money had not been put into an IRA, the individual would have had to pay taxes of $280 before using the money for consumption. So one way to interpret the traditional IRA is to think of the individual giving up $720 of consumption today to get $7,245 of consumption 30 years from now.

Now think about what would happen to the same individual who puts savings into an American Dream Savings account after paying income taxes on his or her full income. Putting an after-tax $720 into an ADS account means giving up the same amount of current consumption as putting $1,000 into a traditional IRA. If the savings are invested in the same way and withdrawn at age 75, the $720 in the ADS account will have grown to $7,245. And since no further taxes are due, the actual spendable return on the ADS account is indeed exactly the same as in the traditional IRA.

Because depositing $720 in an ADS account produces as much retirement consumption as $1,000 deposited in a traditional IRA, while the limit on contributions is $2,000 to either plan, the new ADS plan has the advantage that savers can accumulate more retirement income with the new ADS plan than with a traditional IRA.

We're sold on the new ADS accounts as an attractive way to encourage saving. We're also convinced from studies of the experience with traditional IRAs that such accounts do raise the national saving rate even if the loss of tax revenue causes the budget deficit to rise. So the new ADS accounts are indeed a good place to begin a legislative shift to policies that favor capital formation and growth.

Martin Feldstein, the former chairman of the Council of Economic Advisers, and his wife Kathleen, also an economist, write frequently together on economics.

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Chairman ARCHER. I now recognize our colleague, Jim McDermott, for an opening statement on behalf of the minority.

Mr. MCDERMOTT. Thank you, Mr. Chairman. I ask unanimous consent to revise and extend my remarks.

I think you can tell by the number of Democrats here how much we think this hearing really means. Clearly, the minority believes that the majority is going to roll a bill out of here with no language, no numbers, and it really is the American dream. I think that this might best be called the peyote savings account act, because when I was a kid, I remember opening my first bank account; and the bank gave away Lincoln heads, and you could put your pennies in those Lincoln heads and you could save and some day, if you put your pennies in that head, you were going to be wealthy and live happily ever after.

Now, in a society where, increasingly, people do not have pensions, in which 1 million people every year are losing their health insurance, in which there is no long-term care in a society where everybody is living longer and longer—our medical system has created a population that is living well into their eighties—and in which higher education is costing so much that even physicians come out of medical school $150,000 in debt, to say that you can put a little bill through the Congress here and reestablish the American dream is simply nonsense.

I come from the party that provided Social Security, that provided loans for houses, that provided the GI bill of rights, that provided a whole series of public programs that made the American dream possible, and most of us in this room, my generation especially, were the beneficiaries of these programs on 1,000 different levels.

Now, what this says is—and you have got to remember, this is in a context where we already have IRAs for people earning less than $35,000 in income for singles, and $50,000 for couples. We are talking about extending IRAs up to the top of the income ladder in this country. It is simply a benefit for rich folks. These new ADSAs are not going to change the lives of the people in this country that are struggling with the American dream. Because in Seattle today, if you want to buy a house, a starter house costs more than $100,000 in Ballard, which is the area where you start, or Wallingford, so that means you have got to come up with ten grand.

Now, if you are making $35,000, raising a family and trying to come up with ten grand, using this IRA as the basis for buying that house simply is never going to make it. Most of us know that our children—my kids are 28 and 26—will not buy houses unless their father or their mother can back the loan for them, or put up the downpayment. And to say that you are going to create this savings account is simply giving them a dream, albeit everybody ought to have a dream, but there ought to be some reality to it.

The reality of this is that in this Congress we are going to pass this bill out with this "dream savings account" in it at the same time that the Appropriations Committee is sitting over in another building cutting Medicare, cutting Medicaid, cutting student loans, cutting HUD—all the programs that make it possible for people to actually participate in the American dream.

And I say that this committee will be fools to pass this bill out if they don't know how it is going to be paid for. Because if you are going to balance the budget and cut taxes, as this does, and give people tax savings or benefits without understanding what the cuts are in the rest of budget, you are simply putting the American dream further out of people's reach.

For that reason, Mr. Chairman, most of the members of the Democratic side didn't bother coming, because this is just plain smoke and mirrors.

Thank you.

Mr. THOMAS. Mr. Chairman.

Chairman ARCHER. Without objection, any members who would like to enter a written statement in the record may do so. I believe Mr. Thomas wishes to do that.

Mr. THOMAS. Thank you, Mr. Chairman. This would be in support of H.R. 682, which is the companion bill to Senator Roth's S. 12. Thank you very much.

[The opening statements follow:]

STATEMENT OF THE HON. BILL THOMAS
COMMITTEE ON WAYS AND MEANS
January 31, 1995

Mr. Chairman, I am pleased that the Committee is finally getting an opportunity to consider restoring the savings incentives provided by the Individual Retirement Account. The "backloaded" IRA covered by the Contract With America is a good start but we should consider going beyond that and adopting the "Super IRA" proposal Congressman Neal and I introduced last week. Our bill, H.R. 682, is much like the "Super IRA" provisions many members of this Committee and of the House supported when they were included in H.R. 11 in 1992. Now, more than ever, we need to consider those provisions.

H.R. 682 provides a range of savings options for taxpayers to use and it eliminates a key concern some younger taxpayers feel when considering whether to open one of these accounts. H.R. 682 will phase out the income limits on making deductible contributions to IRAs, give homemakers the option of creating an IRA as large as that available to one working outside their home and creates a "backloaded" IRA like the Contract's so taxpayers can invest net income in return for tax-free earnings later on.

The need to expand savings is clear. Americans typically save less than people in other countries and the effect is to reduce families' security. A Merrill Lynch survey shows half of American families have less than $1,000 in net financial assets. Even those within ten years of retirement (ages 55 to 64) only have $6,880 in net financial assets such as checking, savings, IRAs or 401(k) savings.

Another survey shows that the 76 million Americans in the "Baby Boomer" group are saving at rates far below what they need to maintain their standard of living after retirement. When we consider the prospect that Social Security may run out of funds early in the next century, the security of the Baby Boomers looks poor indeed. We need to develop savings incentives that will make them more secure. I strongly support the use of the Individual Retirement Account for that purpose.

Tax-preferred savings accounts such as IRAs and 401(k) plans do increase savings. Viewed on a long term basis, taxpayers do contribute new savings to these accounts when the accounts are made available. While some "shuffling" of existing savings into tax deferred accounts may occur, one study indicates that as much as 66% of IRA investments comes from new savings. Few people have enough liquid assets to continue shuffling assets from one type of savings into tax-preferred accounts for very long.

A 1991 Money Magazine reader survey confirms the popularity of the "super IRA" truly is with the people we want to serve. An unusually high 23,000 Money readers responded to the survey. 97% said they would contribute to IRAs if IRAs were restored; the remaining 3% were largely already retired. 80% said they would contribute earned income, new savings, to their IRA. IRA popularity cuts across all income groups and people were more interested in IRAs than in capital gains.

The Money survey also shows why young people do not use IRAs today: risk avoidance. While many of the respondents indicated

they were not inclined to make early withdrawals, some three-quarters of the respondents in their 20s says they do not use IRAs because they do not want to lock away funds they cannot touch in emergencies or in meeting critical family needs. The super IRA, with its elimination of the 10% early withdrawal penalty for withdrawals for education, medical costs, buying homes, long-term care and times of unemployment, provides a savings vehicle which gives working families the liquidity they want. At the same time, it provides a savings vehicle taxpayers cannot easily invade to fund current consumption of consumer goods.

H.R. 682 provides savers with a variety of incentives and options. People deserve choices in managing their money and I hope my colleagues will join me in seeking H.R. 682's passage this year.

STATEMENT OF REPRESENTATIVE JIM RAMSTAD
WAYS AND MEANS COMMITTEE
HEARING ON CONTRACT WITH AMERICA

Mr. Chairman, as I have stated at several of these hearings, I am deeply concerned about our nation's declining savings rate.

The United States household saving rate compares miserably to that of our partners in the Group of Seven industrialized nations (G-7). In 1993, the U.S. household saving rate was just half that of the next lowest G-7 member, at 4.4%.

Relieving the tax burden on those who invest in IRAs will prompt Americans to save more of their income than they currently do. I firmly believe that in addition to enacting tax policy that encourages rather than discourages saving, we must keep that policy in place over the long-term. Nothing is more frustrating and disheartening to American taxpayers than constant changes in the tax code that severely limit their ability to plan for the future.

I am pleased we have a panel of distinguished experts to discuss these issues today.

I thank you all very much for being here today and look forward to your testimony.

Chairman ARCHER. Senator Roth, you are our first witness today, and we are delighted to have you over here on the House side. I know that you, early on, were one of the initiators of the back-ended IRA. We welcome your testimony.

STATEMENT OF HON. WILLIAM V. ROTH, JR., A U.S. SENATOR FROM THE STATE OF DELAWARE

Senator ROTH. Well, thank you, Mr. Chairman and members of the Ways and Means Committee. It is particularly a pleasure to be here today with our new chairman. I appear before this committee to testify concerning the need to encourage increased savings in America.

I believed back in April 1989 when I last testified before this committee, as I do now, and as Federal Reserve Chairman Alan Greenspan has since confirmed, that our national savings crisis is the key domestic economic policy problem of this country.

A few months after offering that testimony, in an effort to increase our Nation's rate of saving, I introduced a little-known proposal referred to as the backloaded IRA. And my idea was rather simple. By offering Americans an individual retirement account, an IRA that would allow them to determine when to take their tax break, we would encourage savings, investment and economic growth; and at the same time, we would decrease our dependency on foreign capital, and we would ease somewhat the tax burden that was growing on the backs of middle-class Americans. Little did I know that in 1994, House Republicans would move forward with this same basic IRA plan, including it in their popular "Contract With America." Indeed, this is an idea whose time has come, and I am here today to offer strong encouragement for this new kind of savings account, the backloaded IRA.

In the Senate, I have reintroduced my original legislation, S. 12, now called the "Roth-Breaux super IRA." Companion legislation has been introduced here in the House by Congressmen Bill Thomas and Richard Neal (H.R. 682), both members, of course, of this committee. This is encouraging, as is the fact that well over half of the Senate has cosponsored this legislation in each of the last two sessions of Congress. In fact, even the President of the United States has joined us.

Indeed, the savings issue appears to be getting the attention it deserves. And I believe the reason why is clear: America's rate of personal saving is last among the G–7 nations. Between 1992 and the present, the rate has plunged from 6 to 4 percent, translating into a drop of personal savings of $100 billion. At the same time, taxes have steadily increased, consuming more than 40 percent of the average family's income, when we consider Federal, State and local obligations.

The IRA I introduced will not only create powerful incentives to increase our Nation's rate of savings, but it will provide tremendous tax benefits. It will give all Americans the option to choose between tax-deductible contributions, traditional frontloaded IRAs, or contribute to a new backloaded IRA. Contributions to this new type of IRA would not be deductible, but earnings would not be taxed when they are withdrawn. It is important to note, Mr. Chairman, that under our bill, these IRA contributions, contributions up

to the full $2,000, can also be made by all spouses who work at home.

By making IRAs more available and more attractive, we address four pressing national problems: The extremely low U.S. personal savings rate; the lack of capital for investment, economic growth and job creation; the high tax burden carried by American families, including the double taxation of savings; and the lack of family resources to pay for higher education expenses, home purchases and medical care costs. Each of these areas will be improved with the super IRA.

We will increase the rate of personal savings. This increase in savings will stimulate economic growth. As Professor Henry S. Rowen of Stanford explains, an increase in the net national savings rate by 5 percent of GDP would increase real wages of the next generation by about 15 percent above its trend, a major increase.

By giving American families tax incentives to save, we will offer a very productive and beneficial way to ease some of the tax burden they are now carrying. And to help our families pay for necessary costs, like first-time homes, education and medical bills, our proposal allows family members to make penalty-free IRA withdrawals across generations to help other family members.

Mr. Chairman, my time has expired, but I would ask that my full statement be included as if read.

Chairman ARCHER. Without objection, your entire statement will be included in the record; and we appreciate your testimony.

Are there any questions, anyone that would like to question? Raise your hand.

Thank you, Senator.

Senator ROTH. Thank you, Mr. Chairman. It was a pleasure to be here.

[The prepared statement and attachment follow:]

SENATOR WILLIAM V. ROTH, Jr.
WAYS & MEANS COMMITTEE TESTIMONY
AMERICAN DREAM SAVINGS ACCOUNT
JANUARY 31, 1995

Mr. Chairman and Members of the Ways and Means Committee, in April of 1989 -- almost six years ago -- I appeared before this committee to testify concerning the need to encourage increased savings in America. I believed then, as I do now -- and as Federal Reserve Chairman Alan Greenspan has since confirmed --that our national savings crisis is "the key domestic economic policy problem of this country." A few months after offering that testimony, in an effort to increase our nation's rate of saving, I introduced a little-known proposal, referred to as the "backloaded" IRA.

My idea was rather simple: by offering Americans an Individual Retirement Account, an IRA that would allow them to determine when to take their tax break, we would encourage savings, investment and economic growth. At the same time, we would decrease our dependency on foreign capital. And we would ease, somewhat, the tax burden that was growing on the backs of middle class Americans.

Little did I know then that in 1994, House Republicans would move forward with this same basic IRA plan, including it in their popular "Contract with America." Indeed, this is an idea whose time has come, and I'm here today to offer strong encouragement for this new kind of savings account -- the "backloaded" IRA.

In the Senate, I have re-introduced my original legislation -- S. 12 -- now called the "Roth-Breaux Super IRA." Companion legislation has been introduced here in the House by Congressmen Bill Thomas and Richard Neal (H.R. 682), both members of this committee. This is encouraging, as is the fact that well over half of the Senate has co-sponsored this legislation in each of the last two sessions of Congress. In fact, even the President of the United States has finally joined us. Indeed, the savings issue appears to be getting the attention it deserves!

And I believe the reason why is clear: America's rate of personal savings is last among the G-7 nations. Between 1992 and the present, the rate has plunged from six percent to four percent, translating into a drop of personal savings of about $100 billion. At the same time, taxes have steadily increased, consuming more than 40 percent of the average family's income, when we consider federal, state and local obligations.

The IRA I introduced will not only create powerful incentives to increase our nation's rate of saving, but it will provide tremendous tax benefits. It will give all Americans the option to choose between tax deductible contributions to traditional "frontloaded" IRAs, or contribute to a new "back-loaded" IRA. Contributions to this new type of IRA would not be deductible, but earnings would not be taxed when they are withdrawn. It's important to note, Mr. Chairman, that under our bill, these IRA contributions -- contributions up to the full $2,000 -- can also be made by <u>all</u> spouses who work at home.

By making IRAs more available, and more attractive, we address four pressing national problems: (1) the extremely low U.S. personal savings rate; (2) the lack of capital for investment, economic growth and job creation; (3) the high tax burden carried by American families, including the double taxation of savings; and, (4) the lack of family resources to pay for higher education expenses, home purchases and medical care costs.

Each of these areas will be improved with the Super IRA. We will increase the rate of personal savings. This increase in savings will stimulate economic growth. As Professor Henry S. Rowen of Stanford explains, "An increase in the net national savings rate by five percent of GDP would increase real wages of the next generation by about 15% above its trend, a major accomplishment!"

By giving American families tax incentives to save we will offer a very productive and beneficial way to ease some of the tax burden they are now carrying. And to help our families pay for necessary costs like first-time homes, education and medical bills, our proposal allows family members to make penalty-free IRA withdrawals across generations to help other family members. Parents and grandparents can help children and grandchildren; children and grandchildren can help parents and grandparents.

This is how we should be preparing for the future, by adopting legislation that provides incentives for self-reliance, thrift, investment and economic growth. Strengthening the Individual Retirement Account will do just this. And I appreciate the strong support we're seeing toward achieving these objectives.

Mr. Chairman, I thank you for the opportunity to testify before you on this important legislation. I would ask that you also include a copy of a side-by-side comparing the provisions in the American Dream Savings Account with the provisions in the Roth-Breaux Super IRA. Thank you.

COMPARISON OF INDIVIDUAL SAVINGS PROVISIONS IN THE SAVINGS AND INVESTMENT INCENTIVE ACT OF 1995 (S. 12) AND THE CONTRACT WITH AMERICA (H.R. 6)

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Prepared by the Staff of the Joint Committee on Taxation
January 30, 1995

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INTRODUCTION

This document, prepared by the staff of the Joint Committee on Taxation, provides a comparison of individual savings provisions of present law; the Savings and Investment Incentive Act of 1995 (S.12), introduced by Senator Roth and Senator Breaux on January 4, 1995; and the American Dream Restoration Act (H.R. 6), introduced by Mr. Crane and others on January 4, 1995, as part of the Contract with America.

Item	Present Law	S. 12	Contract With America (H.R.6)
1. **Deductible IRA contributions**	An individual may make deductible contributions to an IRA up to the lesser of $2,000 or the amount of the individual's compensation if the individual is not an active participant in an employer-sponsored qualified retirement plan (and, if married, the individual's spouse also is not an active participant). If the individual is an active participant, the $2,000 limit is phased out between $40,000 and $50,000 of AGI for married taxpayers and between $25,000 and $35,000 of AGI for single taxpayers.	Income limitations:--The bill would increase the AGI limits for IRA deductions for active participants in 1995, 1996, 1997, and 1998. Thereafter, the bill would repeal the limits on IRA deductions for active participants. In the case of married taxpayers, for years before 1999, the IRA deduction for active participants would be phased out between the following AGI amounts: for 1995, $65,000 and $75,000; for 1996, $90,000 and $100,000; for 1997, $115,000 and $125,000; and for 1998, $140,000 and $150,000. The bill would also provide that a person is not considered an active participant merely because his or her spouse is an active participant in an employer-sponsored retirement plan. In the case of single taxpayers, for years	The bill would retain present law.

Item	Present Law	S. 12	Contract With America (H.R.6)
		before 1999, the IRA deduction for active participants would be phased out between the following AGI amounts: for 1995, $50,000 and $60,000; for 1996, $75,000 and $85,000; for 1997, $100,000 and $110,000; and for 1998, $125,000 and $135,000. Coordination with elective deferrals:--The bill would provide that the IRA deduction limit for any individual is coordinated with the limit on elective deferrals to section 401(k) plans (and similar plans). Thus, an individual's deductible contributions to an IRA and elective deferrals could not exceed the annual limit on elective deferrals. **Effective dates.**--The phase up of the income limits and the rule providing that an individual is not an active participant merely	

Item	Present Law	S. 12	Contract With America (H.R.6)
		because the individual's spouse is an active participant would be effective for years beginning after December 31, 1994. The repeal of the limits on deductible IRA contributions for active participants would be effective for years beginning after December 31, 1998. The coordination of the IRA deduction limit with the limit on elective deferrals would be effective for years beginning after December 31, 1994.	
2. **Inflation adjustment for IRA deduction limit**	The $2,000 limit on IRA contributions is not indexed for inflation.	The bill would index annually the $2,000 limit on IRA contributions in $500 increments. **Effective date.**--The limit on IRA contributions would be indexed beginning after 1995.	The bill would retain present law.

Item	Present Law	S. 12	Contract With America (H.R.6)
3. **Spousal IRAs**	In the case of a married individual whose spouse has no compensation (or elects to be treated as having no compensation) the $2,000 limit on IRA contributions is increased to the lesser of $2,250 or the individual's compensation.	Under the bill, the compensation of both spouses would be taken into account in determining the IRA deduction limit for each spouse. Thus, a couple would be permitted to make up to a total of $4,000 of IRA contributions (up to $2,000 for each spouse), if the aggregate compensation of the couple is at least $4,000. **Effective date.**--The provision would be effective for years beginning after December 31, 1994.	The bill would retain present law.
4. **IRA investments in coins and bullion**	IRAs are not permitted to invest in certain collectibles. The acquisition by an IRA of a collectible is treated as a distribution in an amount equal to the cost of the collectible. Collectibles are defined as any work of art, rug or antique, metal or gem, stamp or coin, alcoholic beverage, or any other	The bill would permit IRAs to acquire any (1) coin certified by a recognized grading service and traded on a nationally recognized electronic network or listed by a recognized wholesale reporting service and which is (or was at any time) legal tender in the country of issuance or issued under the laws of any State, or	The bill would retain present law.

Item	Present Law	S. 12	Contract With America (H.R.6)
	tangible personal property specified by the Secretary of the Treasury. The prohibition on investment in collectibles does not apply to certain U.S. commemorative gold and silver coins or coins issued under the laws of any State.	(2) gold, silver, platinum, or palladium bullion, if the coin or bullion is in the possession of the IRA trustee. **Effective date.**--The provision would be effective for years beginning after December 31, 1994.	
5. **Nondeductible tax-free IRAs**	No provision. (However, present law does permit individuals to make nondeductible contributions to an IRA to the extent an individual is not permitted to (or does not) make deductible contributions. Earnings on such contributions are includible in gross income when withdrawn.)	In general.--The bill would repeal the present-law rules relating to nondeductible contributions and replace them with new provisions that permit individuals to make nondeductible contributions to IRA Plus accounts.	In general.--The bill would permit individuals to make nondeductible contributions to an American Dream Savings (ADS) account.
		Contribution limit.--An individual could make contributions to an IRA Plus to the extent they do not make deductible contributions to an IRA.	Contribution limit.--The maximum annual contribution that could be made to an ADS account would be the lesser of $2,000 or the individual's

Item	Present Law	S. 12	Contract With America (H.R.6)
		For this purpose, the active participant rules and the rule coordinating IRA contributions with elective deferrals would be disregarded in determining the maximum deductible IRA contribution the individual is permitted to make.	compensation. This amount would be in addition to any contributions that may be made to present-law IRAs. The $2,000 limit would be indexed annually for inflation beginning in 1996. Inflation adjustments would be rounded to the nearest $50.
		Contributions for nonworking spouse.--The compensation of both spouses would be taken into account in determining the contribution limit for each spouse.	Contributions for nonworking spouse.--Same as S. 12.
		Contributions after age 70-1/2.--The bill would not permit contributions to be made to an IRA Plus account after age 70-1/2.	Contributions after age 70-1/2.--The bill would permit contributions to be made to an ADS account after age 70-1/2.
		Taxation of distributions.--Distributions would not be includible in income to the extent attributable to contributions that have been in the IRA Plus	Taxation of distributions.--Distributions would not be includible in income if the distribution (1) is made at least 5 years after the individual first

Item	Present Law	S. 12	Contract With America (H.R. 6)
		account for at least 5 years. The bill would provide rules to determine how earnings are allocated to contributions made at different times and ordering rules to determine the order in which contributions are withdrawn.	made a contribution to any ADS account and (2) is (a) made on or after the date on which the individual attains age 59-1/2, (b) made to a beneficiary after the death of the individual, (c) attributable to the individual's being disabled, or (d) is for the purchase of a first home, higher education expenses, medical expenses, or long-term care insurance premiums.
		Rollover contributions.--The bill would permit amounts withdrawn from IRAs to be transferred into an IRA Plus. The amount transferred would be includible in gross income in the year the withdrawal was made, except that amounts transferred to an IRA Plus before January 1, 1997, would be includible in income ratably over a 4-year period. The 10-percent early withdrawal tax would not apply to	Rollover contributions.--The bill would permit amounts in IRAs to be rolled over to an ADS account if the rollover occurs before January 1, 1998. The amount otherwise includible in income due to the IRA withdrawal would be included in income ratably over a 4-year period. The 10-percent early withdrawal tax would not apply to such rollovers.

Item	Present Law	S. 12	Contract With America (H.R.6)
		amounts transferred from an IRA to an IRA Plus. **Effective date.**--The provision would be effective for taxable years beginning after December 31, 1994.	**Effective date.**--The provision would be effective for taxable years beginning after December 31, 1995.
6. **Other**	A 10-percent additional tax applies to distributions from IRAs and tax-qualified retirement plans made before age 59-1/2, unless the distribution is on account of death or disability or is made in the form of periodic payments. In the case of tax-qualified retirement plans, the 10-percent additional tax also does not apply to distributions made to an employee after separation from service after age 55 or to distributions used to pay medical expenses of the employee and his or her dependents that exceed 7.5 percent of AGI.	The bill would exempt from the early distribution tax distributions from IRAs, elective deferrals (and earnings thereon) under qualified cash or deferred arrangements, and tax-sheltered annuities used for first-time home purchase or education expenses. In addition, the bill would expand the exception for extraordinary medical expenses so that it applies to expenses of all children and grandchildren of the employee or the employee's spouse and all ancestors of the employee or the employee's spouse, whether or not they are a dependent for income tax purposes. The bill also would exempt from the tax	No provision.

Item	Present Law	S. 12	Contract With America (H.R.6)
		distributions from IRAs to persons who have been receiving unemployment compensation for at least 12 weeks. **Effective date.**--The provision would be effective for distributions after the date of enactment.	

Chairman ARCHER. Our next two witnesses are Senator Kay Bailey Hutchison from the State of Texas and Senator Barbara Mikulski from the State of Maryland. If you would like to take seats at the witness table, we would be pleased to hear from you.

Is Senator Mikulski here?

Senator HUTCHISON. I have not seen her this morning. She was planning to come when I talked to her yesterday. I am sure she will be here, and I hope that she makes it before we finish.

Chairman ARCHER. Senator Hutchison, we are delighted to have you before our committee. We know that you have taken the lead in moving for homemaker IRAs. We would be pleased to hear you tell us about that. You may proceed.

STATEMENT OF HON. KAY BAILEY HUTCHISON, A U.S. SENATOR FROM THE STATE OF TEXAS

Senator HUTCHISON. Thank you, Mr. Chairman. I am very pleased to be here with you as chairman of the Ways and Means Committee. I have worked with you and known you for a long time, and I know you are going to do a terrific job for the people and the taxpayers of America.

I want to add another dimension to the bill that you are discussing now, and I hope that you will be able to add homemakers into the present system in the bill before you today. It would mean a lot to the homemakers of America to know that the Congress of America has acknowledged that work done inside the home is every bit as important as work done outside the home, if not more so.

This bill would just very simply—and let me say that Senator Mikulski and I are the prime cosponsors in the Senate, a similar bill has—in fact, an exact bill has been introduced in the House by Congresswomen Nancy Johnson, Jennifer Dunn, Barbara Kennelly, and it—it is a very bipartisan effort. We have 57 sponsors in the Senate at this time, and I believe that there is really no one who is against this bill.

What our bill would do is allow homemakers simply to set aside $2,000 a year, just as those of us who work outside the home are able to do. Today, under current law, a single-income, married couple saving $2,250 per year, which is the maximum, for 30 years would have $188,554 for retirement if you assume 6 percent average interest. But if that couple is permitted to save $4,000 a year, after 30 years they will have $335,207, an increase in savings of almost $150,000.

According to the Bureau of Labor Statistics, 23 percent of all women over the age of 16 are married homemakers. So it is obvious that their retirement needs for their families are the same as two-income earner couples. In fact, their needs may be greater; because the homemaker stayed home to raise the children, a single-income couple may have earned less money to set aside for the future. We can help them meet that need by enacting this legislation.

Everyone knows that women go in and out of the work force at a greater rate than men, because they have children. Many times they stay home for a few years, so they don't have the total accumulation that people who work outside the home continually would have. So I think it is very important that we acknowledge that this is a matter of equity and it is good economics. Although there is

a modest cost in the bill, right now about $55 million per year, for which we can suggest offsets—but I know that you are aware of all of the offsets that could be gotten——

Chairman ARCHER. Don't be bashful, Senator.

Senator HUTCHISON [continuing]. But for $55 million a year, I actually think if we had dynamic scoring, it would be a net plus, not a minus, because we all know if you have more capital formation, that creates more jobs which creates more revenue. So I hope that you will look at this as a matter of equity and a matter of good economic policy.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF UNITED STATES SENATOR KAY BAILEY HUTCHISON

COMMITTEE ON WAYS & MEANS
HOUSE OF REPRESENTATIVES

January 30, 1995

Mr. Chairman, thank you very much for allowing me and my colleague, Senator Barbara Mikulski of Maryland, to appear today. Last Thursday, Senator Mikulski and I, along with 55 co-sponsoring Senators, introduced a bill that will allow the homemakers of this country to make fair, fully deductible Individual Retirement Account contributions. Representatives Johnson, Kennelly, and Dunn introduced identical legislation in the House. The bills will allow equal IRA contributions by Americans that work at home -- women, and a growing number of men, who have suffered unfairly under an out-of-date section of the tax code.

Under the current IRA rules, single-income married couples are limited to a deductible IRA contribution of $2,250 each year; $2,000 for the working spouse, and $250 for the homemaker. But if both spouses in a household work outside the home, each is permitted to contribute up to $2,000 annually to an IRA -- that's a combined contribution of $4,000. The bill does not change the current pension limitation of section 219(g), which phases-out the deductibility of IRA contributions for married active participants in retirement plans if they earn more than $40,000 a year.

Under current law, a single-income married couple saving $2,250 each year for thirty years will have $188,554 for retirement, at six percent interest. If that couple is permitted to save $4,000 a year, after 30 years they will have $335,207 -- an increase in savings of almost $150,000.

According to the Bureau of Labor Statistics, 23% of all women over the age of sixteen are married homemakers. It's obvious that their family's retirement income needs are the same as a two-income couple's. In fact, their needs may be even greater -- because the homemaker stayed home to raise the children, a single-income couple may have earned less money to set aside for the future. We can help them meet that need by giving them the incentive and opportunity to save.

Women have longer life expectancies than men, and make less money for the same work. They leave work to have children and care for their families, and then return to find that they have fallen behind on their retirement savings. With lower pension and social security benefits, homemakers have much less for retirement. We must not deny them their best opportunity to save.

I support many of the tax policy changes that have been proposed this year, including expanding IRAs. But before we expand IRAs or make other changes, we need to make IRAs fair. We must permit homemakers to save, like all other Americans, for their retirement.

It is time the Congress recognizes that work done inside the home is as important as work done outside the home, if not more so. I urge the Committee to include this legislation in the Contract tax bill so that American homemakers can begin saving this year.

Thank you, Mr. Chairman.

Chairman ARCHER. Thank you, Senator.

Senator Mikulski, we are delighted to have you with us this morning, and we would be pleased to hear your testimony, and you may proceed.

STATEMENT OF HON. BARBARA A. MIKULSKI, A U.S. SENATOR FROM THE STATE OF MARYLAND

Senator MIKULSKI. Thank you very much, Congressman Archer. It is a delight to come before the Ways and Means Committee, and I congratulate you on your chairmanship and look forward to working with you, both on the IRA equity for homemakers, as well as the super IRA, because I feel one of the most important national objectives we must accomplish is to encourage savings and investment and to give, if you will, "good guy" and "good gal" bonuses to ordinary, middle-class people. That is why I am delighted to join with my colleague, Senator Kay Bailey Hutchison, and members also of the Ways and Means Committee on the IRA Equity Act for Homemakers.

Ladies and gentlemen of the Ways and Means Committee, all women work. Work is work, whether it is done inside the home or outside the home. Senator Hutchison has given a very clear and concise and crisp discussion of this legislation, and I just want to amplify why it is important that we do it.

The Hutchison-Mikulski bill in the Senate has stayed simple and to the point. Why? What we want to say is this: Homemakers who stay at home work. They perform some of the most important and valuable work that is done in the United States of America, child rearing. In this, equity demands that they get the same IRA opportunity as their income-earning spouse.

This legislation accurately reflects their values. It gives help to those who are willing to practice self-help through saving. It acknowledges the value of motherhood and the work that is done in the home as being important to the American society.

Not all work is done in the marketplace. Productivity in the workplace is the result of the work of mothers in the home, preparing America's workers and leaders. We often don't count what counts. The gross domestic product just looks at the marketplace. We need to stand up and count the work that goes on in the home.

Motherhood has always been important and today we are saying it is absolutely important. When we say, honor your father and your mother, it should not only be a commandment, but a public policy. The law should be clear that moms and dads will be rewarded—will not only be rewarded now, but in their future and in their retirement years. Current rules of government do not support this. The Hutchison-Mikulski bill acknowledges the pattern of women working in and out of the marketplace.

This is an empowerment strategy for women. Many women work some time in the marketplace, are at home for child rearing, and then back in the marketplace. This essentially constitutes a portable benefit package for them. They don't have linear careers, they don't follow that pattern where, once in the marketplace, they stay in the marketplace. So what we are able to do is analyze that situation and see that often when it comes to retirement, because women take time out to be in the home, or always stay in the

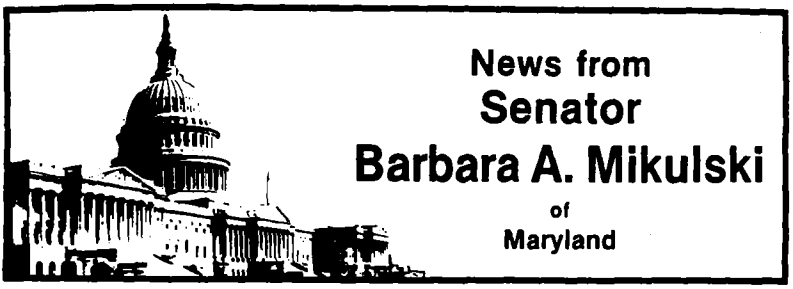
home, they don't have a pension plan; and if they do, it is spotty, erratic and most often skimpy.

This is not a recipe for a relaxing Gucci retirement. It is a plan to make sure that ordinary women who choose to be in the home—or men, because it is not gender identified—will be able to give help to themselves and practice self-help.

So, Mr. Chairman, I am going to leave my testimony here for you. I have gone into it in great detail. But I like this because it accomplishes several national goals, and I am happy to join with the architect of the legislation, Senator Kay Bailey Hutchison.

Chairman ARCHER. Without objection, both of your statements will be inserted in the record in their entirety.

[The prepared statement follows:]



FOR IMMEDIATE RELEASE
January 30, 1995

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STATEMENT OF SENATOR BARBARA A. MIKULSKI ON IRA EQUITY LEGISLATION

I am delighted to work on a bi-partisan basis with Senator Hutchison again to pass IRA Equity legislation.

Work is work, whether it is done inside the home or outside the home. And we should reward work. With this legislation we do.

I like this legislation because it reflects our values; it gives help to those who practice self-help.

It acknowledges the value of motherhood and it acknowledges that work done in the home is important to American society. Not all work is done in the marketplace. A substantial amount of the most important work of America goes on in the home.

This legislation will provide the same IRA tax deduction to stay-at-home moms and dads as is available now to those who earn an income.

Current law allows workers to set aside up to $2000 a year in an IRA -- but only if they get an income. So two-income couples can contribute $4000.

But one-earner couples, where one spouse stays home to raise the kids, well, the best they can contribute to their IRA each year is $2250.

Our IRA Equity bill says every couple gets the full $4000 contribution. Period.

Motherhood has always been important. Today we're seeing it's absolutely important.

I believe that when we say honor your father and your mother it should not only be a commandment, but a public policy. The law should be clear that mom and dad will not only be rewarded now, but in the future, in their retirement years.

For someone whose work is as a full-time mom, it's not only an occupation, it's a pre-occupation.

When we're talking about productivity in the workplace we need to remember that the work of mothers today is preparing America's workers and leaders of tomorrow.

Often in our society we don't count what counts. We look at the Gross Domestic Product, we look at what is done in the marketplace, but what is not counted is what is done in the home or what is done as volunteer work.

I happen to believe that one of the most important areas of productivity is the work that goes on in the home.

The current rules of government do not support this. We see this in the rules governing pension plans. And we continue to see inequity for women in the workplace in many ways, like bringing home smaller paychecks.

This is important pro-family legislation. It truly acknowledges the value of the family. It gives help to those who practice self-help. And it builds strong communities.

It also acknowledges the pattern of women as they work in and out of the marketplace. Many women do not have linear careers, with glittering resumes, tickets being punched and revolving rolodexes that take them on the path to glory.

Most women do the ordinary with enthusiasm, whether its raising their family or raising the productivity of the private sector in the marketplace. But because they work, and have their children, and return to the marketplace, often their pension plans are spotty, erratic, and most often, skimpy.

That is not a recipe for a relaxing retirement, but a plan for poverty.

Passing this legislation not only offers a measure of fairness and hope, it just makes good sense. It --

-- boosts our national savings,
-- helps women have the opportunity for a comfortable retirement, and
-- strengthens our commitment to family values.

I support this legislation because I want to put our values into pragmatic public policy, and I am pleased to join with my colleagues on a bipartisan basis to reward hard-working Americans.

I will continue to fight for passage of IRA Equity because it's time Congress puts the law where our values are.

# # #

Senator HUTCHISON. Mr. Chairman, could I add one thing?

Chairman ARCHER. Surely.

Senator HUTCHISON. We have a broad range of support for this bill from the American Association of University Women, the Business and Professional Women, the Concerned Women of America, the Eagle Forum and the Women's Political Caucus, among others. So I think that there is a broad range of political support, as well as support for the concept on the merits.

Chairman ARCHER. I think the fact that you and Senator Mikulski are sitting there side by side, both embracing this, is pretty good evidence that there is bipartisan support.

Senator MIKULSKI. We are pals.

Chairman ARCHER. Let me ask you, does your bill apply to all income levels? Can anyone qualify, irrespective of their annual taxable income?

Senator HUTCHISON. Yes, within the current law caps. We don't change current law, so that deductibility depends on the total income of the single-income earner family.

Chairman ARCHER. So you would limit it only to people under $35,000 a year, as under the current law?

Senator HUTCHISON. Well, for the deductibility, but of course anyone can contribute to an IRA, whether it is deductible or not.

Chairman ARCHER. So that is current law?

Senator HUTCHISON. Yes. It does not change current law.

Chairman ARCHER. OK. So you have a current law which permits a nondeductible $2,000 contribution, and you would add a deductible contribution. I assume that that would be in lieu of the $2,000 nondeductible contribution, or would it be in addition thereto?

Senator HUTCHISON. No, Mr. Chairman. This does not change current law standards. Everything that applies today would apply in the future. The one-income-earner couple's joint income would be the test for deductibility or not. So I am not adding deductibility where we don't now have it.

Chairman ARCHER. But what I am trying to determine is whether this would permit a $2,000 nondeductible and an additional $2,000 deductible?

Senator HUTCHISON. No.

Senator MIKULSKI. Mr. Chairman, just to clarify, under current law, a $2,000 contribution can be made. For the spouse at home, if you wish to add the spouse, you are capped at only being able to contribute $250, so it would be $2,250.

This would allow a $2,000 and a $2,000. The deductibility would only apply according to whatever standards the Congress ultimately decides, what will be the standards for deductibility.

Chairman ARCHER. How high could the family income be before you would not qualify for this new benefit?

Senator MIKULSKI. Whatever is in current existence would be that. And also if—in the super saver legislation, which I know the committee is considering, if it raises the income levels for deductibility, this will go by the same rules of the game as you establish for IRAs generally.

Chairman ARCHER. So this would go right along with the American dream savings account provision insofar as any limit to deductibility based on taxable income?

Senator MIKULSKI. That is right.

Senator HUTCHISON. Right. There is no change.

Chairman ARCHER. Senator Mikulski, did I understand you to say that you support the American dream savings account?

Senator MIKULSKI. No, I didn't support the American dream savings account. I said I supported legislation related to a super IRA, but I would hope that we could find common ground and bipartisan support on this, because we must encourage savings; there is no doubt about that.

The capital needs of the world when one sees what they are—even in our own country we must encourage capital formation. And we need—and that capital formation is going to come not only from big institutional accounts like pension plans, but ordinary people saving through ordinary instruments of savings in our country, whether it is savings accounts, CDs, mutual funds, the good old American way. I want to give help to those who are practicing self-help. And that is why I would support raising the income deductibility limits and what we can do to encourage that.

Chairman ARCHER. How would you distinguish between the super IRA and the American dream savings account?

Senator MIKULSKI. Well, Mr. Chairman, I am not prepared to answer that today, because I don't have my side-by-sides with me. But I don't want the headline news to be tomorrow that "Mikulski Supports the American Dream IRA."

I support the American dream, and then what the legislative framework will be, I think will be arrived at through bipartisan negotiation.

Chairman ARCHER. Well, my understanding is that there are differences between the American dream savings account and the super IRA.

Senator MIKULSKI. I am sure there is. I just haven't focused on the precise details this morning. I have already had two meetings in the commute from Baltimore. I wish all that was aerobic.

Chairman ARCHER. Thank you very much. Are there any questions from members?

Mrs. Kennelly.

Mrs. KENNELLY. Yes, thank you, Mr. Chairman.

The other night we heard Mr. Clinton really embrace IRAs. We have heard two Senators, in a bipartisan manner, embrace IRAs; and Ms. Dunn and Mrs. Johnson and I are sponsoring this bill on the House side. And, Mr. Archer, I understand you are going to let us move forward if at all possible, if it fits in the plans.

How are we doing, Mr. Archer?

Chairman ARCHER. How are we doing on moving this forward? Well, the committee, of course, will take action on this when we get into markup.

Mrs. KENNELLY. Thank you, Mr. Archer.

Chairman ARCHER. Mrs. Johnson, Ms. Dunn and yourself may offer an amendment to include this in the Contract, and it will be duly considered.

Mrs. KENNELLY. I thank you for this hearing, Mr. Archer.

May I just put on the record some of the figures that Mrs. Hutchison cites with regard to why this is a good idea?

Chairman ARCHER. Yes.

Mrs. KENNELLY. Yes.

[At the time of printing, no information was received.]

Chairman ARCHER. Apparently we have a number of people that want to question, so we will do it in the regular order.

Mr. Thomas.

Mr. THOMAS. Thank you very much, Mr. Chairman.

I want to thank both of you for this obvious plus in addition to the whole concept of IRAs. I think at this stage, it is less useful to talk about the American dream IRA, or the super IRA, and talk about the fundamentals. Senator Mikulski, I want to thank you for the statement you made about the fundamentals of the saving concept.

The gentleman from Washington prior to your arrival indicated that the reason there weren't very many Democrats here was that he believes that this is all smoke and mirrors. I was going to make a comment about the fundamental difference between the two parties, that we really believe that somehow creating incentives for people to put their own money away is not only good public policy, but it is very smart public policy, and that, frankly, it is very much a part of the American dream. The legislative process will work out what that particular format is.

I am a cosponsor, original—was with Senator Bentsen and Jake Pickle in the old days of the super IRA—and pleased to share with Roth and Breaux and Richard Neal on this side. Your comments I think are really critical, because one of the things that I have noticed among homemakers is a concern, in a relative sense, about a sense of worth and that they know they are important and doing a good job. I have had a number of discussions with friends whose wives choose not to work, and the idea of getting a monthly statement in which savings have been put away in their name and seeing the growth of that amount is, I think, a very strong reinforcer of their worth. Your approach, especially the difference in dollar amounts—clearly at the maximum end of someone's income, but translate these into a middle income—is nevertheless a clear reinforcer of worth, getting these monthly statements. I want to compliment you for making sure that we focus on that aspect of the American dream.

I invite any comments. Have you had folks talk about the reinforcement aspect of a savings account like the IRA that you are asking for?

Senator HUTCHISON. Absolutely, Congressman. I appreciate your bringing that out, because it is one of the important ways that we can say to the homemakers of America how important the work they do is; and this does quantify, if you will, what they will be able to build up.

And let me say that this works for families or for broken families. If a single-income-earner family stays together, they have taken a loss in income through their working lives, and this gives them a chance not to lose the security in their retirement years. But if it is a broken family, if a homemaker loses her husband, either through death or divorce, she then has that security which is denied her without this opportunity to set something aside in her own name. That is her security for retirement years. And this is perhaps the greatest need that we have for divorced mothers who

have not been in the workplace. So it is a win-win situation from every standpoint, and I thank you for bringing that out.

Mr. THOMAS. Thank you very much, Mr. Chairman.

Chairman ARCHER. Mrs. Johnson.

Mrs. JOHNSON. Thank you, and I welcome my colleagues and commend you on the leadership you have provided on this issue, and we look forward to joining you in advocacy of the homemaker IRA as we move this process forward.

I think it is important to focus on the difference between the bill you are advocating and the American dream savings account, and that is the issue of deductibility. Nondeductibility makes it harder, and the American dream savings account is a nondeductible contribution. There are some very real benefits from it and it is a wonderful idea, but in terms of helping homemakers and particularly young couples, helping women, early, to save, you really need that deductibility, a family needs to be able to get that.

And I thank my colleague from California for putting so clearly the ownership issue. Women in America, partly because of the security of today's world, do need from very early in their life to have their name on retirement benefits. So it is not just the portability, it is the ownership; and deductibility in this sector is critical to being able to make that second contribution. And I really thank you for your testimony here today, and I commend you on your leadership.

Senator HUTCHISON. Well, thank you for your help and leadership from the beginning on this. I really appreciate it.

And I also think that the difference is, which Mr. Archer mentioned, it is front-end deductibility or back-end deductibility; and I think having the range of choices is very important. The American dream can go hand in hand with the present system and people can choose what is best for them, and it is like a cafeteria of options. And I think adding this to the present system—and I know the American dream accounts are gender or homemaker neutral—this would just add another option that is able to be gotten for homemakers that is not now on the books and wouldn't be even in the future without this amendment.

Mrs. JOHNSON. Right. In other words, a lot of those who would benefit from your bill simply couldn't benefit under the American dream savings account, because they wouldn't have enough assistance in savings.

Senator MIKULSKI. Congresswoman Johnson, I think you have outlined a very serious issue in terms of the deductibility. Congresswoman—Senator Hutchison and I wanted to be very careful that when we proposed this idea 2 years ago—this was really Senator Hutchison's first and prime legislative initiative when she came to the Senate, and I was the first on the other side of the aisle to join with her, for all of the values that we said we wanted to achieve.

We were also very mindful of the deficit, to be careful that we wouldn't run into a buzz saw of opposition, that we would be adding to the deficit, so we were very careful to keep within the current law related to deductibility. As the Congress works on the super saver and the American dream savings account and someone looks at the deductibility issue, again, we didn't want to be de-

feated under the guise of the deficit. So that is why we put ourselves within that framework.

The policy concerns that you have raised are the same that Senator Hutchison and I and all of the cosponsors have, particularly where there is a single wage earner. So that is an important point.

But I just want to make one other point about the so-called American dream restoration or super saver. The other aspect that I like is that while the homemaker is at home and has her IRA, at such time where she might choose to return or enter the marketplace, she would then have the ability to turn to this as an educational expense.

If I think of a homemaker who has been at home, her kids are now through school, and guess what? They are tuition poor, because about the time she is ready to return to the marketplace or enter the marketplace, they have hefty tuition bills for higher education. But if she chose to study being a paralegal or something, that would be right there for her; she could borrow and—then I am sure quickly—be able to quickly repay it. Also, for long-term care in the future.

Mrs. JOHNSON. That is really an excellent point, because most women who stay home and take care of their children, particularly if they end up staying at home 10 or 15 years really do need to go back to school and would need the resources to do that.

Senator MIKULSKI. I know the red light is on, and there are women—Kay Bailey and Barb Kennelly and Jennifer Dunn—and Roscoe Bartlett backing this; this is an incredible alliance.

But I just want to say this, that we need to show that this legislation really helps women help themselves. We are in a postrights era, and the most important right, though, that you can have is the right to be able to take care of yourself in your old age and prepare for education.

Mrs. JOHNSON. Thank you.

Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Rangel.

Mr. RANGEL. Thank you both, Senators. And Barbara, welcome back home, and I want you to know that I look forward to supporting this amendment to the American dream.

One of the very few benefits of being in the minority, unlike it was for us last year, is that we don't have to worry about paying for anything, because that is done through scoring mechanisms; and so even though I was excited about the deficit being reduced for the third time in 3 years—the first time since Harry Truman—we will have the luxury here of perfecting a bill that we can all vote for, all of the popular things. And I can't wait to vote for the $500-per-child tax credit that costs us in 10 years $288 billion.

Another exciting provision is the neutral cost recovery; that is only $120 billion over 10 years. The most exciting, really, I guess, everyone would know is the capital gains tax preference; and that is only $183 billion over 10 years. Of course, these are only U.S. Treasury Department estimates. I am certain the majority will have something far more exciting to come up with.

But under the Treasury, the dream savings account in its present form is $17.7 billion, and of course the additional contribution, which I support, will increase that.

I am not certain, because the Chair hasn't advised us yet, but it appears as though after we excitedly support all of these parts, then we would vote on the total package. And that is where we are going to have a problem, because like someone said on the other side, you keep putting together these billions and pretty soon you are dealing with real money.

But I would want you to know that you can count on my support for the inclusion, but I don't know where I am going to be during the markup when this is finally over. But thank you both for your contribution.

Chairman ARCHER. The gentleman from Kentucky, Mr. Bunning will inquire.

Mr. BUNNING. No questions.

Mr. THOMAS [presiding]. Mr. Herger. Mr. Herger is not here.

Mr. McDermott.

Mr. MCDERMOTT. Thank you, Mr. Chairman. I want to echo the remarks of Mr. Rangel. I think all of us are looking forward to voting for all of the good things and leaving the cutting to the Republicans, because I think that turnabout is sort of fair play. We will have a really great session on this side of the aisle, we will vote for it, just because it is a good idea; there ought to be equity.

But what I am concerned about is, what do you think the likelihood is that this can be paid for in the Senate? We sort of lose touch with what is going on over there, and I keep wondering if you have any feeling for whether or not you will be able to make 20- to 30-percent reductions across the board. If you take Social Security and Medicare and defense off of the table, will they be able to balance the budget in the Senate? Can you get the votes up for a 20- to 30-percent cut on the rest of the budget?

Senator MIKULSKI. If you can balance it in the House, we will be able to balance it in the Senate.

Senator HUTCHISON. Let me say that, yes, I do think we can, and I think it is a matter of setting a budget and then prioritizing. And I would just say, Congressman, that in the lists of priorities, I think equity in IRAs for homemakers would be at the top of the list.

Now, I have suggestions of potential cuts that could be used, but they could be used for the entire bill, and I am sure that you will make those choices. But I just think we have to say, like every other home, every business, every State and local government in this country, that we can set a bottom line and then determine what the priorities are within that framework. And if I were voting, one of the priorities that I would have would be savings incentives, and I think adding homemakers into the mix is a matter of equity.

Mr. MCDERMOTT. Senator, if you—you heard the array that Mr. Rangel put forward of things that are being proposed in that body, and I wonder if you could rank them in order for me, which of those things do you think is most important? Would you think the $5,000 deduction for adoptions would be the most important, or the $500 credit per child, or this particular proposal you are making? Would you say this proposal is more important than the $500 per child or the $5,000 for adoption or the capital gains proposal? If we have to make tough choices here, which item would you put first?

Senator HUTCHISON. Well, not surprisingly, I would put equity for homemakers and retirement security right at the top of the list. But I also think, Congressman, that phasing in is an option that we are all going to have to look at. And I would rather phase in this equity, just as I would phase in tax credits for children or other very good proposals that you might determine. But I think we will find when we phase in that these are things that will add to the economy, not take away.

I truly believe that there will be a benefit, not a detriment, to revenue if we encourage savings. So if we phase it in, I think we will be able to reap that benefit as we go.

Senator MIKULSKI. Congressman McDermott, you raise a very important issue, and I think that whatever legislation we come out with, it should have the fundamental goals that we wish to achieve in our society—one of which, of course, is truly to reward work and work among the working poor. That is why I would hope that no matter what we do, we would keep the earned income tax credit and think how we will even strengthen that as we move to welfare reform, so that we can reward work and make sure that for the working poor, work pays.

The second public policy assumption should be that we should be stimulating savings over consumption, and therefore, whatever the legislative framework is that stimulates savings should do that.

When we look at issues relating to the family and help—giving help to those who wish to practice self-help, the deduction, the allowance, if you will, for children does need to be changed. The children's deduction has been held constant even though inflation has been a significant issue.

I joined with Dan Coats last year in increasing the deduction for children, because I think that is important. But if you get to a $200,000 limit on that as income, I think that is excessive. I think once you reach $200,000, you are beyond being ordinary, middle class. So I think that income level would need to be changed.

In terms of encouraging adoption, I don't think people need a tax deduction for adoption. What I find is that among Maryland families, people are willing and eager to adopt children, particularly childless couples. The issues are the at-risk children and also the rules that get into the very complicated issue of interracial adoption. So it is not that people need—the middle-class people I know that are willing to go to Russia, willing to go to Romania, willing to go to Argentina, Chile, Peru, Brazil to adopt children don't need a $5,000 tax credit; they need other types of help. And for those other American families that wish to adopt, we need to work at the adoption rules for the at-risk children that often prevent people who wish to adopt children from being able to adopt them.

Mr. THOMAS. The gentleman's time has expired.

Mr. MCDERMOTT. Thank you.

Mr. THOMAS. The gentlewoman from Washington, a cosponsor of the bill.

Ms. DUNN. Thank you, Mr. Chairman. Yes, as an original cosponsor in the House on this legislation, I want to commend the two Senators for their leadership in pushing this issue, keeping focus on this issue; and just tell you that the important points of the IRA Equity Act, I believe are its focus on values that we hold dear, the

value of giving credence and standing to the people who stay at home and raise our children and care for our elderly; or who do volunteer work in the community, which we need to focus on much more seriously as we look toward the new operation of programs like welfare, for example; or who are retraining themselves during a phase in their life when they need to be at home and not employed in the workplace; and also the value of equity to folks who are staying at home and to women who are working in the home.

I think it also achieves that goal that this committee has supported, and that is so important, which is to increase savings in this Nation. I do want to inform the Senators that in a meeting where I was present with Republican women Members they showed great enthusiasm for this legislation. I expect that we will be able to increase our sponsors very considerably in the next few days, and I also believe that it is a responsibility that comes down to us when we find how we are going to fund this program.

I believe that we will find the sources. I have some sources in mind that I want to contribute, Senator Hutchison, to your list; and I look forward to working with you on this very important legislation.

Senator HUTCHISON. Thank you for your leadership, Congresswoman Dunn.

Chairman ARCHER [presiding]. I am delighted to hear all of these gratuitous offers of extra revenue. We will certainly find a use for all of them as the year goes on.

Senator HUTCHISON. Mr. Chairman, as long as you don't take them and then not put our amendment in the bill, that will be fine.

Chairman ARCHER. Well, I am sure that the proponents who will offer the amendment will carefully craft it.

I am curious, though. We had an opening statement, Senator Mikulski, from our colleague, Congressman McDermott in which he said he basically didn't think that we ought to give IRA opportunities to people who had incomes over $35,000, because that would be giving money to the rich. I believe that is what the gentleman from Washington said; I don't want to quote him incorrectly.

But your support of the super IRA would eliminate all of the——

Mr. MCDERMOTT. If the gentleman will yield——

Chairman ARCHER I just hope that you can have some influence over our colleague, Mr. McDermott, so he will go along with us.

I will be happy to yield to the gentleman from Washington.

Mr. MCDERMOTT. If you recall, I said at the end of my statement that I am for all of these good things, I support everything, as long as we can pay for it. And I stand ready when you show us where you are going to get the money.

However, if you are going to ruin all of the things that you are trying to fix with the IRA, it simply doesn't make sense to me. And I am willing to support these things as long as you can come up with a balanced budget—and I was pleased to hear Senator Mikulski say if we can balance it, it will pass in the Senate. We look forward to seeing your budget and your numbers.

Chairman ARCHER. Well, I can assure the gentleman that we will offset any tax reductions with spending cuts, and the gentleman can put that in the bank. So I am glad that he supports——

Mr. MCDERMOTT. In my piggybank?

Chairman ARCHER. I am glad that he supports the concept, irrespective of the earnings limit.

Are there any other members who would like to question the witnesses?

We thank you very much. Both of you have made excellent presentations to the committee this morning.

Senator MIKULSKI. Thank you very much. It is good to see old colleagues, and new Members that I hope to become better acquainted with.

Senator HUTCHISON. Thank you, Mr. Chairman.

Chairman ARCHER. Thank you.

Our next witnesses are two of our colleagues in the House, Congressman Bill Orton of Utah and Congressman Bill Baker of California. If you will take seats at the witness table.

Congressman Orton, you will be our first witness, and we will ask you to keep your oral presentation under 5 minutes. Without objection, your written statements will be made completely a part of the record in their entirety. Congressman Orton, you may proceed.

STATEMENT OF HON. BILL ORTON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF UTAH

Mr. ORTON. Thank you, Mr. Chairman. I have submitted a detailed written statement with several exhibits to explain some of the technicalities of how my proposal would actually function.

Mr. Chairman, members of the committee, I very much appreciate the opportunity to testify before you today. The goal of increasing savings and investment is critical to our country's long-term economic prospects. I commend you for calling this hearing.

Mr. Chairman, study after study have demonstrated that the most significant barrier to home ownership in this country is the high level of downpayment generally required to secure approval of a mortgage loan. Yet, because of our current tax laws, the $850 billion currently invested in individual retirement accounts are effectively precluded from being used for such downpayment purposes, either directly by a homeowner or through a parental loan. I have come before you today to advocate changes to these laws to dynamically open up this $850 billion of assets and put them to work to promote home ownership.

Yesterday, I reintroduced the First-time Home Buyer Affordability Act in this Congress. It is H.R. 726. I have been working on this legislation for over 3 years. It was introduced in the previous two Congresses. The last Congress, H.R. 1149, was a bipartisan effort with 28 cosponsors, almost equally split between Republicans and Democrats, including the distinguished chairman of the Rules Committee, Gerald Solomon. It was also endorsed by both the National Association of Home Builders and the Mortgage Bankers Association of America. The bill that I filed yesterday is virtually identical, with a few minor perfecting changes.

I would like to take just 1 minute to explain to you the need for this legislation. Current IRA statutes prohibit an IRA accountholder from engaging in a number of what are called "prohibited transactions," including loans to family members and one's own personal use of IRA funds. If anyone uses IRA funds for a pro-

hibited transaction, the penalties are severe. The money that is used is subjected to full taxation at the State and Federal levels, plus a 10 percent premature withdrawal penalty. Combined, that can equal over 50 percent of the money withdrawn. The result is that, under current law, individuals are effectively precluded from using IRA funds to make a downpayment to buy a home.

My legislation overcomes this barrier by providing a targeted exemption of the prohibited transaction rules to allow individuals to access IRA accounts to make a downpayment on a first-time home purchase.

Specifically, my bill permits individuals to borrow money from their own IRA account to make all or part of a downpayment for a first-time home purchase of a primary residence. This is similar to loans permitted right now from one's 401(k) account.

It also permits parents to lend money within their IRA account to their children for the use of a downpayment on a first-time home purchase of a primary residence. It also permits these transactions to be structured either as a loan or an equity investment, a home equity participation agreement.

I would like to pose just one general question of fairness to my colleagues. IRA accountholders are currently permitted to invest in Ginnie Mae mutual funds, which consist of single-family mortgages on other people's homes. However, IRA funds may not be used to finance their own home nor that of a family member. In other words, your IRA can be used to purchase the home of anyone in the country, except for your own home or that of a family member.

This policy is unfair, antihome ownership and antifamily. My proposal would change this. It would do so in a flexible manner but it would also do so in a targeted and careful manner.

The public policy purpose of the bill is to promote entry into the housing market. Therefore, the home buyer must be a first-time home buyer. In addition, the home purchase must be a principal residence. Finally, the loan or equity investment must be repaid upon the sale of the home.

My bill also contains specific provisions to prevent self-dealing or tax gaming. I won't take you through each provision right now. Simply stated, my bill takes a somewhat different approach from most of the penalty waiver provisions, because my bill would also allow the use of the funds without taxation. It does so by changing the prohibited transaction rules to allow the IRA itself to invest in the home mortgage rather than having to withdraw the money from the IRA and pay the tax on it, even though the penalty is waived and then use what is left over.

I believe, Mr. Chairman, that this approach is totally consistent with the proposal in the Contract With America. It does no harm to the concept and I would urge this committee to consider including this general approach in the bill that is marked up. And I would be happy to respond to questions.

Thank you.

[The prepared statement and attachments follow:]

STATEMENT OF REP. BILL ORTON

before the
House Ways and Means Committee
January 31, 1995

"FIRST-TIME HOMEBUYER AFFORDABILITY ACT OF 1995"

Mister Chairman, members of the Committee, I appreciate the opportunity to testify before you today. The goal of increasing savings and investment is critical to our country's long term economic prospects. I commend you for calling this hearing.

Mr. Chairman, study after study have demonstrated that the most significant barrier to homeownership in this country is the high level of downpayment generally required to secure approval of a mortgage loan.

Yet, because of our current tax laws, the $ 850 billion currently invested in individual retirement accounts (IRA's) are effectively precluded from being used for such downpayment purposes, either directly by a homebuyer or through a parental loan. **I have come before you today to advocate changes to these laws to dynamically open up this $ 850 billion of assets and put them to work to promote homeownership.** It is my hope that this committee will consider addressing this issue when marking up HR 6, the "American Dream Restoration Act."

Yesterday, I re-introduced the "First-time Homebuyer Affordability Act." I have been working on this legislation for over three years. I first introduced this bill back in 1992, in the 102nd Congress. Last year, I re-introduced this legislation, as HR 1149. **HR 1149 was a bi-partisan effort, with 28 co-sponsors, about equally split between Republicans and Democrats, including the distinguished Chairman of the Rules Committee, Gerald Solomon. HR 1149 was formally endorsed last year by both the National Association of Home Builders and the Mortgage Bankers Association of America.** The bill I re-introduced yesterday is virtually identical to HR 1149, with a few minor perfecting changes.

First, let me explain the need for this legislation. Current IRA statutes prohibit an IRA account holder from engaging in a number of "prohibited transactions", including loans to family members and use of one's own IRA funds for personal use. If anyone uses IRA funds for a prohibited transaction, the penalties are severe. The money that is used is subjected to full federal and state income taxes. In addition, a 10 percent premature withdrawal or distribution penalty is assessed on the amount withdrawn. Combined, an IRA account holder may be forced to pay over 50 % of the amount withdrawn in taxes and penalties [see Exhibit B]. The result is that **under current law, individuals are effectively precluded from using IRA funds to make a down payment to buy a home.**

PROVISIONS OF "FIRST-TIME HOMEBUYER AFFORDABILITY ACT OF 1995"

My legislation overcomes this barrier by providing a targeted exemption from prohibited transaction rules to allow individuals to access IRA accounts to make a down payment on a first-time home purchase. By structuring the use of funds as an economic transaction entered into by a self-directed IRA account, the tax and premature withdrawal penalties are avoided -- resulting in a substantial savings to the homebuyer. By eliminating barriers to the use of IRA funds, this change would have a significant impact in increasing homeownership. Finally, this approach is pro-savings. By structuring use of IRA funds as an economic transaction within an IRA, the monies used to buy a home are eventually restored to the IRA, available for continued tax-deferred re-investment.

Specifically, my bill:

(1) **Permits individuals to borrow money from their own IRA account to make all or part of a down payment for a first time home purchase of a primary residence. [This is similar to loans permitted from one's 401(k) account].**

(2) **Permits parents to lend money within an IRA account to their children for use as a down payment on a first-time home purchase of a primary residence, AND**

(3) **Permits the transactions permitted in (1) and (2) above to be structured as an equity investment (ie., a home equity participation agreement).**

Mr. Chairman, I would like to pose a general question of fairness. IRA account holders are currently permitted to invest in a Ginnie Mae mutual fund, which consists of thousands and thousands of single family mortgages -- on other people's homes. However, IRA funds may not be used to pay for or finance your own home, nor for the home of a family member. In other words, **your IRA account can be used for the purchase of any home in the country except your own home or the home of a family member? This policy is unfair, anti-homeownership, and anti-family.**

Moreover, consider the purpose of IRA's. IRA's are intended to promote long-term productive investments to provide a nest egg for retirees. Historical studies have shown that one's home is generally the largest and most important asset people have. It is probably also the best investment they will ever make. Shouldn't IRA funds be available for this important purpose?

Consider, finally, that we do permit individuals to borrow from their 401(k) retirement accounts to purchase a home. A 401(k) plan is nothing more than a self-directed retirement plan -- in much the same way an IRA account is. If we allow people to borrow money from a 401(k) plan for this purpose, shouldn't we also allow borrowing from an IRA account?

I believe we should. My legislation allows this to be done in a flexible, but responsible manner. My bill allows 100 % of the funds in one's IRA account to be used for a first-time home purchase, structured either as a loan or an equity sharing investment.

Under my bill, IRA advances structured as a loan may be flexible. Any loan from an IRA can be for a term of up to 15 years. The loan may be interest only (no principal amortization). And, interest on the loan may be deferred until repayment of the loan. These two options increase flexibility with respect to cash flow. Finally, the loan may be unsecured or may be secured (typically by a second lien on the home). This increases flexibility with respect to second mortgage limitations typically imposed by secondary market mortgage lenders like Fannie Mae and Freddie Mac.

IRA advances structured as an equity sharing agreement are intended to mirror current free market practices, in which homebuyers give up part of the appreciation of value of their home in return for vital down payment assistance. To preserve the concept of having the IRA engage in economic transactions, my bill requires that equity sharing arrangements be structured under terms similar to those made in arm's length transactions.

While flexible, the bill is also structured in a careful, targeted manner. The public policy purpose of the bill is to promote entry into the housing market. Therefore, the home buyer must be a first-time homebuyer. In addition, the home purchase must be a principal residence. Finally, the loan or equity investment must be repaid upon the sale of the home.

My bill also contains provisions to prevent self-dealing or tax-gaming. For example, the interest rate on the loan must be no less than 200 basis points below and not more than 200 basis points above comparable Treasury rates. In this way, the IRA earns at least a fair rate of return, but individuals cannot funnel excessive tax-deferred funds into an

account. Perhaps most importantly, my bill provides that forgiveness or default on loan or equity repayment subjects an IRA to premature distribution treatment -- making the funds subject to tax and withdrawal penalty. This effectively prevents individuals or parents from converting IRA funds tax-free to personal use through a fabricated default.

COMPARISON WITH PENALTY WAIVER

Over the last few years, there has been a great deal of support for the "penalty waiver" concept. This approach was included in HR 4210, a major tax bill approved in the 102nd Congress, but vetoed by the President. The penalty waiver provision was also included in the Super-IRA bills introduced last year by Senator Roth in the Senate and Representatives Thomas and Pickle in the House. Many members of both the House and Senate have introduced legislation incorporating this concept.

Quite simply, the penalty waiver approach provides for a waiver of the 10 % penalty on premature IRA withdrawals for certain identified purposes. Typically, qualified purposes in legislative proposals include first-time home purchase, higher education expenses, and emergency medical bills.

Clearly, adoption of this type of proposal would make it easier to access IRA's for these purposes. However, penalty waiver advocates generally fail to emphasize that the IRA account holder would still owe federal and state income taxes. At best, a penalty waiver would marginally reduce the huge negative incentive against using IRA funds to buy a home.

Let me illustrate this point [see Exhibit B]. Take a hypothetical case in which a young couple plans on buying a house, requiring a down payment of $ 10,000. Let's assume the couple's sole source of long-term savings is the $ 10,000 they have in their IRA account. Let's also assume that this couple is in a marginal 28 % federal tax bracket, and a 6 % marginal state tax bracket. As Exhibit B shows, **even under a penalty waiver approach, this couple would still forfeit almost 1/3 of the amount in their IRA account to state and federal taxes. Moreover, they would only have $ 6,768 left to invest -- not enough to make the required down payment. In contrast, under my legislation, the couple could lend themselves all of the $ 10,000 -- with no tax or penalty consequences.**

This difference is especially important when considering parental loans. It is true that certain penalty waiver proposals permit parental withdrawals to assist their children with a down payment. But I think it would be a very rare case in which a parent would be willing to take $ 10,000 from their IRA account, suffering an unnecessary tax of from $ 3,000 to $ 4,000, to assist their children with a down payment.

Thus, a penalty waiver sounds like a good public policy change. However, in practice, it would have only a marginal impact -- reducing one's tax/penalty by only around 20% of the amount otherwise owed. This incentive will induce relatively few people to actually take money out of their account to buy a house, compared to current law. As a result, it will produce a very small increase in the level of homeownership in this country.

Let me turn now to your legislation, Mr. Chairman. As I understand it, the "American Dream Restoration Act" does not provide for a penalty waiver, or other direct incentive to take money directly out of an IRA account to buy a home. However, current IRA account holders would be permitted to roll over their account into a new Dream Savings Account, after which they could withdraw that money, tax and penalty-free, for a first-time home purchase (among other things). The effect is to give current IRA account holders the equivalent of a penalty waiver -- since they will suffer a tax from the rollover, but no tax or penalty from the subsequent withdrawal. Again, I believe this is a commendable change. However, I believe we can and should do more to access IRA accounts for homeownership.

Mr. Chairman, the impact of your "American Dream Restoration Act" is to increase opportunities for IRA investments and to increase flexibility for meritorious purposes, such as a first-time home purchase. I believe my legislation is consistent with and promotes these goals. The "First-time Homebuyer Affordability Act" could easily be added onto your bill. Therefore, I would ask the Ways and Means Committee to consider adding the provisions of my legislation to the American Dream Restoration Act when that bill is marked up.

EXHIBIT A

EXECUTIVE SUMMARY
FIRST-TIME HOMEBUYER AFFORDABILITY ACT OF 1995

Current IRA statutes prohibit an IRA account holder from engaging in a number of "prohibited transactions", including loans to family members and use of one's own IRA funds for personal use. This bill provides a targeted exemption from such prohibitions to access IRA accounts to make a down payment on a first-time home purchase -- without tax or premature withdrawal penalty. This approach could be used either in place of or in conjunction with the so-called "penalty waiver approach. Specifically, the bill:

(1) Permits individuals to borrow money from their IRA account to make all or part of a down payment for a first time home purchase of a primary residence [similar to loans permitted from one's 401(k) account],

(2) Permits parents to lend money within their IRA account to their children for use as a down payment on a first-time home purchase of a primary residence, AND

(3) Also permits the transactions permitted in (1) and (2) above to be structured as an equity investment (ie., a home equity participation arrangement).

UNDER THIS APPROACH, FUNDS WOULD BE FREE OF TAX AND PREMATURE WITHDRAWAL PENALTIES. IN COMPARISON, UNDER THE PENALTY WAIVER APPROACH, INDIVIDUALS WOULD SUFFER TAX CONSEQUENCES OF OVER $ 3,000 ON A $ 10,000 INVESTMENT.

ANOTHER ADVANTAGE IS THAT FUNDS ARE AVAILABLE FOR TAX-DEFERRED REINVESTMENT WHEN THE FUNDS ARE RESTORED TO THE ACCOUNT.

GENERAL PROVISIONS

* Home purchases are limited to first-time homebuyers.
* The home purchased must be a principal residence
* All funds in one's IRA account can be used for a down payment.
* Loan may be either secured or unsecured
* Interest on loan may be deferred; loan may be interest only
* Loan can be for a term of up to 15 years
* The interest paid on any loan and the repayment of a loan or equity investment continues to accumulate within the IRA account on a tax-deferred basis

RESTRICTIONS TO PREVENT SELF-DEALING

* Loan or equity investment must be repaid upon the sale of the home
* Loan interest rate must be no less than 200 basis points below and not more than 200 basis points above comparable Treasury rates
* Forgiveness or default on loan or equity repayment subjects IRA to premature distribution treatment - subject to tax and withdrawal penalty.

EXHIBIT B

USE OF FUNDS COMPARISON --

FIRST-TIME HOMEBUYER AFFORDABILITY ACT of 1995 and PENALTY WAIVER APPROACH

TYPICAL TAXPAYER

Investment within IRA Account		Penalty Waiver Approach	
IRA Account:	$ 10,000	IRA Account:	$ 10,000
Less tax:	-0-	Less tax:	3,232
AVAILABLE FUNDS:	**$ 10,000**	**AVAILABLE FUNDS:**	**$ 6,768**

NOTE: **UNDER CURRENT LAW, AVAILABLE FUNDS = $ 5,768**
[Additional effect of 10 % penalty for premature withdrawal]

ASSUMPTIONS:
* Marginal federal tax bracket = 28 %
* Marginal state tax bracket = 6 %
* **EFFECTIVE STATE/FEDERAL TAX = 32.32 %**
(Note: effective rate is lower than sum of both, due to federal tax deductibility of state income taxes)

TOP BRACKET TAXPAYER

Investment Within IRA Account		Penalty Waiver Approach	
IRA Account:	$ 10,000	IRA Account:	$ 10,000
Less tax:	-0-	Less tax:	4,434
AVAILABLE FUNDS:	**$ 10,000**	**AVAILABLE FUNDS:**	**$ 5,566**

NOTE: **UNDER CURRENT LAW, AVAILABLE FUNDS = $ 4,566**
[Additional effect of 10 % penalty for premature withdrawal]

ASSUMPTIONS:
* Marginal federal tax bracket = 38.5 %
* Marginal State tax bracket = 9.5 %
* **EFFECTIVE STATE/FEDERAL TAX = 44.3425 %**
(Note: effective rate is lower than sum of both, due to federal tax deductibility of state income taxes)

EXHIBIT C

QUALITATIVE COMPARISON OF

FIRST-TIME HOMEBUYER AFFORDABILITY ACT of 1995 with PENALTY WAIVER APPROACH

1. **SHORT TERM TAX SAVINGS TO INDIVIDUAL.**

The First-time Homebuyer Affordability Act has two major short term advantages over a penalty waiver: (a) the individual avoids imposition of taxes and (b) more funds are available for down payment on a home purchase. [see Exhibit B for comparison].

2. **PROMOTION OF HOME OWNERSHIP/ECONOMIC GROWTH**

Because of the advantage in 1 above, it will result in significantly greater use of IRA funds for home purchase. This will stimulate higher levels of homeownership. Resulting increased housing starts should also stimulate economic growth.

3. **LONG TERM TAX SAVINGS TO INDIVIDUAL**

Under the penalty waiver approach, there is a permanent withdrawal of funds from the IRA account. As a result, the compounded tax deferral of principal and interest is lost. In contrast, since all IRA funds are retained under the First-time Homebuyer Affordability act, interest/earnings continue to be tax deferred during the period they are invested in the home AND are tax deferred in the period after the home investment ends.

4. **PREVENTION OF LEAKAGE FROM RETIREMENT FUNDS.**

Economists have made a strong connection between our low rate of national savings and our failure to make productivity gains. Adequate national savings is critical as a source of capital for modernization so that American companies can compete internationally. The "First-time Homebuyer Affordability Act" promotes the goal of increased individual savings, by permitting first time home investments within IRA accounts, thus avoiding leakage from retirement and savings accounts. In contrast, a penalty waiver approach tends to encourage funds to flow out of savings accounts.

Chairman ARCHER. Thank you.

Congressman Baker, we are delighted to have you here with us today, and we will be pleased to hear your testimony.

You may proceed.

STATEMENT OF HON. BILL BAKER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Mr. BAKER. Thank you very much, Chairman Archer, and it is an honor to be here.

I want to thank you for allowing me to come before the committee to discuss the critical issue of IRA reform and the national savings rate as it relates to the Contract With America. I have prepared a written statement to supplement my testimony, and with your permission, request that it be inserted in the appropriate point in the record.

Americans save but a fraction of what other people in other nations save. Our savings rate in America is an anemic 4 percent. Taxpayers don't recognize how their lack of savings harms overall productivity and how it relates to interest rates.

The American taxpayer's aversion to saving money is partially due to our erratic and punitive tax policies. It is very difficult to tell someone who is struggling to raise a family and who is being taxed between 40 and 46 percent of their income, to go out and accrue another $2,000 to $5,000 and put it away for their retirements, especially without any tax deduction.

Before 1986—and this is important—19.5 percent of individuals filing tax returns claimed IRA deductions. So prior to the disastrous 1986 Tax Act, almost 20 percent of the people were saving for their retirement; 16 million people saved in those days $13 billion. So these horrendous figures you hear, if you go back to an IRA you are going to bankrupt the Nation and keep the budget from being balanced, in 1986, 16 million were saving $13 billion, an average deduction of just over $2,000. In 1993, an equal number of returns filed, only 5 percent of taxpayers claimed deductions.

So what happened is people when they didn't get the carrot of deductibility, forgot about preparing for their retirement years, so only 4.1 million people saved a total of $7.9 billion. So without that incentive of tax deductibility, we have told people, don't prepare for your future, just go to the Social Security window.

The Federal Government should encourage greater savings. In a Merrill Lynch survey recently conducted, married people earning $50,000 a year need to accumulate $170,000 by the time they reach 65 to maintain their current standard of living, even with pension and Social Security benefits. The average baby boomer couple will save only 40 percent of that during their lifetime because they have no incentive to save.

IRA reform is needed now and to be effective it must bring more people into the pool. It has to be more flexible, as Mr. Orton just mentioned, and it cannot sacrifice the purpose, retirement savings, for other duties, such as the social welfare aspects of the current Social Security program.

Mr. Chairman, my IRA reform, the Family Reinvestment Act, meets these criteria. It replaces the inadequate $2,000 deduction with $2,500 each spouse, regardless of whether they work. It is

cruel for the nonworking spouse to raise a family and come then to the end of the line and have no retirement benefits. Even more cruel if a divorce occurs during that time and the person who has spent their time at home is left without adequate retirement.

It extends eligibility to a nonemployed spouse. We phase in this bill over a 10-year period, and I wouldn't care if it was over 100 years, as long as the road of 1,000 miles begins with the first step. This allows investors to borrow from their plans for only three purposes: One, first-time home buyer; and for college; and for medical and retirement benefits, for the person himself or herself, before retirement.

It maintains the focus of IRA on retirement. I want to emphasize the word "borrow." If you have a son or granddaughter that needs to go to college, you can take from your IRA and loan them that money. But they must repay it—fat chance.

You will probably during your working life repay it so that at the end of the line, you would have your retirement plan intact. So the borrow facility is important.

The nonworking spouse part of this bill is important. And raising over a number of years the amount saved each year to $5,000 per couple is extremely important, if we don't want to depend totally on government-financed retirement accounts.

I would like to close with this warning. The optimists tell us that if we go through the baby boomers receiving money from Social Security and they collect for 20 years before we bankrupt Social Security, we will go to the year 2030. If the pessimists are correct and we bankrupt it in the first few years of the baby boomers coming to the window, then we will bankrupt Social Security by 2013. It has nothing to do with politics, has nothing to do with Republicans, Democrats, Contract With America; just there are too many people asking for too great a retirement amount, considering the number of people still working, and you will run out of money. That is a fact.

What is the answer; to bemoan that, to change Social Security, to get into a long war in which we go to the ballot box and tell somebody they hate the elderly more than I love the elderly? That is not the answer. The answer is to wean people today, get them on their own retirement plans, and IRA is the way to do it. If, to answer Mr. McDermott's question, this means postponing balancing the budget for 1 more year to take care of the $13 billion that people will save if they get the deductibility so be it, because you have corrected a problem that will reach us in the middle of the 21st century and hit us very hard.

I appreciate the time to speak and will answer any questions that you might have.

[The prepared statement follows:]

TESTIMONY OF THE HONORABLE BILL BAKER BEFORE THE HOUSE WAYS AND MEANS COMMITTEE

IRA REFORM IN THE CONTRACT WITH AMERICA AND THE FAMILY REINVESTMENT ACT

January 31, 1995

Mr. Chairman, I appreciate having the opportunity to speak here today on an issue of national economic importance. The health of our economy is obviously dependent upon many factors, most of which you will consider in this committee. And now, as we consider the various reforms contained in the Contract with America in Congress, we have an opportunity to address one such economic concern in the near future -- our national saving rate. So today, Mr. Chairman, I am here to talk about my bill to reform Individual Retirement Accounts, the Family Reinvestment Act, which I will soon reintroduce.

That Americans save but a fraction of what people in many other nations do is well known. The current estimate of the rate of saving in the U.S. is an anemic four percent. Most Americans, however, are less aware not only of the magnitude of the problem, but of its very existence. The fact is, in order to maintain even modest economic growth, we must either bring money into the economy through foreign investment, or increase our own saving rate.

What most Americans know about the savings crisis is limited to what they see reflected in their own lives. Many find themselves increasingly unable to meet their own needs. But what they see less is how their inability or unwillingness to save harms overall productivity. Few notice the drop in the availability of investment capital. But many people do know of American industry's increasing reliance on foreign capital to fund operations and fuel the economy, and they recognize it as a disturbing trend. The connection must be made between personal savings and our addiction to foreign capital in order to maintain economic growth if people are to clearly recognize their role in this tenuous situation.

A study released last year by the National Center for Policy Analysis demonstrates that the household saving rate has a greater impact on foreign capital imports than does the federal budget deficit (as is commonly blamed). According to the study, the $55.3 billion decline in personal savings between 1992 and 1993 exceeded the $42.8 billion decline in the budget deficit at the same time. Meanwhile, foreign capital imports increased because less savings were available for investment. Government borrowing, it seems, is less a factor than personal savings.

So why don't Americans save more? Though no one reason can be given, certainly our government's erratic and punitive tax policies have had a forceful impact. Our tax code rewards consumption and discourages saving. When the average wage earner learns that accumulating interest only raises his taxes, the benefits of consumption seem greater than the benefits of saving. Some sort of tax neutrality is needed if Americans are to be convinced to put more money away for their future needs. And they must be convinced. Getting our saving rate up to around eight percent would add over $180 billion annually to the national supply of savings, and virtually eliminate the need for foreign capital.

Because the federal government has a role in reducing interest costs and increasing jobs and production, it can and should play a significant role in encouraging greater savings. As fewer and fewer young workers finance the retirement of more and more retirees, recent polls reveal that young Americans no longer believe government-run Social Security will be sufficient to sustain them in later years (indeed, it was never intended to). And a survey done by Merrill Lynch indicates that the average married couple making $50,000 per year would need to accumulate at least $170,000 in savings by age 65 to maintain its standard of living, even with a pension and Social Security. Yet these same individuals are penalized through the tax code from saving more on their own. The average baby boomer couple is likely to save only 40 percent of what it will need to retire. It is for these reasons that expanding the availability and scope of Individual Retirement Accounts is a timely public policy consideration.

For true reform of the current IRA to be effective, it must make IRAs more attractive and thereby bring more taxpayers into the investment pool. It must also make IRAs more flexible to be used as individuals' needs arise. But flexibility must not sacrifice the true purpose of the IRA -- retirement savings.

Mr. Chairman, my IRA reform bill, the Family Reinvestment Act, meets these criteria.

First, my bill seeks to bring new investors into the IRA system. It scraps the wholly inadequate $2,000 deduction level, replacing it with a $2,500 yearly deduction. It also expands eligibility to include non-employed spouses, a group which is unfairly excluded under current IRA rules. And my bill "phases in" higher-income taxpayers as it increases the current income phaseout levels over a five year period. The levels are raised from $25,000 to $100,000 for individuals and from $40,000 to $200,000 for couples. All of the levels in my bill are indexed to inflation after the phase-in period is complete.

Next, my bill seeks to make IRAs at least as flexible for the average American as the popular Thrift Savings Plan, or TSP, is for government employees. The TSP is a benefit that many workers take

advantage of here on Capitol Hill. Though my purpose here is not to sing the praises of the TSP, I should explain that involvement in the plan allows investors to borrow at the current rate from their plans. The key is that this money is a qualified distribution which must be repaid. It is time for all American families to be offered this kind of flexibility.

My bill allows qualified distributions for first-time home buyer expenses on a principal residence for the IRA holder, his spouse, his child, or his grandchild. This includes acquisition costs, construction or reconstruction, and financing and closing costs. This loan must be repaid with interest within 15 years of the distribution to avoid being taxed.

Similarly, qualified distributions for higher education expenses are allowed, including for such items as tuition, fees, books, supplies and enrollment and attendance costs. This loan must be repaid with interest within ten years. My bill also treats numerous qualified distributions received in the same taxable year as one, so individuals may borrow from their accounts as money is needed.

Finally, my bill maintains the focus of the IRA option on its principal purpose -- increasing savings. The repayment requirement is meant to assure that these accounts are not used only as tax-free pools for home-buying or education expenses, but remain the retirement investment tool they were originally intended. Loans outstanding at the end of the repayment period are treated as "unqualified" distributions and taxed as income, plus the current ten percent penalty, plus interest. Distributions from the IRA also may not drop the total balance below $1,000. Together, these rules will help to ensure that taxpayers continue to plan for their retirement, even as they confront important financial hurdles along the way.

Mr. Chairman, I don't think we, as fiscal conservatives, will disagree that these are important measures to address. But what concerns me is that the proposed IRA changes in the Contract with America do not go far enough in accomplishing our stated goals.

The American Dream Savings, or ADS, account outlined in the Contract in H.R. 6, the American Dream Restoration Act, is commendable in its goal, yet I believe it comes up short in the areas my bill addresses. First, the ADS account, as a "back-ended" IRA, effectively repeals the current IRA deduction, a significant incentive for lower- to middle-income wage earners. My bill actually increases this deduction in order to make saving for retirement a more attractive option. Despite the unique nature of a "back-ended" IRA, I do not believe the ADS offers sufficient incentives to bring additional taxpayers into the IRA system. And although the rules of the ADS do not include special purpose qualified distributions as gross income, I believe the most important goal of the savings tool is compromised in that **there is no repayment requirement**. This is essential to any IRA reform.

The debate over the Contract, Mr. Chairman, is really about empowering people to provide for themselves. The federal government should seize its role as the facilitator of greater personal freedom and opportunity. I believe very strongly in the stated goals of the Contract. They are, to a substantial degree, why I am in Congress. But as it stands right now, I believe the provisions related to IRA reform can be improved.

Thank you, Mr. Chairman, for letting me come here today to express my opinions on IRA reform. I am sure this committee has and will continue to consider very seriously issues like IRA reform, which affect the well-being of families, individuals, and the economy. I call upon you, Mr. Chairman, to lead your colleagues in this committee in examining all opportunities for increasing savings in America. I firmly believe that as you do, you will discover that my Family Reinvestment Act clearly corresponds with the other monumental changes we are all striving to make to enhance the lives of Americans in the future.

Thank you very much for your time.

# # #

Mr. THOMAS [presiding]. I thank the both of you for your testimony. It is interesting how economics gets in the way of politics. We appreciate your indication that there is an inevitable facing us, regardless of what the political position is that we take. Any member on the majority side wish to inquire?

Does the gentleman from Washington or the gentleman from Michigan wish to inquire.

We thank both of you very much for your testimony.

Mr. THOMAS. I would ask that the next panel come forward, John L. Steffens, chairman of the board of Securities Industry Association, Kenneth Feltman, executive director, Employers Council on Flexible Compensation; William Gale, senior fellow, Brookings Institution; Mary Mohr, chairperson, Savings Coalition of America; John Brennan, president, The Vanguard Group; and Charles Hazen, Southampton, Pa.

Any written statements will be made a part of the record, and you have 5 minutes to proceed. If you will allow me, I will start with Mr. Steffens.

STATEMENT OF JOHN L. STEFFENS, CHAIRMAN OF THE BOARD, SECURITIES INDUSTRY ASSOCIATION, AND EXECUTIVE VICE PRESIDENT, MERRILL LYNCH AND CO., WASHINGTON, D.C.

Mr. STEFFENS. I am John Steffens, the chairman of the Securities Industry Association and executive vice president of Merrill Lynch. The SIA is the securities industry's trade association, representing 800 securities firms in North America which account for about 90 percent of all securities activity in the United States. These firms have had extensive experience with IRAs in the past and overall, our industry manages about $585 billion of clients' IRA assets.

Thank you for focusing your attention on what I think is a vital issue, the Nation's savings crisis. This issue is vital to our economic future.

The name of the saving vehicle you are considering today, the American dream savings account, is right on the mark. The SIA believes that savings crisis has truly put the future of the American dream at risk. Whether the American dream is defined as financial security, a home, an education, a good job or comfortable retirement, low savings is going to make that more difficult to achieve.

Congress has an opportunity and a responsibility to change this; to help solve the savings crisis that exists today; and most importantly, to put Washington back on the side of the American dream by expanding IRAs. IRAs are a proven and powerful tool to boost savings. The SIA believes the facts are fairly simple. IRAs worked before from 1982 to 1986. And the newly proposed IRAs will work even better.

The SIA's full position is outlined in the written testimony. Let me summarize six reasons why IRAs are the right economic policy for America, the right tax cut for the middle class, and the right savings vehicle for American families.

First, it is clear that the American people themselves want to bring the IRA out of retirement. A postelection survey done by The Luntz Research Companies showed that the IRA was the most pop-

ular tax proposal included in the Contract With America. This shouldn't be surprising since other research has shown that concerns about savings and retirement rank higher than almost every other political issue.

Second, there is a growing consensus among academics that IRAs work. SIA recently asked two leading economists, Jonathan Skinner and Glenn Hubbard to sort through the scores of IRA studies that had been done over the last several years. After reviewing this body of scholarly work, these professors concluded that there is compelling evidence that IRAs did, in fact, boost personal and national saving. They noted that even some past IRA critics now acknowledge IRAs work.

Third, IRA critics overstate the significance of any shuffling of assets into IRAs. A quick look at the facts shows why. In 1983, half the American families had less than $1,000 in net financial assets. Even families headed by people 45 to 54 years old had median net financial assets of only $2,600. The bottom line is these people simply don't have enough assets to shift savings from other vehicles to IRAs for long.

Fourth, middle-class Americans will be the biggest winners from the new IRA. The committee should recognize that IRAs were overwhelmingly used by middle-income Americans from 1982 to 1986. Over 75 percent of IRA contributions were made by families with incomes of less than $50,000.

Fifth, the new IRAs will foster a culture of savings in the United States. A new IRA program is going to encourage financial firms to spend tens of millions of dollars advertising the savings benefit, and I think this will help educate Americans on the need for long-term savings. This will send a very important signal to Americans that it is time to become a nation of savers again.

Finally, while IRAs worked before, the features of the new IRAs will help them work even better. New proposals like the American dream savings account, the Thomas-Neal super IRA, the President's IRA, and certainly the homemaker IRA, which creates equal treatment for spouses who work in the home, all of these include withdrawal features that will make the IRA even more popular and effective.

The other key feature of the proposed IRAs is the back-end tax incentive. At Merrill Lynch, we have conducted extensive market research on back-end savings accounts and we are convinced that they hold great appeal to the American public. In fact, we forecast that roughly one-half of Americans, if given a choice and clear explanation of the benefit, would opt for a back-end IRA.

Ideally, the SIA would like to see IRAs with both front-end and back-end account options. Then Americans could decide for themselves which type of an account would be better given their personal view of the future. But even if the new legislation includes just the back-end option, as the American dream savings account does, SIA still believes that it would boost savings in the United States dramatically.

Let me close by mentioning that most Americans feel today that government discourages them from saving. You can change this by bringing back the IRA. Contributions to a new and popular IRA could accumulate to more than $1 trillion over the first 10 years

of this program. This would not only provide a huge pool of capital to help the U.S. economy grow, but would also create a $1 trillion nest egg for American families in the future.

Finally, as IRAs boost savings, they will also pay fiscal dividends for the Federal Government. The econometric model used by Merrill Lynch suggests that the successful implementation of IRAs could reduce U.S. interest rates by 50 basis points over the coming years. This would mean a savings of some $25 billion a year to the U.S. Government in terms of reduced interest payments on government debt and would help every American in terms of reduced interest costs on mortgages and other loans.

In short, a revitalized IRA would not only work, we at SIA believe that an expanded IRA would be a first and very important step toward saving the American dream.

Thank you very much.

[The prepared statement and attachments follow:]

TESTIMONY OF JOHN L. STEFFENS
SECURITIES INDUSTRY ASSOCIATION

Mr. Chairman and members of the Committee, I am John L. Steffens, chairman of the Securities Industry Association (SIA) and Executive Vice President, Merrill Lynch and Co., Inc. SIA commends you, Mr. Chairman, and the Ways and Means Committee for focusing attention today on America's "saving crisis." We appreciate the opportunity to share our views with you.

The membership of SIA accounts for more than 90% of securities activities in North America. Its roughly 800 member firms range from large firms engaged in a full spectrum of domestic and international securities and securities-related activities to small or local firms engaged exclusively in retail brokerage. The securities industry manages over $585 billion of client Individual Retirement Account (IRA) assets -- about 64% of all IRA assets.

SIA has long been convinced that the United States is not saving enough to remain globally competitive as a nation or financially secure as individuals. The membership of our association believes it is vital that we begin to address this crisis by expanding and modernizing IRAs.

The name of the new saving incentive you are considering today -- the "American Dream Savings Account" -- is particularly apt. In many ways, the U.S. saving crisis has put the future of the American Dream at risk. Whether the Dream is defined as financial security, a home, an education, a good job, or a comfortable retirement, the continued lack of adequate saving makes the American Dream more difficult to achieve.

SIA believes that an expanded IRA will help solve the saving crisis and go a long way toward saving the American Dream. My statement this morning will outline the scope of the saving shortfall in the U.S., address the need for expanded IRAs, and then discuss some specific features of the American Dream Savings Account (ADS Account) and other IRA proposals.

The U.S. Saving Crisis

The United States faces a saving crisis. Americans today are saving less than at almost any time since World War II. The personal saving rate has plummeted from 8 percent of disposable income in 1970 to only about 4 percent in 1994 (see Figure 1). In fact, American households currently save less than *half* as much as those in Britain and Germany and less than a *third* as much as those in Japan and France (see Figure 2).

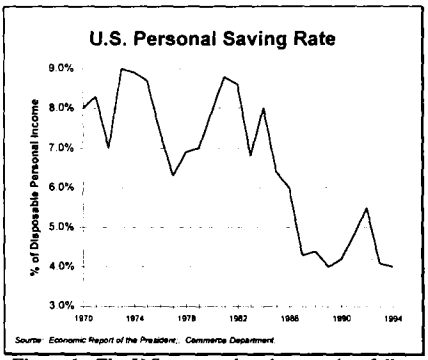

Figure 1: The U.S. personal saving rate has fallen 50% since 1970.

This drop in personal saving has driven the decline in U.S. national saving (which is defined as the sum of all saving by households, businesses, and government) -- a fact some have failed to recognize. There is a persistent myth in Washington that the fall in national saving is attributable largely -- or even entirely -- to rising Federal budget deficits. To the contrary, a close look at the U.S. saving statistics reveals that the fall in personal saving has been a larger contributor to the drop in national saving over the last 25 years than has the increase in the budget deficit. Net national saving has

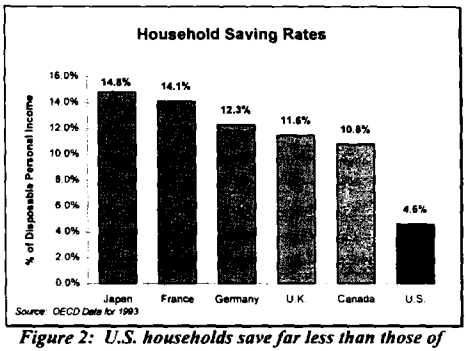

Figure 2: U.S. households save far less than those of our international competitors.

fallen from an average of 8.5 percent of NNP during the 1970s, to 4.7 percent during the 1980s, and to only 2.4 percent so far during the 1990s.

The overall economy and individual Americans alike are being seriously hurt by this historic fall in saving. At the national level, the saving crisis saps the fuel for long-term economic growth, because domestic saving is a vital source of the capital for domestic investment. In today's economy, the fall in personal saving from 8 percent to 4 percent represents a loss of roughly $200 billion of capital that could have been put to work in the U.S. economy. The cost of losing this capital is evident in the steady declines of U.S. domestic investment. While domestic investment averaged about 8 percent of NNP in the 1950s, 1960s, and 1970s, it fell to 6.1 percent in the 1980s and has fallen to just 3.1 percent so far in the 1990s.

As members of this committee know well, the macroeconomic result of low investment is straightforward: Fewer jobs at lower wages. By limiting investment in the American economy, the saving crisis slows business growth and hinders the advance of U.S. living standards.

However, and I want to stress this point this morning, the impact of the saving crisis is *personal* as well as national. As SIA member firms witness every day in our dealings with clients across the U.S., low saving has direct and serious implications for individual families.

This point is illustrated by an analysis of American household finances recently commissioned by my firm, Merrill Lynch. The study shows that *half of all American families in 1993 had less than $1,000 in net financial assets*[1] (see Figure 3). Although older households naturally had greater wealth than younger ones, the study found that even families headed by individuals ages 45 to 54 had only $2,600 in median net financial assets

Mr. Chairman, one of the themes of today's hearing is the future of the American Dream. With these figures in mind, is it any wonder the American Dream is a fading vision for many families? They simply don't have a cushion of saving to fall back on in hard times -- let alone the resources to buy a first home, fund a child's college education, or provide for a secure retirement.

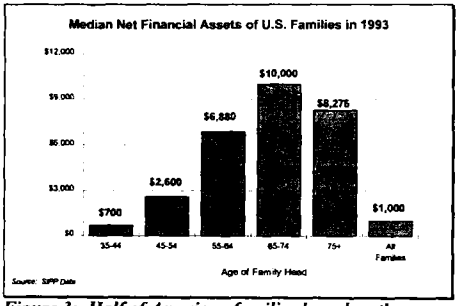

Figure 3: Half of American families have less than $1,000 in net financial assets.

On a similarly personal note, other academic research has shown that the future of retirement looks especially bleak for the 76 million members of the Baby Boom generation. Stanford University economist B. Douglas Bernheim's research on the Merrill Lynch Baby Boom Retirement Index[SM] reveals that Baby Boomers, on average, are now saving at only about <u>one-third</u> the rate needed for a secure retirement.

Dr. Bernheim arrives at this result by comparing the rate Baby Boomers are <u>actually</u> saving for retirement with the rate at which they <u>should be</u> saving in order to retire at age 65 with the same standard of living they enjoyed during their pre-retirement years. An Index of 100 percent would mean that Baby Boomers are saving at just the rate needed to retire at a consistent standard of living. Yet, Dr. Bernheim's most recent calculations -- which are based on data from a national survey of more than 2,000 Baby Boomers -- place the Index at only 35.9 percent, roughly one-third the minimum rate of saving.[2]

In light of work by the Bipartisan Commission on Entitlement and Tax Reform (i.e., the Kerrey Commission) -- as well as a range of academic research -- this calculation may even be based on *over-optimistic* assumptions. Specifically, Dr. Bernheim's "standard" analysis assumes that the future holds no systematic increase in taxes or decrease in the retirement benefits currently promised to Baby Boomers. These are difficult assumptions to justify in light of the Kerrey Commission's conclusion that the Federal government is on an unsustainable fiscal path, which will require extensive changes to current programs, including Social Security.

Sadly, all of this means that the Baby Boomers' financial preparedness is probably far worse than indicated by the "standard" Baby Boom Index results. In fact, when Dr. Bernheim recalculated the Index under an assumption of even moderate future Social Security cuts, he found that it fell from 35.9 percent to just 18.2 percent, suggesting that Baby Boomers should be saving more than five times -- rather than three times -- what they save currently.

Solving the Saving Crisis

Mr. Chairman, SIA believes that America's economic future hinges in large part on solving the saving crisis. Increased saving is vital both to prepare the overall economy for strong growth into the next century and to provide American households with greater financial security today and into retirement.

Fortunately, economic policy makers have a powerful tool to revive the nation's "saving habit." You can expand and modernize IRAs. SIA has been pleased to see the broad, bi-partisan support for an expanded IRA in Congress as well as such strong support for new IRAs from the President and his Administration.

Let me point out that the restriction of IRAs has played an important role in the decline of U.S. saving. Indeed, the drop in annual IRA saving is equal to about 40 percent of the decline in annual personal saving since 1986. Annual IRA contributions peaked in 1985, at just over $38 billion (or, expressed in 1993 dollars, $50 billion). They have fallen every year since, reaching a level of just $8 billion in 1993[3] (see Figure 4). If the IRA hadn't been curtailed by the Tax Reform Act of 1986, we conservatively estimate that the total pool of IRA assets possessed by American families would be $400 billion larger than it is today.

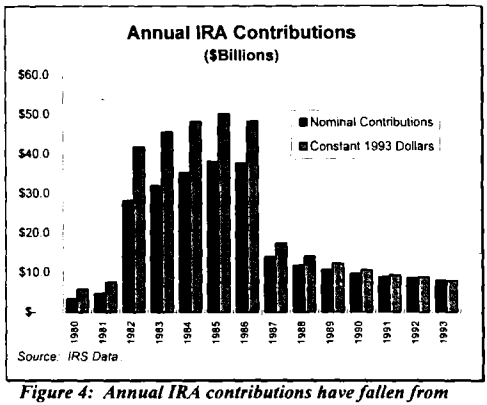

Figure 4: Annual IRA contributions have fallen from $38 billion in 1986 to just $8 billion in 1993.

SIA believes that a revitalized IRA will be popular with the American people, will lift personal and national saving, and will provide an important middle-class tax cut. The balance of my statement will address generally the case for expanded IRAs and specifically the features of the American Dream Saving Account this Committee is considering today.

The first point I would like to make is that the American people clearly want to bring the IRA out of "retirement." IRAs enjoy *exceptional* public support. In fact, a post-election survey by The Luntz Research Companies showed that IRAs were the single most popular tax proposal included in the Republican "Contract With America."

This shouldn't be a surprise. Other recent public opinion surveys have revealed that concerns about saving and retirement rank as high -- or higher -- than nearly every political issue on the table, including health care. In an August 1993 survey of 1,200 Baby Boomers commissioned by Merrill Lynch, 88 percent of respondents said losing their health insurance was one of their fears, while an even greater number, 91 percent, said they feared "Not having enough money to retire on."

Mr. Chairman, it is vital for this Committee to recognize one other reality: Right now the American people reject the idea that Washington is helping them save for the future. Fully 70 percent of Baby Boomers *disagree* with the statement, "The government encourages me to save."[4]

Second, there is a growing consensus among the academic community that IRAs successfully increase both personal and national saving. The list of top academics who have found that IRAs "work" includes Martin Feldstein (Harvard), David Wise (Harvard), James Poterba (MIT), Steven Venti (Dartmouth), Richard Thaler (Cornell), and former-Harvard economist Lawrence Summers, now Treasury Undersecretary for International Affairs.

Since the period of widespread IRA eligibility -- from 1982 to 1986 -- there has been an outpouring of academic research into the effectiveness of IRAs. SIA recently asked respected economists Jonathan Skinner (University of Virginia) and R. Glenn Hubbard (Columbia Business School) to sift through this research and attempt to draw some conclusions from the bulk of the scholarly work. In their new paper, "The Effectiveness of Saving Incentives: A Review of the Evidence," Professors Hubbard and Skinner conclude there is "compelling" evidence that IRAs increase both personal and national saving and recommend that expanded IRAs and 401(k)s be included in any comprehensive strategy to boost U.S. saving.[5]

In fact, Professors Hubbard and Skinner point out that even new research by Eric Engen (UCLA), William Gale (Brookings), and John Karl Scholz (University of Wisconsin) -- who have been critical of IRAs -- suggests that expanded IRAs would indeed boost saving. Computer simulations by Professors Engen, Gale, and Scholz show that, over the long run, increasing the limit on IRA contributions would boost net national saving by $4 for every $1 in tax revenue lost by the government. In their new paper, Professors Hubbard and Skinner characterize this finding as revealing a "powerful bang for the buck" from IRAs.[6]

Third, SIA believes that the significance of any "shuffling" of existing assets into IRAs has been vastly overstated by critics of the IRA program. We reach this conclusion for three reasons. First, consider the financial wealth actually possessed by typical American households. As mentioned earlier, half of all U.S. families in 1993 had less than $1,000 in net financial assets. The fact is, most Americans -- even if they were willing to lock their existing saving up in relatively illiquid accounts -- simply don't have very much in the way of financial assets to "shuffle" over to an IRA. The overwhelming share of households would run out of money to shift into the ADS Accounts or other IRAs in just a few years.

Second, a number of empirical studies of IRA saving suggest that the extent of "shuffled" saving is actually quite limited. For example, in a 1991 paper Professors Wise and Venti estimate that fully 66 percent of an increase in IRA contributions comes at the expense of current consumption; 31 percent comes from the tax subsidy; and only 3 percent comes from a "re-shuffling" of existing saving.[7] Professors Wise and Venti conclude, "Most of the new IRA saving resulting from an increase in the [IRA contribution] limit would represent a net increase in total saving; there would be little substitution away from other saving."

Cornell economist Richard Thaler has offered a third important insight concerning the "shuffling" critique of IRAs.[8] Dr. Thaler has argued that IRAs increase saving *regardless* of whether the money put into them was "shuffled" from another saving account. Why? Because people are much less likely to spend IRA saving over the long run than money in a regular checking or saving account. As Dr. Thaler writes, "Money in a saving account can be splurged on a new car, but money in an IRA is likely to stay put." This is a simple point, but one often missed by those who criticize IRAs on the grounds they are funded with "shuffled saving." Because IRAs get money into an account targeted for specific needs -- where it won't be quickly spent -- they will increase long-term saving even if the funds put into them would have been saved anyway in a regular account.

Taken together, SIA believes these three arguments demonstrate that there is much less to the "shuffled saving" critique of IRAs than meets the eye.

Fourth, all the evidence shows that middle-class Americans will be the big winners from an expanded IRA. From 1982 to 1986, IRAs were overwhelmingly used by middle-income Americans. At the peak of the IRA program in 1985 and 1986, 75 percent of IRA contributions were made by families with annual incomes under $50,000.[9] In fact, the contribution limit on the ADS Accounts and other IRAs ensures their "progressivity" -- the relative benefits of funding these saving vehicles will always be greater for families with lower incomes.

Unfortunately, the IRA income limits established in 1986 were *not* indexed for inflation. This is why IRA eligibility continues to decline sharply. Among workers whose spouses also

work, 53 percent were eligible for a full IRA deduction in 1987. This fell to 45 percent eligible in 1991 and only 38 percent eligible in 1995.[10]

Treasury Undersecretary Summers has highlighted one direct impact of dwindling IRA eligibility: *dwindling IRA advertising*. Dr. Summers argues that IRA advertising played a key role in improving attitudes toward saving and that, without this advertising, America has lost a powerful reminder of the need to save. In his words:

> *"Given our national saving problem, it is unfortunate that polls reveal that many people regard increased saving as bad for the economy because it reduces demand for goods. IRAs and the advertising they generate are a useful counterbalance to this sentiment. The existence of IRAs may cause people to focus more on the need to save for their retirement than they otherwise would. IRAs certainly give banks and other financial institutions a strong incentive to remind people of the need to save for retirement. Unfortunately, since the partial repeal of IRAs in 1986, this incentive has dwindled."*[11]

Dr. Summers's observations bring me to my fifth point: Beyond their direct benefit as a saving vehicle, expanded IRAs will play an even larger role in solving the saving crisis. They will help shift American culture. A restored IRA will encourage banks and other financial service providers nationwide to spend tens of millions of dollars advertising "saving." As with the IRA program from 1982 to 1986, this advertising will be diverse and prolific. It will no doubt succeed in getting many clients who formerly contributed annually to IRAs back into the "saving habit." This advertising will also lead millions of new savers to open IRA accounts.

Mr. Chairman, SIA hopes that this Committee understands just how significant such a change in advertising message could be. It should be viewed as an integral part of a "national saving campaign." Anyone who doubts this has only to compare the experience of walking down a city street in Canada -- where the windows of financial service firms advertise the opportunity to save in that nation's tax-preferred accounts -- with the experience of walking down a similar street in the U.S. -- where window advertising by financial firms often promotes more and better ways to *borrow*. The difference is striking and, I believe, goes a long way toward explaining why the household saving rate in Canada is more than twice the household saving rate in the U.S.

By restoring the IRA, the 104th Congress can literally change the advertising message reaching the passer-by on countless streets across America. The promotional efforts surrounding an expanded IRA would send a powerful message, day-in and day-out, to U.S. consumers: *"It's time to become a nation of savers."*

Sixth and finally, while IRAs worked before, the newly proposed IRAs will work even better. The IRAs of the 1970s and 1980s were designed only for retirement saving. Yet, as the ADS Account, the Thomas-Neal "Super IRA" and the President's IRA proposal all recognize, retirement is just *one* of the components of the American Dream. Education costs, a home, or medical expenses may be even more pressing needs for today's families.

The expanded withdrawal features of the ADS Account will make it an even more popular -- and effective -- saving incentive than the traditional IRA. At Merrill Lynch, our research has shown that people who begin to save for any reason begin to save more in other forms. In other words, putting some money away for the future, regardless of the objective, fosters a broader, healthy "saving habit." Based on our experience, we believe the ADS Account's withdrawal features will encourage new saving among Americans who may still be years away from seriously focusing on retirement. And once these people begin to save -- whether it is for a home or for education costs -- they will keep at it, consistently adding to their ADS Account balances.

The experience in Canada over recent years backs this point up. The Canadian Registered Retirement Saving Plans (RRSP) which now exist provide for unlimited, penalty free withdrawals before retirement. An important new study by Professors Wise and Venti shows that these plans have been extremely successful in stimulating new saving.[12]

Another key element of the ADS Account -- as well as the Thomas-Neal "Super IRA" and the President's IRA proposal -- is the "back-end" tax incentive. This feature would allow Americans to make deposits to the account from *after-tax* dollars, while qualified withdrawals would be tax free. Although "back-end" saving incentives and traditional, "front-end" saving

incentives are economically equivalent, the existence of the "back-end" incentive can offer important new flexibility for American savers.

There is some controversy among the academic community over whether "back-end" saving vehicles would be as popular and effective as "front-end" IRAs were during the early 1980s. Mr. Chairman, this Committee should realize that, since a "back-end" saving incentive has not existed in the U.S., academic economists lack any empirical evidence on which to draw conclusions.

At Merrill Lynch, we have conducted extensive market research on "back-end" tax incentives over the past five years. This research has included a series of in-depth, national public opinion polls as well as qualitative, focus-group discussion sessions. Based on this evidence, we are convinced that a "back-end" saving incentive will be extremely popular with, and widely use by, the American people. Merrill Lynch's early forecasts show that about half of Americans, if given the choice, would opt for a "back-end" saving incentive.

Ideally, SIA would like to see Congress give Americans a choice between a "front-end" and "back-end" saving incentive by including both of these options in any new IRA legislation. This would provide individuals with the flexibility to select the saving incentive that best matches their personal view of the future.

Nevertheless, if new IRA legislation passed by the Congress includes only a "back-end" saving incentive -- as the ADS Account does -- SIA still believes it will be a successful vehicle to boost personal and national saving in the U.S.

Saving the American Dream

A revitalized IRA would create a vast pool of new savings in the American economy. Merrill Lynch's early estimates suggest that contributions to a new and popular IRA could accumulate to more than $1 trillion within the first ten years of the program. These funds would represent not only $1 trillion of capital for new investment by U.S. businesses, but also a $1 trillion nest egg for the benefit of American families.

Even the Federal budget would be helped by greater saving. I personally believe it is realistic to project that a new IRA program could add $40 billion annually to net national saving. Based on the econometric model we use at Merrill Lynch, this additional saving would lead over the long run to a 50 basis point drop in U.S. interest rates. And lower interest rates, of course, equate to budget savings for the Federal government. According to the "rules of thumb" published each year by the Congressional Budget Office, a 50 basis point decrease in interest rates would lead within a few years to more than $25 billion in annual Federal budget savings simply due to lower interest payments on outstanding government debt.[13]

In closing, Mr. Chairman, let me reiterate SIA's conviction that, by bringing back and modernizing the IRA, the 104th Congress will truly help America prepare for the economic future. Families will begin shoring up their household balance sheets. And the overall U.S. economy will be supplied the capital it needs to produce more jobs at higher wages.

In short, a revitalized IRA will be an important first step toward saving the American Dream.

# # #

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Mr. THOMAS. Thank you.
Mr. Hazen.

STATEMENT OF CHARLES E. HAZEN, SOUTHAMPTON, PA.

Mr. HAZEN. Good morning, Mr. Chairman and members of this committee. My name is Chuck Hazen. I reside in Southampton, Pa. I thank you for inviting me here to participate in our democratic process today. It is an opportunity I never had before and one I never expected to have. It reinforces my belief in our democracy and proves to me that our elected representatives do want to know what ordinary citizens think about the proposals that you may enact into law. I am proud to have this chance to be part of the lawmaking process. I want to thank those of you who saw fit to come sit to hear what I had to say this morning.

I was somewhat taken aback by a comment earlier this morning in testimony, in that the segment of the populace of which I am a member was categorized as being ordinary. I, on second thought, realized that that is in reality a compliment, and I thank you for that. It may even promote an inception of a lapel button of some sort.

As I understand my role, you want me as a private citizen to talk about the American dream savings account proposal. You also want me to talk about my belief that long-term care insurance is important to me and to the majority of people like me. I believe that the ADSAs, as I am told we can call these new savings accounts, would be a very good thing to make available to the American people. I also believe that almost every hardworking middle-class American would buy long-term care insurance if they knew what it does and if they could afford its cost.

One of the most interesting things about your ADSA proposal is that a person can combine the good features of saving through an ADSA, with a desire to buy long-term health insurance care.

Mr. Chairman, I am an average middle-class American, 64 years old and I work part time as a self-employed estimator for a contractor. I retired last year after a 30-year career as an insurance claims adjuster. My wife Peg and I have worked hard all our lives. We have raised and educated our children.

We have saved so we can enjoy an independent retirement. We want to do everything we can to assure in our remaining years we will have as much comfort in and choice of lifestyle as possible. We also want to leave a legacy for our children and grandchildren.

We believe in savings. We believe in planning. Peg and I believe that our government should make sure that people who cannot take care of themselves are cared for, but we also strongly believe in our own individual responsibility to take care of ourselves when we are able to do so. That means I have an obligation to consider the future and to plan and save so that my needs and the needs of my wife will be met.

Both Peg and I want our children and grandchildren to enjoy the fruits of our lifetime of labor. It is possible to make that happen. I don't want to spend my old age having my needs met by welfare or Medicare or the government. I don't want my wife to have to rely on the government to take care of her should she outlive me and need nursing home care.

As much as I do not want either Peg or me to end up relying on the government for our care in our old age, I also don't want to use up all our lifetime accumulated assets on nursing home care. I want something left for our children and grandchildren. That means I need and must purchase long-term care insurance.

We are now in the process of acquiring long-term health care insurance for both of us. The premium for the plans which would cover both of us would be $3,000 or $4,000 a year depending on the benefits level we select. For about $3,000 we can buy coverage that would pay us $130 maximum per day for up to 4 years of nursing home care for each of us. This particular policy also provides for a 5 percent per year inflation adjustment for 5 years.

This policy has a coverage level that is lower than I would like, but at this time, it is what we can best afford. I wish I would have addressed this need and the availability of this coverage 10 years ago. At age 54, the premium would have been about half of what it is at the present time.

I also wish ADSAs had been available 10 years ago. If they had been, I could have invested up to $2,000 a year for myself and another $2,000 a year for Peg in such an account. Then we could have accumulated sufficient money to buy the coverage I feel we really need. We then could have purchased a higher level of coverage.

It is not too late, of course. I am still working, and assuming this proposal becomes law and assuming the market creates competitive products, I would buy an ADSA even now. It is likely that I would seriously consider using some of the money we would save in an ADSA to enhance my long-term care coverage 5 years from now.

Mr. Chairman, I am 100 percent behind your proposal to create ADSA opportunities to save. For younger people, they represent wonderful opportunities to save for retirement, yet they still have flexibility. People would not have to wait until they are 59½ if they wanted to use their ADSA money to buy a first home, to pay for long-term care insurance, to cover the cost of their children's college educations, or to meet unexpected medical expenses.

It seems to me that this idea is a much more cost effective way for government to help citizens who believe, as Peg and I do, that if we can, we have an absolute responsibility to take care of ourselves and our family.

The tax advantage of an ADSA will be a big help in saving for retirement. Before retirement, it will be a big help for people who want to protect their lifestyle and their ability to choose how and where they will live, when and if they become too old to take care of themselves. In short, an ADSA that lets people save enough to buy adequate long-term care insurance can allow people who have worked and accumulated a nest egg to protect their dignity and their choice.

It will then leave a legacy for their children. It would allow them personal control and freedom even during old age.

I think that the ADSA proposal with emphasis on long-term care is also certain to save the government money in the long run. It will be less expensive to provide the tax subsidy to help people meet their personal responsibilities than it would be to finance the cost of governmental paid nursing home care. It is a proposal that will have only winners—individuals, families and the American

people; because after all, the government when it is paying a bill is really you and me paying that bill. The government really is the American people.

Again, Mr. Chairman and members of the committee, I am proud to be here offering you my views on this proposal, which I certainly support. Thank you for this opportunity to participate.

If you have any questions, I will be glad to respond to them. Thank you.

Mr. THOMAS. Mr. Brennan.

STATEMENT OF JOHN J. BRENNAN, PRESIDENT, THE VANGUARD GROUP, ON BEHALF OF THE INVESTMENT COMPANY INSTITUTE, WASHINGTON, D.C.

Mr. BRENNAN. Thank you, Mr. Chairman. Good morning.

I am John Brennan, president of The Vanguard Group. I appreciate this opportunity to testify today on behalf of the Investment Co. Institute, the national association of America's mutual funds industry.

The Institute's membership consists of some 5,000 mutual funds, including The Vanguard Group. Institute member funds serve more than 38 million shareholders and almost one-third of all U.S. households. Vanguard itself has over $130 billion in mutual fund assets under management, representing more than 4 million individuals. That sum includes $22 billion in individual retirement account (IRA) investments in 1.5 million IRA accounts.

Because our industry's primary focus is on saving and long-term investment, we are confronted daily with this sobering fact: America's personal savings rate is far too low. Government statistics show that personal saving as a percent of disposable personal income has tumbled over the last decade, from a level of 8 percent in 1984, to a low of 4 percent in 1993.

Most Americans recognize that fact. They are not confident their savings will be sufficient to meet their retirement needs. They doubt that Social Security benefits will fill that gap. Their dilemma is finding ways to save more in the face of stagnating household incomes, increasing costs and bigger tax bites.

One part of the message sent in November by middle-class voters all across America was a demand that Congress give them a fighting chance to provide for their long-term financial security. In effect, voters were saying: "We are willing to take our share of the responsibility for our personal futures, but we want some relief from tax burdens to help us do that."

Fortunately, we don't have to "reinvent the wheel" to find sensible middle-income tax relief that responds to that call. Expanding taxpayers' opportunities to save for the future by contributing to individual retirement accounts can accomplish that goal.

The Republican Contract With America offers an excellent starting point by proposing the American dream savings account, an IRA designed to meet retirement needs and increase personal savings.

Restoring families' full access to IRAs is the most responsible of all possible middle-class tax relief. We support combining the American dream savings account with legislation reestablishing universal access to a fully deductible IRA. That way individuals

and families can choose to structure an investment program that best suits their particular needs. Providing IRA choices—this is the best way we believe to empower working families to save for their own future needs.

From a national perspective, the conclusion that IRAs increase personal savings is quite clear. To those who suggest that IRAs result in only a shifting of assets, I would note that financial institutions would not be so strongly supportive of expanded IRAs if it led to a mere shifting of money from one account to another. The experience of the mutual fund industry indicates that IRAs do in fact result in increased accumulations, not simply assets shifted from one pocket to the other.

While IRA choices are, in our view, the best answer, substantial experience in the IRA market has taught us another important lesson: A saving program that is not simple and marketable will not succeed. We cannot emphasize this enough: If an IRA is complex, it will not work.

If only tax accountants can understand it, they will be the only ones who use it. For savings incentives to work, the rules that govern them need to be stable and predictable. Frequent changes in the law create uncertainty and reduce contributions.

Our best recommendation is this: Make the IRA available as broadly as possible, keep it simple and make it permanent. You can be certain that enacting an IRA with complex rules and limitations will not work to increase personal savings.

I want to thank Chairman Archer and the committee for the opportunity to testify today on this issue of great importance to our Nation's future. I would be happy to answer any questions anyone might have.

[The prepared statement and attachment follow:]

TESTIMONY OF JOHN J. BRENNAN
INVESTMENT COMPANY INSTITUTE

Good morning, I am John J. Brennan, President of The Vanguard Group. I am testifying today on behalf of the Investment Company Institute, the national association of America's mutual fund industry. The Institute's membership consists of over 5,000 mutual funds, including The Vanguard Group. Institute member funds serve more than 38 million shareholders and almost one-in-three American households. Vanguard manages over $130 billion for more than 4 million individuals, nearly one half of those assets are invested through tax advantaged savings programs like Individual Retirement Accounts (IRAs) and 401(K) plans. I want to thank Chairman Archer and the Committee for the opportunity to testify today about an issue of great importance to our nation's future.

A. INTRODUCTION

Mutual funds permit millions of individuals to pool their savings in a fund professionally managed by an adviser who invests on their behalf in a wide variety of securities. Today, America's mutual funds serve an important financial management role for countless middle-income families -- not just the ranks of the wealthy. Median household income of mutual fund shareholders is approximately $50,000 a year.[1] Increasingly, mutual funds also serve as the investment medium for retirement programs, including employer-sponsored retirement plans and IRAs. As of December 1993, mutual funds held over $636 billion in retirement plan assets, of which $341 billion were IRA investments.[2]

Our industry's primary focus is on saving and long-term investment. For this reason, we are confronted daily with the sobering fact that America's personal saving rate is far too low. Most Americans realize this fact -- they are not confident their savings will be sufficient to meet their retirement needs, and they doubt Social Security benefits will be able to fill the gap. Their dilemma is finding ways to save more in the face of stagnating household incomes, increasing costs and bigger tax bites.

One part of the message sent in November by middle-class voters all across America was a demand that Congress give them a fighting chance to provide for their own long-term financial security. In effect, voters were saying: "We're willing to take our share of responsibility for our personal futures, but we want some relief from tax burdens to help us do that."

The Republican "Contract With America" responds directly to this need with the American Dream Savings Account, a type of IRA designed to meet retirement needs and increase personal saving. We enthusiastically support that proposal. By expanding the IRA options available to middle-class Americans, the American Dream Savings Account will provide direct, tangible tax relief by letting Americans save more and plan for retirement. We urge the Committee and the House to act promptly on this proposal.

B. AMERICA IS NOT ADEQUATELY PREPARING FOR RETIREMENT

There is a clear need for Congress to establish a more powerful incentive to increase retirement saving. Future retirees will have a longer life expectancy and, therefore, a longer retirement period than prior generations. It is also well known that the increasing cost of maintaining Social Security benefits must be funded by a shrinking work force. When the so-called "baby boom" generation (born between

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[1] Profiles of Mutual Fund Shareholders, Investment Company Institute (Fall 1992).

[2] Annual Mutual Fund Pension Statistics, Investment Company Institute (August 1994).

1946 and 1964) reaches retirement, there will be more retirees supported by fewer workers than ever before. Today, for each person 65 and older there are almost 5 persons between 20 and 64; when today's younger workers reach retirement in 2040, there will be only an estimated 2.7 persons between 20 and 64 for each person 65 and older.[3] In fact, the Social Security Administration reports that the program is insufficiently funded in the long run, and that it is projected to have a negative cash flow by approximately the year 2013.[4]

Recent studies indicate that even if our current mix of entitlement obligations and taxes remains unchanged, today's low saving rates could leave 46 million members of the "baby boom" generation with retirement living standards lower than today's median for 65 year-olds.[5] Even under that scenario, described as "an optimistic extreme," they conclude that future generations will need more private saving to provide them with as much purchasing power as current retirees.

This is not going unnoticed by the American people. A survey released in December 1994 by the Employee Benefit Research Institute reports that roughly two-thirds of Americans age 26 and over are not confident that Social Security will continue to provide benefits of equal value to the benefits received by retirees today.[6]

What are Americans doing in the face of this increased need for personal retirement saving? Unfortunately, they are saving less than ever before.

Government statistics show that personal saving as a percent of disposable personal income has tumbled over the last decade -- from a high of 8.0% in 1984, to a low of 4.0% in 1993.[7] If government deficits are factored in, the situation appears even more bleak: since the 1960s, "net national saving" has dropped from more than 8% to less than 2% today.[8]

The Institute has been concerned about the falling saving rate for some time. An Institute study released three years ago confirmed that, compared to other generations, the Baby Boom generation seems much less prepared financially for their retirement years. Despite a higher number of two-income families and a considerably higher per capita income than previous generations, their saving rates are lower than the two generations that preceded them. The study found that

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[3] Board of Trustees, Federal Old-Age and Survivors Insurance and Disability Insurance Trust Fund, 1994 Annual Report (U.S. Government Printing Office, 1994); Bipartisan Commission on Entitlement and Tax Reform, "Interim Report to the President" (August 1994).

[4] Ibid.

[5] See "Saving the American Dream," An Economic and Public Opinion Study Sponsored by Merrill, Lynch & Co., Inc. (1994); Auerback, Alan J. and Kotlikoff, Laurence J., "U.S. Fiscal and Saving Crisis and Their Impact for Baby Boomers" (May 1994), printed in Employee Benefit Research Institute, " Retirement In The 21st Century -- Ready Or Not," EBRI Policy Forum (1994).

[6] Employee Benefit Research Institute, "Retirement Confidence In America: Getting Ready For Tomorrow," EBRI Special Report SR-27/Issue Brief No. 156 (December 1994).

[7] Economic Report of the President, Transmitted to the Congress February 1994 (United States Government Printing Office), Table B-27.

[8] Bipartisan Commission on Entitlement and Tax Reform, "Interim Report to the President" (August 1994).

more than 6 out of every 10 Baby Boomers state that they are not saving for retirement, even though more than half expressed worry about meeting their financial needs during retirement.[9] Subsequent research only confirms these alarming trends.[10]

The evidence is overwhelming. Saving by America's middle class is simply not keeping pace with future needs. The prospects looking forward are unsettling. A policy response by government is imperative.

C. EXPANDING IRA OPTIONS IS AN EFFECTIVE POLICY RESPONSE

The Institute strongly believes that the best policy response is legislation to enhance individual retirement saving. We believe IRA options that are easy to understand and consistently maintained, can and will increase personal saving -- and help alleviate this coming national crisis.

Strong academic evidence supports the conclusion that IRAs do increase saving and do result in new saving.[11] A stable program, consistently maintained, will produce increased saving, not just a shifting of assets into tax-favored retirement programs. A saving habit can be developed through the use of an effective marketing campaign that reinforces the benefits of regular saving.

The psychological impact of an IRA on saving behavior should not be underestimated.[12] Common sense dictates that an IRA is more likely to produce long-term retirement saving than short-term saving vehicles. Money in your wallet is more tempting to spend than money in the checking account, which, in turn, is more tempting than a saving account. Even less tempting are funds set aside for retirement, such as money in an IRA. **We believe that money in an IRA is less likely to be spent than money in a savings account, so IRAs will increase long term saving even if all the money put into IRAs would have been put into some other shorter term saving account.**

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[9] "The Baby Boom Generation, A Financial Portrait," Investment Company Institute (Spring 1991).

[10] According to research performed for Merrill Lynch, half of American families currently only have approximately $1,000 in net financial assets. Anderson, Joseph M., "The Wealth of U.S. Families In 1991 and 1993," Capital Research Associates (December 1994). "Net financial assets" as used in the study include checking, savings and money market deposit accounts, CDs, stocks, bonds, mutual fund shares, IRA and Keogh accounts, 401(k) accounts, and other financial instruments, less unsecured debt (such as unpaid bills, bank debt and credit card balances) and debt secured by financial assets. Employer pension fund accruals are not included in net financial assets. See also, Employee Benefit Research Institute, " Retirement In The 21st Century -- Ready Or Not," EBRI Policy Forum (1994) and Employee Benefit Research Institute, "Public Attitudes on Retirement Income," EBRI Report G-55 (1994)

[11] See, e.g., Hubbard, R. Glenn and Skinner, Jonathan, "The Effectiveness of Saving Incentives: A Review of the Evidence" (January 1995)(includes a discussion of the major research papers); Venti, Steven F., "Promoting Saving For Retirement Security," Testimony before the Senate Finance Subcommittee on Deficits, Debt Management, and Long Term Growth (December 7, 1994); Thaler, Richard H., "Self-Control, Psychology, and Savings Policies," Testimony before the Senate Finance Subcommittee on Deficits, Debt Management, and Long Term Growth (December 7, 1994); Skinner, Jonathan, "Individual Retirement Accounts: A Review of the Evidence," printed at 54 Tax Notes 201 (January 1992)(includes collection of citations to relevant research studies by Professor Skinner and others); Venti, Steven F. and Wise, David A., "The Evidence On IRAs," printed at 38 Tax Notes 411 (January 1988)(includes discussion and collection of citations to earlier series of papers by Professors Venti and Wise).

[12] Thaler, Richard H., "Self-Control, Psychology, and Savings Policies," Testimony before the Senate Finance Subcommittee on Deficits, Debt Management, and Long Term Growth (December 7, 1994).

In the end, of course, all the statistics, scholarly research and academic studies in this area must give way to basic instinct and business judgment. The Institute and its members have made expanding the IRA our highest legislative priority, and we expect that the banking and brokerage industries share a similar objective.

That may be the clearest and most compelling testimony of all. What it is saying is that the investment and money management firms in the nation -- including many household names like Merrill Lynch, Fidelity, IDS, T.Rowe Price and Vanguard -- are convinced that expanding the IRA will significantly increase net saving by encouraging people to save more and over longer periods of time.

We would respectfully submit that, in the debate on whether IRAs contribute to net savings, deference be paid to the collective business judgment of the marketplace, which has proven its efficiency in the past in identifying opportunities for increasing investment saving.

D. EXPANDING IRA OPTIONS WOULD BENEFIT MIDDLE-INCOME FAMILIES

Because IRAs reduce taxes paid on income, they sometimes have been criticized as benefiting primarily the wealthy. Yet the evidence suggests the contrary -- **most contributions to IRAs are made by middle-income families.**

At the IRA program's peak in 1986, 75 percent of all IRA contributions were accounted for by families with annual incomes of less than $50,000.[13] **Moreover, it has been shown that, before its discontinuance, the universal IRA was increasingly attracting contributions from lower income brackets.** In the period of 1982 - 1986, the median income of new contributors (expressed in 1984 dollars) dropped an average of 24 percent, i.e., from $41,277 in 1982 to $28,677 in 1986.[14]

The best proof that IRAs are not "tax breaks for the rich" is the simple fact that expanding IRA options is undeniably viewed as important by America's middle-class voters. Frank Luntz, a prominent national pollster, has reported that a recent poll of the American public on budget, deficit and Social Security issues found that 65 percent of respondents felt strongly that Congress should restore tax deductible IRAs for all income levels. In fact, enhancing IRAs was the single most popular of all the tax proposals in the poll.[15]

The Congress should not, however, judge IRA expansion proposals solely on the basis of their popularity. All tax cuts are popular. America needs responsible tax cuts -- ones that increase saving, spur investment and do so without overstraining fiscal policy. Fortunately, we don't have to reinvent the wheel to find such a tax cut. Expanding taxpayers' opportunity to contribute to IRAs meets all of these sensible criteria.

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[13] Venti, Steven F., "Promoting Saving For Retirement Security," Testimony before the Senate Finance Subcommittee on Deficits, Debt Management, and Long Term Growth (December 7, 1994). IRA participation is also closely related to age. Nearly 50 percent of all families in the 55-65 age group had an IRA account. Thus, even though less than one-third of all families have an IRA at any single point in time, Professor Venti concluded that over their lifetimes, at least half of all families could be expected to participate in an IRA program.

[14] J. Skinner, "Individual Retirement Accounts: A Review of the Evidence," 54 Tax Notes 201 (January 1992).

[15] Luntz Research Companies, "Budget and Contract Post-Election Survey" (1994).

E. ENACTING IRA LEGISLATION NOW IS AN ESSENTIAL STEP TOWARD CURING OUR PERSONAL SAVING SHORTFALL

Proposals to expand the IRA have gained strong and well-deserved bipartisan support, and they include a number of thoughtful approaches.

The Republican "Contract With America" offers a new "American Dream Savings Account" that allows a non-deductible annual contribution of up to $4,000 for a married couple ($2,000 for an individual). If the account is held for five years, the taxpayer could withdraw funds tax-free and without penalty for retirement, first time home purchases, higher education or medical expenses.[16]

The Administration's proposal would expand tax-deductible IRAs and would permit the use of pre-retirement withdrawals to pay for first home purchases, higher education expenses, catastrophic health care expenses, long-term unemployment, or the care of an elderly parent. The Administration proposes to raise the current tax deductible IRA income limit for couples from $40,000 (phasing out at $50,000) to $80,000 (phasing out at $100,000). The Administration also would allow individuals the option of the "back-end IRA" for non-deductible contributions to an IRA, with the earnings exempt from tax when withdrawn.[17]

Congressmen Thomas and Neal recently introduced H.R. 682, The Saving and Investment Incentive Act of 1995, which would restore a fully deductible front-end IRA and establish a nondeductible, tax-free back-end IRA. The Senate is also, once again, active in this area. Senators Roth and Breaux have introduced a bill similar to H.R. 682.[18]

Some of these IRA proposals include provisions that would allow non-wage-earning spouses and spouses of workers covered by retirement plans to make full IRA contributions. These elements of the proposals are important steps that will help provide spouses with greater financial security. We strongly support spousal eligibility as a vital element of any IRA measure that Congress adopts.

In the final analysis, all of these IRA options respond directly to the need to increase personal saving. Congress can act most effectively by giving Americans a choice of IRA vehicles. That way individuals can choose to structure an IRA investment program that best suits their particular needs. Some may want the tax-free distribution option of the back-end IRA like that in the American Dream Savings Account, while others may find the immediate tax deduction of the front-end IRA is the incentive they need to save. Still others may want to divide their IRA contribution into front- and back-end IRAs.

While IRA choices are, in our view, the best answer, the mutual fund industry's substantial **experience in the IRA market has taught us an important lesson: a saving program which is not amenable to a simple marketing campaign is not likely to be as effective as Congress would like.** Economic studies on IRAs and

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[16] H.R.6, The American Dream Restoration Act.

[17] See U.S. Department of the Treasury, Treasury News, "Tax Cut Proposals In President Clinton's Middle Class Bill of Rights" (December 16, 1994).

[18] See, S. 12, The Savings and Investment Incentive Act of 1995.

saving have concluded that marketing plays a role in IRA purchases.[19] An IRA saving program that is easy to understand is most likely to be successful.

To doubt the importance of "marketing" and "marketability" to a successful saving initiative is to ignore the realities of the marketplace. We all can attest to the barrage of advertisements that pervade television, radio, newspapers, magazines, and billboards urging us to buy, spend, and consume. To promote saving you also need an effective "message" that encourages people to save and invest for their and their family's future. The saving record compiled between 1982 and 1986 proves the point. **When virtually all Americans enjoyed access to a simple, universally deductible IRA, financial institutions across the country actively promoted and marketed them as saving programs. As a result, millions of families invested more than $250 billion in just four years.** The IRA experience since 1986 is just the opposite and some studies have suggested the post-1986 drop off in IRA saving could be attributable to the greater difficulty financial institutions faced in trying to market the more complicated post-1986 IRA.[20] IRA legislation with multiple limits, set offs, exceptions, exclusions, rules and other technicalities cannot be effectively marketed, because the IRA it produces cannot be effectively explained to most Americans. We cannot emphasize enough, if an IRA is marked by complexity, it will not work! If only tax accountants can understand it, they will be the only ones to use it.

Moreover, for saving incentives to work, the rules that govern them need to be stable and predictable. Frequent changes in the law create uncertainty and reduce contributions. Such changes do not just confuse individual savers. They also undercut the willingness of financial institutions to make costly, long-term investments in marketing these saving programs to the public. **Our best recommendation: make the IRA available as broadly as possible; keep it simple; make it permanent.**

F. STRENGTHENING OTHER RETIREMENT SAVING PROGRAMS CAN ENHANCE SAVING

In our view, there are other simple actions that would promote retirement security of American workers, and other aspects of the retirement saving problem need to be addressed now.

Pension plan coverage in the small employer sector requires urgent attention. One of the major distinctions between the small employer (i.e., one with 100 or fewer

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[19] See, e.g., J. Skinner, "Individual Retirement Accounts: A Review of the Evidence," 54 Tax Notes 201 (January 1992). Skinner also reported that a large fraction of IRA households contributed exactly $2,000 even when each spouse was eligible to contribute $2,000. He cited the IRA marketing campaign's focus on the $2,000 contribution limit for individuals as a possible explanation. Ibid.; Feenberg, D. and Skinner, J. "Sources of IRA Saving," Tax Policy and the Economy (3d ed. L.Summers) (1989).

[20] In a recent article discussing the role of tax policy in shaping middle class tax cuts, Gene Steuerle, a Senior Fellow at the Urban Institute, said: "There is a fair amount of evidence that the current system adds enough complexity to deter saving in these [individual retirement] accounts. Thus, when IRA deductions were limited by income class, even those who did not face those new income limitations cut back on their IRA saving. One reason, perhaps, was that banks, mutual funds, and other institutions found it much more difficult to advertise these accounts in any simple way. If the simplification goal is important, then one would need to be careful not to add too many bells and whistles onto bills expanding IRA account availability." Steuerle, G., "Middle-Class Tax Cuts and Principles of Tax Policy," Tax Notes p. 1722 (December 26, 1994). See also Summers, Lawrence H., "How Best to Give Tax Incentives for Saving and Investment?" Testimony Before the Senate Finance Committee (September 29, 1989); J. Skinner, "Individual Retirement Accounts: "A Review of the Evidence," 54 Tax Notes 201 (January 1992).

employees) and larger employers is in the retirement plan area. As of 1993, only 29 percent of the employees who worked for a small employer worked for a company that offered a retirement plan, as compared with 83 percent in the larger companies.[21]

In our view, the simplified employee pension, or "SEP," is an under-utilized retirement plan vehicle through which small employers not currently maintaining retirement plans could be encouraged to provide retirement income for their employees.[22] The SEP is a simple, easy-to-administer retirement plan ideally suited for the small employer market, where coverage is woefully inadequate.

A variant of the SEP, a salary reduction SEP or SARSEP, has become increasingly popular in the small employer market. Modest changes in the current legal restrictions on the salary reduction SEP would make it more attractive to small employers and should increase coverage substantially. For example, simplifying both the 401(k) and the salary reduction SEP nondiscrimination rules would ease the burdens on small employers, promote greater retirement plan coverage and increase retirement saving. The Institute also recommends expanding the class of employers that could take advantage of the salary reduction SEP beyond the current "25 or fewer employees" size limit, and eliminating the requirement that at least 50% of the employees of the employer eligible to participate must elect to have salary reduction contributions made to the SEP. Each of these changes can be simply implemented.

G. CONCLUSION

Today's IRA savings are already one of the pillars of the American Dream -- because they are helping millions of families secure their future retirements through investments that help create saving, jobs and economic growth now. By working together to expand IRA options and restore full IRA eligibility to the middle class, we can empower millions more families to realize their own American Dreams.

Thank you again, Mr. Chairman, and the other members of this Committee, for permitting me to testify.

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[21] See Employee Benefit Research Institute, "Employment-Based Retirement Benefits: Analysis of the April 1993 Current Population Survey," EBRI Issue Brief No. 153 (September 1994).

[22] A SEP is an employer-sponsored arrangement through which the employer makes contributions to IRAs maintained for individual employees in accordance with a written plan. The SEP can be simply established by an employer completing five boxes on a half-page pre-printed IRS form. The employer does not need a lawyer, actuary or pension consultant to establish or maintain the SEP.

APPENDIX

INVESTMENT COMPANY INSTITUTE

SYNOPSIS OF ACADEMIC STUDIES ON THE IRA'S EFFECTIVENESS AS A SAVING INCENTIVE

The Institute has long supported legislative efforts to enhance individual retirement saving. A great deal of research has been done in recent years on the effectiveness of IRAs as incentives designed to increase personal saving. The primary issue on which many of these studies focus is whether the IRA tax incentive produces new saving or a windfall to typically higher income groups. Would IRA contributors have saved the money anyway, such that their contributions are simply assets shuffled from taxable to tax-favored accounts that do not increase overall personal saving? The mutual fund industry's experience has convinced us that IRA saving options that are easy to understand and consistently maintained can and do increase personal saving. This appendix is a synopsis of the work of a number of prominent scholars who have concluded that IRAs do result in new saving.

In a January, 1995 study, Professor R. Glenn Hubbard of Columbia University and Professor Jonathan Skinner of the University of Virginia published several important conclusions.[1] They focused on whether savings incentives like the IRA are likely to improve households' financial resources in retirement. They found evidence that IRAs and 401(k) plans account for between one-fifth and one-half of financial wealth among lower-middle-income households. They also found that most researchers studying saving incentives agree that in the long run, 401(k)s and IRAs have an important positive impact on saving behavior. For example, they cited recent calculations by economists suggesting that increasing the limit on IRA contributions will increase net national saving by $4 for every $1 reduction in tax revenue. They conclude that a long-term saving strategy for the U.S. Government should include saving incentives such as IRAs and 401(k) plans, and that since saving incentives appear most effective in the long term, policies introduced to encourage saving should remain in place.

In an earlier study, Professor Skinner studied IRS tax return tapes containing a sample of more than 5,000 tax returns filed for the years 1982-1986, to reexamine the evidence on the effectiveness of the IRA program.[2] He found that the IRS data "suggests a strong persistence in IRA purchases, with the probability of contributing to an IRA -- given enrollment in the prior year -- remaining over 80 percent during the entire period 1982-1986." In other words, he concluded that IRAs are a good way for individuals to contribute to their saving -- they do create new saving -- by ingraining the saving habit. Professor Skinner's study also cited data showing that, before its discontinuation, the universal IRA was increasingly attracting contributions from lower income brackets. Again using the IRS tapes of tax returns, Skinner found differences between those who first contributed in 1982, and subsequent new contributors. In the period of 1982-1986, the median income of new contributors (expressed in 1984 dollars) dropped an average of 24 percent, i.e., from $41,277 in 1982 to only $28,677 in 1986, although the fraction of new enrollees was low in that final year.

Dartmouth Professor Steven Venti has spent nearly a decade studying the saving effectiveness of what he calls "targeted retirement saving programs," such as IRAs, that allow individuals to save on their own behalf for the specific purpose of financing consumption in retirement. In recent testimony before a Senate Finance Subcommittee, he examined saving data from the Survey of Income and Program Participation for three different age groups

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[1] J. Skinner & R.G. Hubbard, "The Effectiveness of Saving Incentives: A Review of the Evidence" (January 19, 1995).

[2] J. Skinner, "Individual Retirement Accounts: A Review of the Evidence," 54 Tax Notes 201 (January 1992) (study also reviews earlier research done by Professor Skinner and others).

(families reaching age 60 to 64 in 1984, 1987 and 1991).[3] Dr. Venti found an "astounding" increase in asset balances the longer the family has been exposed to targeted retirement programs. The typical family with the longest exposure to targeted retirement savings programs -- those with nine years of exposure -- had nearly three times the targeted retirement assets of the typical family with only two years of exposure. He noted a comparable increase in total assets as well. Dr. Venti concluded that since total financial assets, including balances in IRAs, are much larger for the younger cohort than for the older cohort, that suggested that targeted retirement saving programs did stimulate new saving over the period, not just a shifting of saving from taxable accounts into tax deferred retirement accounts. He went on to conclude that "the weight of the evidence shows that these targeted retirement saving programs do increase saving."

Further according to Professor Venti, at the IRA program's peak in 1986, about 16 percent of tax filers contributed to an IRA, and about 29 percent of all families with heads of households under age 65 had positive IRA balances. While the likelihood of households having an IRA increased with income and age, at the peak of the program, 75 percent of all IRA contributions were accounted for by families with annual incomes less than $50,000.[4]

Professor Venti also has done a series of papers with Professor David A. Wise of Harvard University in which they examined saving.[5] In their 1991 paper, they estimate that fully 66% of the increase in IRA contributions comes at the expense of current consumption; 31% comes from the tax subsidy, and only 3% comes from a reshuffling of existing saving. That is, that IRA contributions do represent new saving.

Professor Richard Thaler of Cornell agrees that, over time, the households that contribute to IRAs and 401(k) accounts accumulate assets in those accounts rapidly, rarely draw them down before retirement, and show no signs of reducing assets in other accounts.[6] He further argues that recent experience with the IRA suggests that saving is as much a psychological as an economic decision. Specifically, Professor Thaler explains that households allocate funds, implicitly or explicitly into categories, or "mental accounts." "Some funds, e.g., those in cash or checking accounts, are designed for current consumption. Others, e.g., those in savings accounts, are for 'rainy days' or 'special occasions'." The various accounts differ in how "tempting they are to invade. Money in your wallet is more tempting to spend than money in the checking account, which in turn is more tempting than a savings account. Even less tempting are funds explicitly set aside for retirement, such as money in an IRA or 401(k) plan." Professor Thaler notes that while some economists have argued that IRAs simply shifted assets from taxable savings accounts into a tax sheltered IRA, those "studies fail to take into consideration that money in an IRA is less likely to be spent than money in a savings account." He argues that once this concept is acknowledged, IRAs can increase long-term saving even if all the money put into IRAs would have been put into some other shorter term saving account.

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[3] Venti, Steven F., "Promoting Saving For Retirement Security," Testimony before the Senate Finance Subcommittee on Deficits, Debt Management, and Long Term Growth (December 7, 1994).

[4] Professor Venti also found that IRA participation is also closely related to age. Nearly 50 percent of all families in the 55-65 age group had an IRA account. Professor Venit concluded that "even though less than one-third of all families have an IRA at any single point in time, over their lifetimes at least half of all families could be expected to participate in an IRA program." Venti, Steven F., "Promoting Saving For Retirement Security," Testimony for the Senate Finance Subcommittee on Deficits, Debt Management, and Long Term Growth (December 7, 1994).

[5] See, e.g., S. Venti & D. Wise, "The Evidence On IRAs," 38 Tax Notes 411 (January 1988) and J. Skinner & R.G. Hubbard, "The Effectiveness of Saving Incentives: A Review of the Evidence" (January 19, 1995) (including citation and discussion of the Venti & Wise 1991 paper).

[6] Thaler, Richard H., "Self-Control, Psychology, and Savings Policies," Testimony before the Senate Finance Subcommittee on Deficits, Debt Management, and Long Term Growth (December 7, 1994).

Mr. THOMAS. Thank you.
Mr. Gale.

STATEMENT OF WILLIAM G. GALE, SENIOR FELLOW, THE BROOKINGS INSTITUTION

Mr. GALE. I thank you for the invitation to testify at this hearing. My testimony is based on research that I have conducted over the past 5 years on the effects of IRAs and 401(k) plans on private saving and national saving.

Let me say at the outset that I agree with every other witness that has appeared this morning that low rates of saving and low rates of investment are one of our Nation's most important economic issues. Nevertheless, I do not support expanding the IRA system, because I believe that the evidence shows that it will lead to little, if any, addition to private saving and could possibly reduce national savings.

I should add that I say this reluctantly. I would love to come here and tell you that there is a quick painless way to fix the decline in savings, but, unfortunately, that is not what the facts say. This is a situation where when something seems to be too good to be true, it probably is. So in my testimony, I would like to talk you through basic elements of my reasoning and the evidence that supports this conclusion. I will focus on four points.

Point one is the overall saving rate. A number of people have mentioned that since the early eighties, the overall saving rate has fallen. You should note that since 1981, total balances in IRA plans, 401(k) plans and Keogh plans have increased by $1.5 trillion—$1.5 trillion represents about 7 years' worth of personal saving, so in the last 13 years these accounts alone have accumulated 7 years' worth of personal savings.

If these amounts represented new saving, it would not be too much to ask that this type of accumulation in 13 years would show up as an increase in the personal savings rate. In fact, as everyone today has mentioned, the personal savings rate has fallen rather than increased over this time period. There is no evidence from aggregate savings rates that saving incentives have had any positive effect on the overall saving rate.

Point two is that saving incentives are poorly designed from an economic perspective. There are two aspects to this: The first is unavoidable, and that is higher interest rates, believe it or not, do not always raise savings. Sometimes they reduce savings.

I am sure you are familiar with examples where higher interest rates raise saving, so let me give you an example of how they might reduce saving. Suppose you have a worker that goes to a financial planner and the planner says that the worker should save enough so that retirement income is equal to 70 percent of income during working years.

The simple fact is, if the worker aims for that goal, the higher the interest rate, the less the worker has to save. At a 20 percent interest rate, the worker needs to put away less than at a 5 percent interest rate.

The second issue is even more fundamental. You don't have to save to have an IRA. Saving more means consuming less or spending less. To put it in the boldest possible terms; saving more means

reducing your current standard of living. People naturally find that painful. People don't like to reduce their current standard of living.

But people love IRAs. Why? The answer is that most people that use IRAs can put the money into the IRA and get the tax benefit without reducing their standard of living. How can you do this? There are several ways, some of which have been mentioned by the earlier witnesses.

First, you can take taxable assets that you already own and put them in an IRA; second, you can take current or future saving that you would have done outside the IRA and put them into the IRA; and third, you could take a loan and put the proceeds into an IRA.

The good news for people doing these things is that they don't have to reduce their living standards and they still get the tax benefit. The bad news for policymakers is twofold. First, if this is how people contribute to IRAs, there is no increase in private saving; and second, there is an increase in the budget deficit. So point two is that the items are designed poorly from an economic perspective.

Point three is the evidence on who contributes to IRAs and what it means. The basic fact is that households with IRAs are much, much wealthier than households without IRAs. In 1986 they had seven times the amount of non-IRA financial assets, four times as much net worth and eight times as much saving.

Why does this matter? It shows that the households with IRAs have very high levels of preexisting wealth and very high levels of current savings. Hence, when witnesses say that the typical household in the economy has little saving and, therefore, can't shift money into an IRA, that is true, but it is irrelevant because the typical household does not have an IRA. Households that do have IRAs have lots of assets and lots of saving that they can easily shift into IRAs and, therefore, get the painless tax break rather than the painful one.

Let me close on point four, which is that I am one of those IRA opponents who allegedly is coming around to view IRAs favorably, according to the survey that was mentioned earlier. This is a draft survey. I feel it is highly irresponsible of the association to issue a draft survey into the public domain. I have sent the authors 12 pages of comments noting factual errors and logical inconsistencies in their study. But the point that is alleged to be my change of opinion, is that after 70 years, IRAs would raise the saving rate by one-quarter of 1 percentage point, for example from 4 percent to 4.25 percent. But first, that effect takes 70 years. Second, the model that generates that effect shows that IRAs reduce saving for the first 35 years. So the point of the model is that if you are willing to accept a reduction in saving for the first 35 years, then you can get some benefit after that. But I would add, if you are really interested in the 70-year horizon, the right thing to do is to rein in Social Security.

Thank you very much. I would be happy to answer any questions.

[The prepared statement follows:]

Testimony of

William G. Gale
Senior Fellow, The Brookings Institution

before the
House of Representatives
Committee on Ways and Means

Tuesday, January 31, 1995

Mr. Chairman and Members of the Committee:

Thank you for inviting me to testify on the desirability of expanding Individual Retirement Accounts.

My testimony consists of three parts: a brief summary of the main conclusions; a fuller exposition of the reasoning behind those conclusions; and a brief concluding statement about alternative ways to raise national and private saving.

Main Conclusions

- The low level of national saving and capital formation is the most important economic problem our country faces. Nevertheless, I do not advocate expanding the IRA program, because I believe that doing so would generate little if any increase in national saving and could possibly reduce saving.

- IRAs, and similar programs like Keogh plans and 401(k) plans, are designed poorly from an economic perspective.

- Despite the $1.5 trillion increase in balances in these accounts since 1981, the personal, private and national saving rates have fallen by substantial amounts.

- Most IRA contributions between 1982 and 1986 (the "golden period" of IRAs) were made by two groups of people: those with very high levels of non-IRA assets and those who were 59 or older. It is likely that contributions by these groups do not represent net additions to private or national saving.

- Highly stylized research models suggest that IRAs may raise the national saving rate in the long run (35 years or more). These results, however, are speculative, are subject to a number of important qualifications, and thus may not be a very good guide to current policy.

- The surest way to raise national saving would be to reduce the deficit in ways that do not reduce private saving. Raising private saving further may prove to be a difficult challenge, but attention should focus on the pension system.

Saving Incentives and The Saving Decline

American saving rates have recently fallen to their lowest levels in decades. These declines have raised concerns that the economy may be unable to finance investment and sustain growth over the long run, and that a significant fraction of the population may not be saving adequately for retirement. As a consequence, raising the saving rate has been a frequent focus of policymakers. One popular legislative remedy for stimulating saving has been the development of special, designated saving accounts, such as Individual Retirement Accounts, 401(k) plans, and Keogh accounts. These accounts, which I refer to as "saving incentives," feature preferential tax treatment of contributions and investment earnings, annual contribution limits, and penalties for early withdrawals.

IRAs were established in 1974 for workers without pensions. In 1981, eligibility was extended to all workers and the limits were raised to their current levels. For a single worker, the limit is the minimum of earnings or $2000. The presence of a spouse raises the limit by $250. In a two-worker household, the limit is the minimum of earnings or $2000 for each worker, so the maximum combined limit is $4000. From 1982 to 1986, eligibility was universal and contributions were tax-deductible. In the Tax Reform Act of 1986 (TRA86) deductibility was phased out

(eliminated) for household with a retirement plan when adjusted gross income exceeded $40,000 ($50,000) for joint tax-filers, and $25,000 ($35,000) for single tax-filers. TRA86 did not restrict IRA eligibility or the tax-free accrual of interest.

401(k)-type plans are similar to IRAs but are available only to workers at firms or other organizations that choose to sponsor the plans. Employees may make tax-deductible contributions. Employers may make independent or matching contributions. The legal annual contribution limit was $9,240 in 1994, but firm-imposed limits and non-discrimination rules reduce the limit substantially for many participants. Keogh plans are similar to IRAs but have higher limits and are directed toward self-employed persons.

Contributions to IRAs averaged about $35 billion during 1982-6 when contributions were fully deductible, but fell by about 75 percent after the TRA86 changes. 401(k) contributions have risen from virtually zero in 1982 to about $60 billion in 1994. KEOGH contributions have remained under $10 billion per year.

These programs have been very popular, but they may not have raised private and national saving. This would be true, for example, if the contributions to saving incentives were financed by shifting money from other existing assets or by redirecting saving that would otherwise have been placed in other assets.

One preliminary way to get a sense of the effects of saving incentives is to examine aggregate trends in saving. Since 1983, contributions to saving incentive plans have amounted to one-third or more of personal saving as conventionally measured. Moreover, from 1981 to 1993, assets in saving incentive accounts rose by almost $1.5 trillion. Since personal saving is about $200 billion per year, saving incentive accounts, in just 12 years, accumulated balances worth about 7 years of personal saving. It would not be unreasonable to expect accumulations of this magnitude to show up as increases in the personal saving rate. However, rather than rising, the personal saving rate fell by almost half over this period.

These trends should be interpreted with caution, however. Economists are unsure about the causes of the saving decline, and many factors affect aggregate saving. Nonetheless, it is clear that saving incentives are large relative to personal saving, and that trends in personal saving show no sign that saving incentives have increased saving.

Do Saving Incentives Stimulate Saving?

The effect of saving incentive plans on national saving is the sum of their effect on private saving and government saving.

Private Saving: Standard economic theory indicates that raising the after-tax rate of return on all saving creates two effects that work in opposite directions and hence may raise or reduce saving. The obvious effect is that the higher return raises the reward to saving and thereby encourages people to undertake more saving. Economists refer to this as a price or substitution effect. The second effect is less obvious but just as real. With higher interest rates, people can save less and still reach a given wealth target. Economists refer to this as an income effect. The income effect reduces the amount that people save in response to an increase in the rate of return. For example, suppose that a worker is saving for retirement with the goal of generating retirement income equal to, some fraction (say, 70 percent) of pre-retirement income. (This is a common financial planning approach to retirement saving.) The higher the interest rate, the less the worker needs to save to reach this goal.

How would this worker respond to an increase in interest rates? For a given target level of retirement income, the worker would save less than before (the income effect). But the worker may very well raise his retirement income goal (the substitution effect). If the increase in his goal is small, the income effect will dominate and saving will fall. If the increase in his goal is large enough, the substitution effect will dominate and saving will rise. Therefore, both the size and the direction of the effect of higher interest rates on all saving is ambiguous. Most empirical estimates and realistic simulation models suggest that the response is not very big.

Saving incentives do not raise the after-tax return on all saving, only on a limited amount of contributions placed in a designated account. For at least two reasons, this may be an even less likely way to raise saving than raising the return on all saving. First, oddly enough, so-called saving incentives do not require that contributors save, or save more than they would have otherwise. Saving requires a reduction in current consumption (or an increase in labor supply). But contributions to saving incentive accounts may be financed by transferring existing taxable assets, by increasing debt, or by reallocating saving that would have been done even if the

incentive had not existed. In each of these cases, the contribution will not represent a net addition to private saving.

Contributions will be most likely to be financed by one of the latter methods for two types of households. The first is households that hold large amount of other assets. These households have more assets to shift and less of a need to maintain all of their assets as precautions against emergencies. The second is older households, who are less likely to face a binding early withdrawal penalty. In the extreme, people older than 59.5 years face no early withdrawal penalties. In each case, IRAs are good substitutes for the saving those households would do anyway, so the IRA contribution will be unlikely to represent new saving. In contrast, contributions will represent a net addition to saving only when they are financed by reductions in consumption, which will occur only when IRAs and other saving are poor substitutes for one another. This is more likely to occur for households that have lower asset holdings, and are younger.

The second problem is that because the subsidies in saving incentive plans are capped by an annual contribution limit, the saving incentive will not affect marginal returns to saving for high-saving households. Rather, for those households the incentive will generate only an income effect, which should reduce their saving. Both of these problems imply that the effects of IRAs on private saving will depend critically on who contributes to IRAs. I examine this issue below.

Public Saving The effects on public saving are also important to consider. To the extent that contributions do not represent new private saving, the effects on public saving are strong and negative for two reasons. First, the tax rate faced by a household during retirement (when withdrawals are typically made) is usually lower than that faced by the same household during working years (when contributions are made). Second, some tax revenues are lost on the accumulated interest because investment earnings on IRA balances are taxed only when they are withdrawn. For example, if the tax rate during working years is 30 percent, the tax rate during retirement is 15 percent, the interest rate is 10 percent and the holding period is 15 years, the present value of tax revenues from a dollar of pre-tax income put into an IRA is 15 cents, but the present value of tax revenues from the same dollar of pre-tax income placed in a taxable account is 54 cents. Hence, in present value terms, the government loses 39 cents. This is larger than the 1 period revenue loss that would be recorded in the budget, 30 cents. If the holding period is 30 years, the present value loss is 55 cents. Thus, in the absence of other policy changes, a saving incentive plan must not only raise private saving but raise it by more than the associated tax loss to the government in order to raise national saving.

Who contributed to IRAs and Why It Matters

One step toward determining the effects of IRAs on saving is to focus on the characteristics of IRA contributors. The table below reports characteristics of different types of households in 1986.[1] The table describes the median or typical household in each category. All dollar figures are in 1986 dollars.

	All Households	Households without IRAs	Households with IRAs	Households that contributed to the Limit 3 years in a row
Age	49	49	50	51
Annual Income	$21,320	$15,667	$35,000	$44,500
Non-IRA Financial Assets	$6,000	$3,000	$21,695	$41,269
Net Worth	$42,710	$25,470	$107,946	$188,943
Saving (Change in Net worth, 1983-6)	$6,129	$2,884	$23,500	$60,691

[1]The table is taken from William G. Gale and John Karl Scholz, "IRAs and Household Saving," American Economic Review, December, 1994.

The table shows that households with IRAs are very different from households that do not have IRAs. In particular, compared to households without IRAs, the typical household with an IRA has seven times the non-IRA financial assets, four times the overall net worth, and eight times the saving. Some of these differences are due to differences in other variables like income or age, but even after controlling for these factors, there are large differences in the underlying saving behavior of household with and without IRAs that can not be explained by IRAs.

These facts have several important implications for understanding how IRAs affect saving. First, these differences complicate the task of measuring the effect of IRAs on saving. Studies that compare IRA contributors and non-contributors have to somehow disentangle the "IRA effect" from the "different underlying saving behavior effect." To see this, suppose there exist two groups: "large" savers and "small" savers. We would expect to see that IRA holders (where large savers are overrepresented) would save more than non-IRA holders (where small savers were overrepresented). But this would provide no information about the effects of IRAs per se, unless there is a way to control for the observable and unobservable differences between large and small savers.

Second, recall that there are two groups for whom IRAs and saving should be very good substitutes and hence for whom IRAs are least likely to represent net additions to saving: those with large amounts of liquid assets, and those who are over 59.5 years old. Related data (not in the table) show that households with non-IRA financial assets over $20,000 or who were 59 or older made more than two-thirds of all IRA contributions in the 1983-6 period.[2] Thus, the data suggest that most contributions were made by households that would consider IRAs and other saving good substitutes, and thus that the overall effects of IRAs on saving are likely to be small at best.

Third, many analysts acknowledge the presence of a "transition period" after IRAs are introduced. The idea is that when IRAs are introduced, people will shift funds from taxable sources into IRAs so the contributions at first will not be new saving. After awhile, people will run out of funds to shift and IRA contributions will eventually become new saving. The question that is debated is: how long will this transition period last? Some IRA proponents have reasoned that since the typical household has very little in pre-existing financial assets, the transition period will be very short: a year or less.

The logic of a short transition period is misleading for two reasons. The first is simply that the typical household in 1986 did not have an IRA, so the typical household is irrelevant to the debate about how long the transition will last. The relevant households are those that contributed to IRAs and in particular those that continue to contribute to IRAs: Did these households many pre-existing assets that they could shift into IRAs. The answer here is a resounding "yes." The table shows that pre-existing asset balances are high among household with IRAs. The typical IRA household in 1986 had over $20,000 in non-IRA financial assets. Among households that contributed to the limit for three years in a row, typical financial asset balances were $40,000. It is clear that for these households, IRAs could be financed from pre-existing asset balances for several years without raising saving.

The second problem with the proponents' logic is even more important: it ignores IRA contributions that are financed by current or future saving that would have been done even in the absence of IRAs. These contributions do not represent new saving. The table shows that typical IRA households and 3-year limit contributors have extremely high levels of other saving relative to their IRA contributions and so could easily finance contributions out of saving that would have been done anyway. The median 3-year saving level for 3-year limit contributors in the SCF was $60,000. Surely, it would not be difficult for many of them simply to shift $12,000 of that into an IRA. The median 3-year saving level for the typical IRA contributor was $23,000. This is certainly large enough to fund all or most of a typical three years worth of contributions.[3] These figures suggest that among households that did contribute to IRAs, there was a large on-going source of funds from which IRA contributions could be financed without raising saving. There is every reason to think the transition period could take a very long time.

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[2]Households who had non-IRA financial assets in excess of $40,000 or where the head was 59 or older made half of all IRA contributions during this period.

[3]The typical IRA household did not contribute every year: less than 1/3 of households with IRAs contributed all five years from 1982 to 1986. Half contributed all three years from 1982-4.

Evidence on the Effects of IRAs on Saving

There are two principal types of formal studies of IRAs. One type compares IRA contributors to non-contributors. The other type compares one group of IRA contributors to another group of IRA contributors.

The earliest studies of IRAs compared the behavior of IRA contributors to that of non-contributors. These studies claimed that IRA contributions raise saving. It has become clear, though, that these studies face very difficult challenges due to the differing propensities to save across different types of households. It is thus unclear whether these studies are uncovering evidence that IRAs raise saving or merely showing that people with high propensities to save tend to save more than people with low propensities to save.

For example, the degree of substitutability between IRAs and other saving can vary across households. The households that tend to contribute to IRAs (high wealth, older) are also the ones that should find IRAs to be better substitutes for other saving, and hence their IRA contributions are less likely to be net additions to saving. The households that tend not to contribute (younger, low wealth) are the ones that should find IRAs to be poor substitutes for other saving. Thus, if these households were to contribute to IRAs, their contributions would be more likely to be net additions to saving.

When comparing the 80 percent or so of the population that did not contribute to IRAs and the 20 percent that did, it is not surprising that the tendencies of the larger group dominate the estimates. That is, the estimate of substitutability for the overall population can be thought of as essentially a weighted average of the substitutability for the different groups and hence tends to reflect the low substitutability for the 80 percent that did not contribute. But the effects of IRAs on saving depend only on whether the households that contributed to IRAs found IRAs to be good substitutes for other saving. As noted above, these households differ systematically from the rest of the population in their substitutability of IRAs and other saving. The effects of IRAs depend in no way on whether people who do not contribute find IRAs to be good substitutes for other saving. Therefore, studies that compare contributors and non-contributors may be generating estimates that apply to the wrong group.

The second type of study has compared one group of IRA contributors to another group of contributors. The great advantage of such studies is that, by comparing one type of "saver" to another type of "saver," the studies control for unobservable differences between the groups in propensity to save. One such study was a paper I wrote with John Karl Scholz. Our model compared the saving behavior of households that contributed the maximum amount and those that contributed less than the maximum. We found that increases in IRA contribution limits would have resulted almost entirely in the redirecting of saving that would have been done anyway. Our paper also showed that it is statistically invalid (at least in our model) to compare contributors and non-contributors.

In another study, Eric Engen, Scholz and I look at two matched group of savers: 401(k) contributors and IRA contributors not eligible for 401(k) plans. Because the 1986 tax reform act reduced the attractiveness of IRAs, any positive effect of 401(k) plans on saving should show up in increased assets of 401(k) contributors relative to IRA participants not eligible for 401(k) plans between 1986 and 1991, controlling for other factors. We found, however, that there was no increase in assets of the 401(k) group relative to IRA contributors not eligible for 401(k) plans. This is consistent with 401(k) plans not raising overall saving. Other work that we have done and research by other scholars has produced similar results suggesting that the expansion of the IRA program has generated little in the way of new saving.

A final type of study has looked at the wealth of different cohorts of families over recent years. The idea is that, if saving incentives are raising saving, then the wealth of a typical 55 year old in 1991 should be greater than that of a typical 55 year old in 1984, because the former will have had access to saving incentives for a longer period of time. Indeed, there does appear to be evidence that the later cohorts have higher levels of financial assets than the earlier cohorts.

But this evidence should be interpreted cautiously, because it omits numerous factors that could work in the opposite direction. First, the analysis omits debt, but contributions to saving incentives can be financed by increasing debt holdings, and the debt/income ratio rose dramatically in the 1980s. Second, contributions can be financed by choosing to invest in financial rather than non-financial assets. The analysis omits non-financial assets, but there was a shift from nonfinancial to financial assets over the decade. Third, the analysis omits pensions, although there are obvious interactions between saving incentives and pensions. During the 1980s, non-401(k) pension coverage fell. Fourth, the 1980s saw the longest peacetime expansion

since at least the 1920s and experienced a dramatic rise in the stock market. These historically rare factors may have contributed importantly to the findings. Fifth, not all of IRA and 401(k) balances represent private wealth, because the household will still have pay taxes on whatever is withdrawn. The after-tax balances are probably only about 2/3-4/5 of the total. It is unclear how accounting for these factors would affect the conclusions.

Would Saving Incentives Work in the Long Run?

There is no necessary relation between the short-run and long-run effects of saving incentives. To examine the long-term effects, Engen, Scholz and I examined the effects of IRAs and 401(k) plans in a computer simulation model that tracks households' consumption, IRA saving, and non-IRA saving decisions over their lifetime.[4]

The results indicate that, following the introduction of an IRA, private saving falls and stays lower for a lengthy period. This occurs because people shift funds from taxable assets into IRAs and redirect into IRAs current and future saving that would have been done in taxable forms if IRAs had not existed. Thus, the model predicts that in the years following introduction of saving incentives, one would expect to see active participation in saving incentives and falling levels of other saving. As noted above, this is, broadly speaking, the pattern that has occurred in the U.S. since the early 1980s, and it is consistent with the reasoning above as to why the "transition period" should be thought to be lengthy.

After several years, the incentive effects of IRAs begin to dominate the shifting effects from other assets and other saving, and the private and national saving rate start rising. In the IRA example, it takes 49 years for the national wealth-to-income ratio to regain its initial value. For 401(k) plans, it takes "only" 35 years to regain the initial national wealth-to-income ratio. After 70 years, the model reaches a steady state. Ultimately, in the long run, the national saving rate is higher by 0.2-0.3 percentage points with IRAs. For 401(k) plans, the estimated effect is somewhat larger, 0.4-1.0 percentage points.

A full understanding of these results requires a number of important qualifications. First, any result projected 70 years in the future should be regarded with caution. Second, if these saving incentives are alternatively enacted and then discontinued, the model suggests that saving will actually be reduced. Given the large number of changes in tax policy in recent years, there is or should be a legitimate concern about whether a result that requires a stable tax structure for 70 years and whose benefits do not appear for at least 35 years should be pursued. So unless policymakers are certain that the policy will stay in place for a long time, the model suggests that introducing saving incentives would reduce saving. Third, for a number of technical reasons, the model overestimates the long-term effects, possibly by large amounts.[5] Fourth, the model does not include other tax-preferred, relatively illiquid assets (housing, for example) so it speaks to the effects of IRAs and 401(k)s only under special circumstances. Since the real world already has numerous tax shelters besides IRAs and 401(k)s, the real world issue is whether policymakers should add or enhance another tax shelter. The model does not address this issue.[6]

Psychological Models of Saving

The standard economic approach to analyzing the effects of saving incentives has come under attack in recent years from scholars who argue that psychological models are better at explaining how people save. These scholars argue that self-control is at the heart of the saving

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[4]See Eric M. Engen, William G. Gale, and John Karl Scholz, "Do Saving Incentives Work?," Brookings Papers on Economic Activity, 1994:1. The model includes overlapping generations of households. In the model, people save as a precaution against income risk and uncertain lifespan. The model predicts fairly accurately a number of characteristics of IRA and non-IRA saving, but overpredicts the saving and wealth of low-income households.

[5]These include: the absence of other tax-shelters, the overprediction of the participation of low-income households in the model, the absence of general equilibrium effects, the overstatement of the 401(k) limits, and the understatement of the 401(k) early withdrawal penalty.

[6]A final caveat should be added. Some proponents of IRAs have tried to recast the simulation results by looking at the ratio of the change in national saving and the change in government revenues. Use of this ratio is subject to all of the caveats above, as well as the fact that the ratio is a misleading and inconsistent indicator of the effects of the programs on saving. Specifically, a higher ratio need not imply a bigger effect on saving. It is easy to construct comparisons of policies where the ratio is higher for one policy but the effect on saving is higher for the other.

problem and that households divide their assets into different types of "mental accounts," some of which they feel are available for current spending and some of which are not. Proponents of these models suggest that IRAs serve to raise saving by giving an immediate benefit (the tax deduction) to people who would otherwise be reluctant to save and by placing the IRA funds "off-limits" in a non-liquid mental account. Other scholars have claimed that the availability of IRAs, coupled with the heavy advertising that accompanied IRAs in the 1982-6 period, can raise saving by informing people of otherwise unknown opportunities for saving, or by giving them saving targets that help convey the need to save.

These theories are intriguing, and merit further research, but their applicability to IRAs is questionable. Specifically, the applicability of these theories depends on who contributes to IRAs. If most IRA contributors had low wealth, then the theories would be more likely to be relevant. However, as noted above, the typical IRA contributor has seven times the non-IRA financial assets, four times the overall net worth, and eight times the saving of the typical household without IRAs. It thus seems clear that the typical IRA household does not need to have special incentives in order to save, and is aware of the opportunities for and need for saving. Moreover, households that are unable to accumulate much in conventional assets, as evidenced by low wealth totals, also tend not to contribute to IRAs. One of the key facts from the 1982-6 "experiment" with IRAs is that low wealth, low income, and young households had very low participation rates.

Raising the Saving rate

Since I believe that raising the saving rate is important, but that enhancing current saving incentives is unlikely to work, it is fair to ask what I would propose instead. First, I would suggest reduced expectations. There is no painless, quick fix for the saving decline. The decline in private saving has occurred over a number of years, and for a variety of reasons. To the extent that the decline is related to the liberalization of credit markets, increased transfers to the elderly, and the decline in wage and income growth, it will be difficult to alter the course of private saving through minor changes in the tax system. Second, the surest way to raise national saving is to reduce the deficit and in particular to reduce it in ways that raise or at least do not reduce private saving. A number of changes to the Social Security system, such as raising the retirement age faster and farther than is currently planned, would work in the right direction.

Third, if we are to raise the private saving rate, it will most likely be through expanding, enhancing, and simplifying the nation's pension system. Pensions differ from saving incentives in that pension participation is less optional, given one's job, and pension balances are less liquid pre-retirement. For these reasons, pensions may provide stronger effects on saving than elective saving incentives. Policy could usefully be directed toward re-examining the overfunding rules and the non-discrimination rules, and seeking ways to enhance pension coverage, especially among low-income workers. Note that these workers currently have access to fully deductible IRAs but do not tend to use them.

Finally, many American workers may be unaware of the need to save for retirement. Some sort of realistic education program may prove useful in raising the saving rate, but is certainly not a panacea.

Mr. THOMAS. Thank you, Mr. Gale.
Mr. Feltman.

STATEMENT OF KENNETH E. FELTMAN, EXECUTIVE DIRECTOR, EMPLOYERS COUNCIL ON FLEXIBLE COMPENSATION, WASHINGTON, D.C.

Mr. FELTMAN. Thank you, Mr. Chairman and members of the committee. The Employers Council represents over 800 employers of virtually all sizes and types and they employ over 14 million working Americans. The council supports the concepts behind the American dream savings account because it is one step toward solving the pending crisis in savings.

For too long, our Tax Code has discouraged savings, and when government creates a bias against savings, none of us should be surprised when people do not save. Passage of incentives will send a signal to all Americans that they must start now to save for their own future well-being. We are pleased that the debate seems to be over the structuring of the incentives; not over whether they are needed. Our recent research shows that incentives are needed.

For example, despite signs of an improving economy, the amount workers are saving for retirement dropped 8 percent in 1994 over 1993, and 34 percent over the past 2 years, according to our new National Workplace Pulse Survey of full-time working Americans. The survey was conducted in November 1994.

Workers expect individual savings to account for more than one-third of their retirement income, and most recognize that they are not setting aside enough to meet their retirement needs. Last year, for example, workers saved an average of only $1,776 annually for their retirement needs. That is compared with $1,932 the year before, and $2,688 in 1991, again according to the survey.

One factor contributing to the decline in retirement savings may be inadequate government incentives. Again, according to the survey, 82 percent of the workers who responded said that tax incentives are inadequate to encourage the average working person to save for retirement. Our research has found a widening gap between what workers believe they will need and get at retirement and what they are actually going to receive. I call this the expectations gap.

Our survey suggests that most workers know they are in trouble, but they are unable to do much about it. It is a cause of anxiety for them, but it is also good news because it suggests that these workers will save more if given incentives. Most people, 66 percent—that is an increase from 60 percent in the prior year—recognize that they are saving too little for their own retirement. They recognize that they, not their employers, not the government, will have to come up with the bulk of their retirement income.

I repeat—workers believe the government could be doing a lot more to help them; 82 percent, an overwhelming majority, tell us that government tax incentives are inadequate to encourage people to save for retirement. For people in their forties and their fifties, time is running out. If they have not salted something away, they need to start now and do so aggressively. No one can step in and help them in time to make much of a difference.

Unless they expect to win the lottery or die young, they are facing a rather bleak old age. They might not be able to afford needed medical or long-term care. These findings suggest that the system itself is simply not working.

Families cannot do it alone. They have too many other priorities, too many other bills to pay. They need help from employers and from the government. But not in the form of new entitlements; rather new incentives to save for retirement.

I believe that Workplace Pulse is sending Congress and all of us a clear message, and just in time. Workers and employers will respond if they are given a reason to save and an incentive to save. People now seem to recognize the reason, but they need your help. That is exactly where Congress should come in. Congress must act before time runs out for an entire generation.

Thank you.

[The prepared statement follows:]

Statement of Kenneth E. Feltman
Executive Director
Employers Council on Flexible Compensation
Before the
Committee on Ways and Means
House of Representatives
January 31, 1995

Introduction

Thank you Mr. Chairman and Members of the Committee. My name is Kenneth E. Feltman and I am executive director of the Employers Council on Flexible Compensation, a non-profit membership association committed to the study and promotion of 401(k) plans, cafeteria medical plans, and other elective compensation plans. The more than 800 members of ECFC are plan sponsors, corporations, governments, unions, universities, hospitals and clinics who are leading the way in the development and refinement of flexibility in benefit plans and the leading actuarial, insurance and accounting firms that design and administer flexible plans.

The Council supports the concepts behind the American Dream Savings Account because it is one step toward solving the pending crisis in savings. For too long, our tax code has discouraged savings. Just as individuals will reap what they sow and will find that when they have not saved enough they will suffer, so does the Government reap what it sows. When Government creates a bias in the tax code against savings, we should not be surprised when people do not save.

The Council favors incentives that will encourage workers and their employers to save to prepare for medical and long-term care needs in retirement. Passage of incentives now will send a signal to all Americans that they must start now to save for their own future well being.

We are pleased that the debate seems to be over the structuring of the savings incentives, not over whether they are needed. Our recent research shows that incentives are needed.

Since 1990, ECFC has co-sponsored Workplace Pulse, a national survey of 1,000 American workers that measures attitudes toward employee benefits and related issues. Unlike most national opinion surveys, Workplace Pulse interviews only Americans who are employed and work a minimum of 30 hours weekly -- no retirees, unemployed or part-timers. Otherwise, the survey population is a statistical profile of the national population in terms of race, gender, age, political affiliation, region and income level. The survey is directed by Dr. Verne Kennedy, senior research analyst for Pulse Surveys of America, and president of the Marketing Research Institute.

I am pleased to have the opportunity to share with the Committee the findings of the most recent Workplace Pulse survey on retirement, conducted last November. We believe that Workplace Pulse has brought into focus some issues that are cause for real concern as the Committee reviews federal tax policies, entitlements and other issues related to retirement.

Survey Background

Since 1991, we have been particularly interested in tracking workers' attitudes toward retirement and retirement savings. We recognize that decisions made by workers themselves today are the single most important factor determining the financial security of tomorrow's retired generation. After three years of attitudinal tracking, we believe

that we have developed a valuable measure of the financial security of the coming generation of retired Americans.

Of the three traditional sources of retirement income -- employer plans, social security and individual savings -- individual savings today is by far the most important. Today's workers have more responsibility to plan and save for their post-retirement income than did the generation in retirement now. Fewer workers can plan on income from defined benefit pension plans and, in general, employer contributions to retirement plans have declined. With the popularity of 401(k) plans and other flexible plans, workers have greater control over their retirement plans. With greater control comes greater responsibility.

Retirement Savings

Our 1993 Workplace Pulse survey suggested we are quickly approaching a crisis in retirement income expectations; we found a widening gap between what workers believe they will need and get at retirement and what they will actually receive. In our most recent survey, we were particularly interested in finding out more about this gap in retirement expectations -- which I call the "expectations gap."

I regret that our November survey shows things are continuing to get worse, not better. Americans are saving even less toward retirement now than they were a year ago, despite signs of an improving economy. Yet people expect to retire at the same time as their parents, they want to retire comfortably and they recognize that they -- not their employers or the government -- will have to provide the bulk of their retirement income.

In October 1992, when we conducted our first Workplace Pulse survey on retirement issues, we found that two-out-of-three workers recognize that they are setting aside too little themselves for retirement -- an average of $223 per month or $2,688 annually. In November 1993, we again asked workers how much they were saving toward retirement and our sample said they were saving an average of only $161 monthly toward retirement, or about $2,000 a year, a decrease of 28 percent from 1992. In November 1994, we found that individual retirement savings dropped again, to $148 monthly, or about $1,776 annually -- a 34 percent decline in just two years at a time when individuals must provide more, not less, of their retirement income. The only good news is that the rate of decline lessened year-to-year, to about 8 percent.

As you might expect, as workers age they save more for retirement. Our survey found that workers over 45 years old have actually increased their savings rate over last year, from an average of $2,408 annually to $2,700, which was about the national average for all age groups two years ago. However, our survey found that workers under 45 are saving significantly less than the national average. Workers under 35 are saving only $1,308 annually.

It is clear that millions of working Americans simply will not be able to retire in financial security unless they are able to change their savings habits dramatically. If current trends continue, the baby boom generation may end up working into their 70s to make ends meet or relying upon their families, welfare, or charity to survive.

Workers' Expectations

Our survey suggests that most workers know they are in trouble, but are unable to do much about it. That is a cause of anxiety for them, but is also good news because it suggest that these workers will save more if given incentives.

Most people -- 66 percent, an increase of six percentage points over last year -- recognize that they are saving too little for retirement. They also recognize that they, and not their employers or social security, will have to come up with the bulk of their retirement income.

Despite this knowledge that their current savings rate will not allow them to retire comfortably, people have not changed their retirement expectations accordingly. This is the "expectations gap."

Despite the national trend towards working later in life, most working Americans say they plan to retire before age 65. The typical respondent plans to retire at age 61. Twenty-nine percent of our sample expects to retire before the age of 60. Our findings on planned retirement age have not changed from last year.

In addition to retiring early, workers do not plan to lower their standard of living when they retire. Seventy percent said they plan to live as well or better than when earning a full salary.

Retirement Planning
Even if they cannot afford to save much now, are workers at least planning for retirement?

Unfortunately not, according to Workplace Pulse. Only 7 percent have completed a retirement financial plan. Nearly one out of four, 23 percent, has yet to start planning and 44 percent say they have only started planning. Though they clearly are not following their own advice, our sample said individuals should begin planning early for retirement, at the age of 25.

Employer and Government Roles
Workers may take some solace in the fact that their employers seem to be doing slightly better in providing retirement support than they were a year ago. Seventy-eight percent reported that their employers provide some sort of retirement or pension plan, up from 71 percent last year. Yet only about 64 percent of our total sample is participating in employer-provided plans, an increase from 58 percent in 1993.

By overwhelming numbers, workers prefer the flexibility and choice provided by 401(k) plans. More than 50 percent want their employers to offer a 401(k). That is a significant increase from 1992, when 401(k) plans were the most popular retirement plan with 41 percent of the sample.

Workers believe the government could be doing a lot more to help them. An overwhelming majority -- 82 percent -- said government tax incentives are inadequate to encourage people to save for retirement.

Long-Term Care
Perhaps no other retirement costs have risen as much as medical care and long-term care. We asked several new questions about long-term care this year, and found some of the same attitudinal disconnect that we found on other retirement issues. Nine-out-of-ten workers want to receive long-term care at home, not in an institution, despite the lack of affordable home health care in many communities. More than half, 52 percent, said that is not likely that they will ever need long-term care, but statistics and projections indicate many more will.

Those who do plan on needing long-term care look toward private insurance or their own savings to pay for it. Relatively few expect the government or their employers to help, and only 16 percent believe their families will take care of them. However, only one-in-eight workers -- 16 percent -- has actually purchased a long-term care policy. Sixty-three percent say they would be more likely to buy long-term care coverage if it were offered through a payroll deduction at a reasonable cost.

Summary
These Workplace Pulse findings give us a better understanding of what is going on and raise several serious policy questions. The new Congress and the Administration must come to grips with the fact that we cannot rely on the economy alone to provide

today's workers with an adequate retirement. The average family just cannot make it alone in this economy. If steps are not taken now, we face a pending social crisis when millions of retiring baby boomers discover that they cannot retire in the lifestyle they expected or when they expected.

Individual workers can no longer look to others for help. Their retirement destinies are in their own hands, and our survey suggests that people are slowly coming to grips with this new retirement reality. They know they are not saving enough. They know they are not planning for retirement. They want a retirement as good as their parents have had, but they're discovering that they just cannot save enough without help.

Should the economy continue to improve, will workers be able to afford to save more? Or will it take an even bigger boost in the economy to turn around this trend? We will not know for sure until future Workplace Pulse surveys, but these results do deliver some sobering messages.

First, it is clear that for people in their 40s and 50s, time is running out. If they have not salted something away, they need to start now and do so aggressively. No one is going to step in and help them in time to make a difference. Unless they expect to win the lottery or die young, they are facing a bleak old age where they will not be able to afford medical or long-term care.

Second, these findings suggest that the system itself is simply not working. Families simply cannot do it alone. They need help from employers and from the government, not in the form of new entitlements, but rather new incentives to save for retirement.

At the same time that many employers have reduced their retirement plans and more responsibility for retirement income has been placed on the worker, the government has quietly made it much more difficult for employers and employees to save. Even the GATT legislation passed last year chipped away at individuals' ability to save for retirement.

We have witnessed the whittling away of the amount individuals can save in tax-favored individual retirement accounts. Non-discrimination rules make it more and more difficult for middle income workers to contribute significantly to their own tax-deferred 401(k) plans. Federal regulations are strangling defined benefit pension plans. It is no wonder that only 14 percent of workers surveyed said that tax incentives are adequate to encourage the average working person to save for retirement.

Acting now to develop and implement a comprehensive national retirement income policy that encourages rather than discourages individual retirement savings is more than good politics. It is also good government. Every retirement dollar salted away today will save the government more dollars years later in health care, welfare and other social programs. As they say in the advertisement, you can pay a little now...or you can pay a lot more later.

I believe this Workplace Pulse survey is sending Congress a clear message just in time. Workers and employers will respond if they are given a reason to save and an incentive to save. People seem to recognize the reason, but they need help. That is exactly where Congress should come in. Congress must act...before time runs out for an entire generation.

Thank you.

Mr. THOMAS. Thank you very much.
Ms. Mohr.

STATEMENT OF MARY L. MOHR, CHAIRPERSON, SAVINGS COALITION OF AMERICA, WASHINGTON, D.C., AND SENIOR VICE PRESIDENT, FIRST TRUST CORP., DENVER, COLO.

Ms. MOHR. Good morning, Mr. Chairman and members of the committee. My name is Mary Mohr. I am senior vice president of First Trust in Denver. First Trust is the country's largest independent trust company. I am also chair of the Savings Coalition of America and am representing them today.

The Savings Coalition includes 50 members, representing a wide variety of interests, including consumer, health care, education and business groups, engineers, homebuilders, realtors, trust companies, banks, and brokerage firms. The coalition would like to thank the committee for holding these hearings and for the invitation to testify in support of the American Dream Restoration Act.

On behalf of the coalition, I want to commend you for your leadership and vision demonstrated in your efforts to restore tax incentives for saving to all Americans.

The Savings Coalition of America was established in 1991 to support incentives to increase personal savings rates. It has as its primary objective to encourage congressional and administrative approval of expanded IRA legislation. The coalition is committed to seeking the enactment of expanded retirement account legislation and supports the key features of H.R. 6, the American Dream Restoration Act.

The coalition believes that tax and economic policy should provide more opportunity and incentive for Americans to save and invest for the future. By restoring the American dream of owning a home, sending children to college and retiring comfortably, the ADS account will respond to many of the concerns that members of the middle class express today. The Savings Coalition of America supports H.R. 6, the Thomas-Neal bill and S. 12, the Roth-Breaux bill in the Senate.

U.S. savings rates are now lower than during any comparable period in American history. According to the CBO, personal savings rates have decreased steadily over the past 25 years, falling from 8 percent in the sixties and seventies, to less than 4 percent today. The causes and consequences of saving rate declines has been the subject of considerable debate among economists and policymakers, but the policy solutions were best articulated to Congress 24 years ago by President Nixon in the following quote:

> Self-reliance, prudence and independence are qualities which our government should work to encourage among our people. These are also qualities which are involved when a person chooses to invest in a retirement savings plan, setting aside money today so that he will have a greater security tomorrow. In this respect, pension plans are a direct expression of some of the best elements in the American character. Public policy should be designed to reward and reinforce these qualities.

The IRA best exemplified these qualities by empowering American taxpayers to take control of their long-term finances, placing responsibility for their retirement squarely on their own shoulders. But after the Tax Reform Act of 1986, Americans watched opportunities to increase their IRA nest egg slip away.

Why? Many working Americans who made tax-deductible contributions to IRAs for 5 years, stopped saving in an IRA because the front-end deductibility, the primary incentive, was taken away with the Tax Reform Act. Financial companies and banks stopped advertising, and savings rates plummeted. Without tax incentives, many Americans found they could not afford to save.

The ADS addresses these obstacles by empowering the middle class to provide for themselves and their families in the future, enabling retiring Americans, who are living, on average, 16.7 years beyond the age of 65, to accumulate additional sources of retirement income; by assisting Americans who have come to realize that Social Security and private pensions combined, provide only 45 percent of the average married person's retirement income; by offering incentives to save in the event of major catastrophic illnesses or long-term care expenses not covered by health insurance, creating the opportunity for all Americans, parents, children and grandchildren to achieve the highest level of education that they would like to attain; by encouraging those Americans who have dreamed of owning a first home but were previously shut out of the housing market, an opportunity to save for a downpayment; and finally, supporting families with one income by recognizing the equal value of work performed in the home.

The Savings Coalition also supports the Thomas-Neal bill which provides savers with two options, by restoring the traditional benefits to all savers as well as providing the back-ended IRA feature. Like H.R. 6, this proposal allows for penalty-free withdrawals in the event of major life events. Both the ADS accounts and the proposed IRA will offer benefits for which most Americans are not currently eligible.

By offering a tax incentive that is universally available to all savers, and that includes the flexibility to accommodate major life events, the ADS account and the IRA are indeed solutions for the nineties. The Savings Coalition of America looks forward to working with the committee and would like to take this opportunity to extend an offer of assistance.

Our members are committed to pursuing the enactment of expanded retirement account legislation and believe that with your leadership, Americans will once again have the opportunity and incentive to save and invest for the future.

Thank you very much, Mr. Chairman.

[The prepared statement and attachments follow:]

TESTIMONY OF MARY L. MOHR
ON BEHALF OF THE
SAVINGS COALITION OF AMERICA
1225 I STREET, NW, SUITE 500
WASHINGTON, DC 20005
202/682-4736

BEFORE THE COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

CONCERNING H.R. 6
THE AMERICAN DREAM RESTORATION ACT
JANUARY 31, 1995

Introduction

Good morning, Mr. Chairman and Members of the Committee. My name is Mary Mohr. I am Senior Vice President of First Trust Corporation of Denver, Colorado. First Trust is the country's largest independent trust company, specializing in self-directed retirement plans. I am also Chair of the Savings Coalition of America and am representing the Coalition here today. The Savings Coalition includes 50 members representing a wide variety of interests, including consumer, health care, education and business groups, engineers, home-builders, realtors, trust companies, banks, security firms and financial service companies.

The Coalition would like to thank the Committee for holding these hearings and for the invitation to testify in support of the American Dream Restoration Act. On behalf of the Coalition, I want to commend you for the leadership and vision demonstrated in your efforts to restore tax incentives for saving to all Americans.

The Savings Coalition of America was established in 1991 to support incentives to increase personal saving rates. It has as its primary objective:

To encourage Congressional and Administrative approval of expanded IRA legislation.

The Coalition is committed to seeking the enactment of expanded retirement account legislation and supports the key features of H.R. 6 - The American Dream Restoration Act. The Coalition believes that tax and economic policy should provide more opportunity and incentive for Americans to save and invest for the future. By restoring the American dream of owning a home, sending children to college and retiring comfortably, the ADS account will respond to many of the concerns that members of the middle class express today. The reasons for supporting this proposal are compelling and reasonable. The Savings Coalition of America also supports the Thomas-Neal bill and S-12, the Roth/Breaux bill in the Senate. We look forward to working with both houses to pursue expanded retirement savings legislation.

Self-Reliance, Prudence and Independence

United States saving rates are now lower than during any comparable period in American history. According to the Congressional Budget Office, personal saving rates have decreased steadily over the past 25 years, falling from 8% in the 1960s and 70s to less than 4% today. The causes and consequences of saving rate declines have been the subject of considerable debate among economists and policy-makers, but the policy solutions were best articulated to Congress more than 24 years ago:

> "Self-reliance, prudence, and independence are qualities which our government should work to encourage among our people. These are also qualities which are involved when a person chooses to invest in a retirement savings plan, setting aside money today so that he will have a greater security tomorrow. In this respect pension plans are a direct expression of some of the best elements in the American character. Public policy should be designed to reward and reinforce these qualities." President Richard Nixon, December 9, 1971 *(Schultz, 1994, p.224)*.

It was with this vision that Individual Retirement Accounts ("IRA") legislation was first introduced. By emphasizing the values of self-reliance, prudence and independence, the IRA was designed to empower American taxpayers to take control of their long-term finances and to place ultimate responsibility for their retirements squarely on their own shoulders.

Enacted in 1974 and liberalized in 1981, the IRA tax incentive allowed every U.S. worker to save and invest up to $2,000 in earnings annually in his or her own personal pension plan. During the IRA's most popular period, from 1982 to 1986, American workers contributed more than $172 billion to IRAs **(Table 1)** *(IRA Reporter, August 1994)*. Increasingly, Americans became aware of the importance of long-term saving and recognized that for many of them, the IRA represented their best opportunity to accumulate retirement funds.

Joseph Nocera cites the IRA as "the financial device that brought home the realization that the American middle class was going to have to take control of its own financial future" *(Nocera, 1994, p.288)*. Among the American middle class, the success of the IRA precipitated what has been described as a major cultural shift. Before the IRA, many middle class Americans felt powerless to control their long-term finances and, although they might save at their local bank or thrift, few had experience as investors. The IRA industry not only helped the middle class to assume a role in securing a more comfortable retirement, but also offered opportunities to expand their understanding of and participation in financial markets.

But when the Tax Reform Act of 1986 ("TRA") sharply curtailed IRA eligibility by excluding taxpayers with incomes over $50,000 (or $35,000 for single taxpayers) who participated in a pension plan at work, it caused a dramatic decline in annual IRA contributions. According to the Internal Revenue Service, contributions fell from an annual average of $34.5 billion during 1982 to 1986, to an annual average of $11.9 billion from 1987 through 1993 **(Table 1)** *(IRA Reporter)*.

Not only did the number of IRA participants decline, but more importantly, many of those working Americans who once considered the IRA as "the people's nest egg" *(Nocera, p.289)*, now found that they no longer had their government's support and encouragement to establish long-term savings.

Fewer Incentives, More Obstacles to Saving

By 1986, Americans watched opportunities to increase their "nest egg" slip away just as quickly as the IRA had been embraced as the solution to saving rate declines. Without tax incentives, many Americans found they could not afford to save. In addition, workers increasingly encountered economic, social and demographic obstacles to maintaining or improving their financial existence. Consider the environment in which middle class families are trying to achieve the American Dream.

> **Economic Uncertainty**
> Having experienced job layoffs and economic stagnation throughout the last decade, members of the American middle class continue to feel uncertain about their ability to provide for themselves and their families in the future.

Aging Population, Longer Retirement
The retirement period has lengthened, requiring more financial support. In 1960, Americans aged 65 and over made up 9% of the population. By 1990, this proportion reached 13%. It is expected to reach 18% by 2020 and 23% by 2050. Retirees reaching age 65 can expect to live, on average, another 16.7 years. A longer retirement period results in "an increasing portion of Americans who will have to depend on sources other than employment for income and vital services" *(Employee Benefit Research Institute, 1992, p.8)*.

Social Security Cutbacks
The Social Security Old-Age and Survivors Insurance ("OASI") program can no longer be depended upon as a primary source of support throughout retirement. Currently, Social Security and private pensions combined provide only 45% of the average married person's retirement income. Yet, Money magazine (June 1991) found that its readers consistently overestimated the amount they will receive from Social Security and their pension funds, and underestimated how much they will need to save for retirement. In addition, existing law will soon begin to push back the current retirement age when Americans can receive full Social Security benefits. These cutbacks will apply to and increase for all workers born after 1937 in anticipation of the disproportionately large number of baby-boomers who will soon be entering retirement *(EBRI, 1992)*.

Underfunded Private Pensions
Reports of the Pension Benefit Guaranty Corp. ("PBGC") taking over the underfunded pension plans of well-known, financially-troubled corporations, have sparked alarm among many workers who are depending on their employer's pension plans to provide a major portion of their retirement income. The PBGC indicates that pension plan underfunding is a problem that will continue to pose risks for many retirees *(Wall Street Journal, February 4, 1993, p.1)*.

Rising Health Care Costs
The aging population and the rapid upward pace of health care costs are having a tremendous impact on medical expenses. Between 1970 and 1990, the price level of medical services and commodities rose 479%, compared with a 337% increase in consumer prices. Even with health care benefit programs, these rising health care costs make it very difficult for working Americans to financially recover from major catastrophic illnesses *(EBRI)*.

Dependent Parents
Today, approximately 60% of the elderly are dependent on their children for support. The proportion of health costs associated with nursing home care and other long-term care will increase as Americans get older. According to the Employee Benefit Research Institute, Medicaid financed up to 43% of the $48 billion U.S. nursing home tab in 1989. But, in the absence of private insurance coverage for long-term care, consumers paid out-of-pocket expenses of approximately 45%.

Higher Education Expenses
The value of a college education has become increasingly important since the early 1970s. The difference between the earnings of a man with a high school diploma and one with a college degree was 39% in 1970 and had grown to 64% by 1988 (Byron, 1991). American parents recognize the importance of higher education, as well as the need to save for college, but few have the resources to do so. This is supported by a Roper Poll commissioned by the National Institute of Independent Colleges and Universities (1991) that showed that only half of the parents who expect their children to attend college save anything at all for future college expenses. Those who do save average only $517 per year. With the average cost of a year of college ranging from $10,000 to $25,000 today, what will Congress do to help aging baby boomers pay for their children's college education?

Housing Affordability

Since the 1980s, Americans have demonstrated declining rates of home ownership, particularly among those in the 25- to 34-year-old-age range. Payments on a typical home in the 1950s represented about 14% of an average 30-year-old's gross income. Today, a median priced home claims about 44% of income *(Burton, Dittmer, Loveless, 1992, p.154)*. Young families have also been squeezed out of the housing market because of their inability to save for a down payment. As housing prices have escalated, down payments of 10% to 20% have become out of reach for the average young American family. Providing opportunities for home ownership not only extends the American dream to more young families, but also pumps millions of dollars into the national economy through new housing starts and increased employment. Job creation then extends to the plumbers, electricians, real estate salespersons and all those working Americans participating in the housing industry.

Family Financial Pressures

Economic forces have made it nearly impossible to raise a family on one income and those families that attempt to must do so without much help from government policy. Under current rules governing IRAs, married couples are limited to a deductible contribution of $2,250 per year if only one person earns income. But, when both spouses work outside the home, each is permitted to contribute up to $2,000, for a total of up to $4,000 annually in an IRA *(Brennan, 1994)*.

The American middle class is experiencing a period of unprecedented uncertainty. For the first time in American history, parents cannot assume that their children's lives will be economically better off than their own. Without a consistent, comfortable standard of living, families are unsure how they will be able to:

- Become homeowners
- Send their children to college
- Support their aging parents
- Support themselves in retirement

Saving rates have declined, and so has the opportunity to achieve the American dream of a better tomorrow.

The American Dream Savings Account and the Individual Retirement Account - The Solution for the 1990s

The proposed American Dream Savings ("ADS") account, like the IRA, is designed to respond to citizens' concerns about the future. By offering tax incentives and empowering workers to accept responsibility, the ADS account provides hope, as well as a means to achieve long-term financial goals.

The Savings Coalition also supports the Thomas-Neal bill, which provides savers with two options, by restoring the traditional benefits to all savers, as well as providing the "back-loaded" IRA feature. Like H.R. 6, this proposal allows for penalty-free withdrawals, in the event of major life events.

Both the ADS account and the proposed IRA will offer benefits for which most Americans are not currently eligible.. By offering a tax incentive that is universally available to all savers and that includes the flexibility to accommodate major life events, the ADS account and the IRA are indeed solutions for the 1990s. The ADS account and IRA incorporate the original values of self-reliance, prudence and independence, while addressing present day concerns. With their approval, the American public's faith in the future and their resolve to achieve their own financial dreams, will be restored.

The Savings Coalition of America Supports the ADS Account

The Savings Coalition of American looks forward to working with the Committee on Ways and Means, and would like to take this opportunity to extend an offer of assistance on any issues related to the legislation. Our members are committed to pursuing the enactment of expanded retirement account legislation and believe that with your leadership, Americans will once again have the opportunity and incentive to save and invest for their future.

TOTAL IRA CONTRIBUTIONS

Historical View

Source: IRA Reporter, August 1994

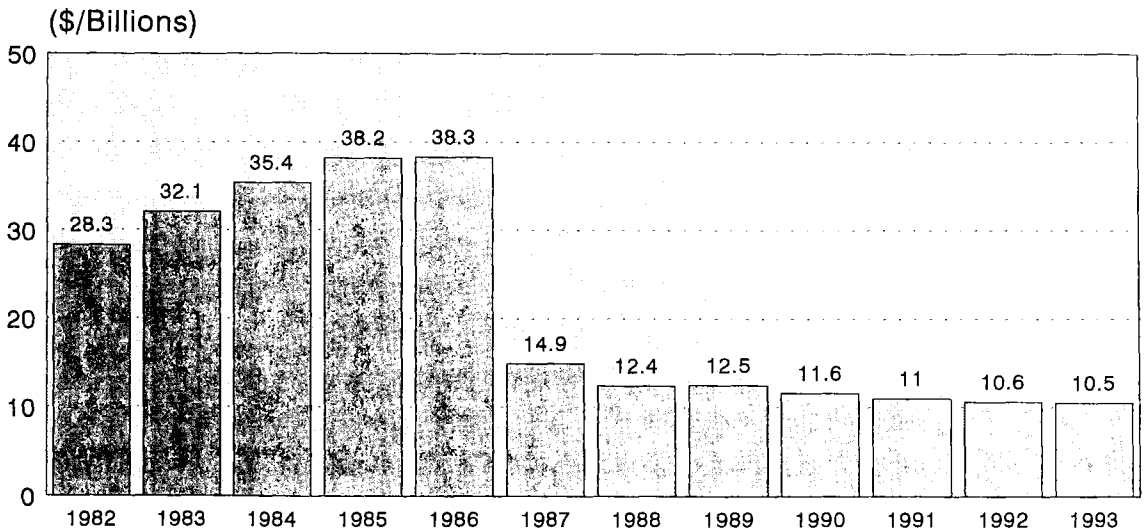

TABLE I

AVERAGE IRA CONTRIBUTIONS

Before and After Tax Reform Act of 1986

Source: IRA Reporter, August 1994

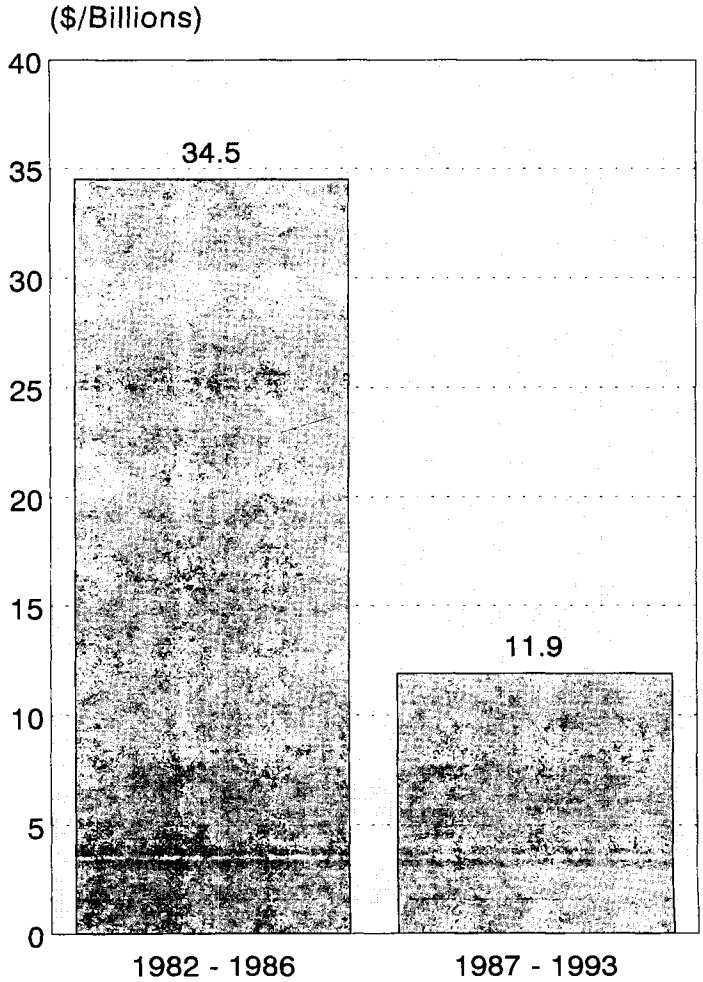

TABLE II

SAVINGS COALITION OF AMERICA

MEMBER LIST

JANUARY 1995

A. G. Edwards, Inc.
American Bankers Association
American Council for Capital Formation
American Council on Education
American League of Financial Institutions
Association of Jesuit Colleges and Universities
The Bankers Roundtable
Chase Manhattan Bank
Citicorp/Citibank
Citizens for a Sound Economy
College Savings Bank
Consumer Bankers Association
Dean Witter, Discover & Co.
Delaware Charter Guarantee & Trust Company
Edward D. Jones & Company
Fidelity Investments
First Trust Corporation
G. E. Capital
Gold & Silver Institute
HD Vest Financial Services
Household International
Independent Insurance Agents of America
Institute for Research on the Economics of Taxation
Institute of Electrical & Electronics Engineers - United States Activities
International Association for Financial Planning
Investment Company Institute
Kemper Corporation
Lincoln Trust Company
Merrill Lynch & Co., Inc.
Mortgage Bankers Association of America
National Association of Federal Credit Unions
National Association of Home Builders
National Association of Independent Colleges and Universities
National Association of Realtors
National Association of Securities Dealers, Inc.
National Association of Uniformed Services
National Rural Electric Cooperative Association
Prudential Securities, Inc.
Resources Trust Company
Retirement Accounts, Inc.
Retirement Industry Trust Association
Savers & Investors League
Saving & Community Bankers of America
Securities Industry Association
Sterling Trust Company
Transcorp Pension
United States Chamber of Commerce
Wheat First Butcher Singer

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Mr. THOMAS. Thank you very much. And I thank all the panelists.

The gentleman from Illinois.

Mr. CRANE. Mr. Steffens, you indicated that your study showed that the back-ended IRA would be very popular with the American people. I was wondering if that study embraced the broad spectrum of income groups, low, middle, upper, or whether it was targeted to a narrower range of income groups?

Mr. STEFFENS. It included a broad range of income groups. The sample size was somewhat limited because we felt that to have it done effectively, we had to conduct one-on-one education because many peoples' initial response was that they clearly would prefer the up front deduction.

Once respondents in our study began to understand the benefits of what would happen if they chose a back-ended IRA, that they would never have to pay taxes, we found that 53 percent would choose to invest in a back-end IRA.

I also think that it is interesting to note that of the remainder, the largest number were concerned that the government would come back after the fact and change the rules; that is, decide to tax savings. That was the primary reason for those that said that they would just as soon get the tax break up front.

Mr. CRANE. Mr. Feltman, did your study embrace a similar range of all income groups and reach the same conclusions?

Mr. FELTMAN. Yes, it did, and we did reach virtually the same conclusions.

Mr. CRANE. Thank you.

No further questions.

Mr. THOMAS. Mr. Rangel.

Mr. RANGEL. Thank you, Mr. Chairman.

I think the economic record is clear that we have to provide for incentives for people to save and we have to have more capital available if America is going to maintain its competitive edge. Equally as important, of course, is the deficit, and we have been making such progress on that every year for the last 3 years, and this entire Contract as presented to us, at least by the estimates of the U.S. Treasury, will cost us over $700 billion over a 10-year period. And there is no question that, one way or the other, whether it is capital gains or IRAs, that we have to build up savings in this country.

But have any of you really considered the impact of what would happen if we did have a hemorrhage on the deficit, based on an extraordinarily novel way of scoring the losses of some of these tax provisions?

Ms. Mohr.

Ms. MOHR. Well, our coalition focuses on the positive. Our belief is that once Americans are given the opportunity and the incentive to save more dollars and that government supports a long-term program such as the IRA, that Americans will create more savings opportunities. Those investment dollars will create jobs in the economy——

Mr. RANGEL. I agree with you 100 percent, the same way I agree that if you invest in education, you will get a more productive worker. We need the investment and it would encourage and would

leverage more investment, and we could have better plant, equipment and better competition; but if these Treasury figures are right, if we are talking about a $700 billion loss after we have now attempted to decrease our deficit, is that not even a factor?

Ms. MOHR. Well, certainly the need to decrease the deficit is obvious to all Americans.

Mr. RANGEL. If these figures are right, is there a balance here? You see, it is my impression that the majority, having the votes and the commitment to the Contract, will just give us one package, and it is up or down. This is a provision that you know is not that expensive, $17 billion over a 10-year period, as compared to $700 billion to get this turkey off the ground. But what do we do?

Is there anyone that has any concern to at least say this is a great provision, we have to provide incentives to get more people to save, but for God's sake, don't raise the deficit. Does anyone think that, or is this provision so important that you think we have to pass this and anything that the majority would say should be included?

I assume all of you read the Contract—do all of you support the Contract, the tax provisions?

Mr. HAZEN. I would have no reason to disagree with your figures as far as the amount of money lost over a 10-year period to the government, but I feel that there would be some savings to subtract from your figures in regard to the number of Americans who would be able to care for themselves in this area, as opposed to the government having to spend moneys to help them in this regard.

Mr. RANGEL. Mr. Hazen, when you reduce the deficit, I don't know what it is like now, but close to one-third of every one of our tax dollars, especially you as a voter and taxpayer, goes to pay the interest on our debt. So if we were really able to get down to a zero deficit, all of us get tax benefits from it because it is a lesser liability.

My point is that if all the economists are convinced, except the ones that they will be able to bring in here, that this is a revenue loser, a substantial revenue loser, should we as lawmakers consider that?

Mr. STEFFENS. Many have not looked at the IRA issue in a dynamic way. The macroeconomic models that we have looked at say that within a 10-year period, the Federal Government could look to save around $25 billion a year in interest, more than offsetting the cost of the IRA program because of the additional supply of savings.

In fact, examining the lost savings from the reduction in IRAs since 1986, you could build a very strong case that that has cost $25 to $40 billion a year for the last 8 or 9 years, plus the interest on that, we would have had an additional $400 billion pool that would have been available to make investments in the U.S. economy.

Mr. RANGEL. I didn't make my question clear. I support the IRA, but as part of a much larger tax package.

Mr. THOMAS. The gentleman's time has expired.

Mr. McCrery.

Mr. MCCRERY. Thank you, Mr. Chairman.

Just to try to give a brief response to Mr. Rangel; you may be interested in a quote from Martin and Kathleen Feldstein regarding the American dream savings account which is a substantial portion of the tax provisions of the Contract. We are sold on the new American dream savings account as an attractive way to encourage saving. We are also convinced from studies of the experience with traditional IRAs, that such accounts do raise the national saving rate, even if the loss of tax revenue causes the budget deficit to rise.

So there are two noted economists who think the value of such a broad savings instrument for the American people outweighs even some loss of revenues to the Federal Government.

Mr. RANGEL. Would the gentleman yield?

Obviously, I did not word my question to Mr. Steffens as clearly as I would like, but is it possible that I can support this IRA provision in this committee and not have it a part of a bigger package? I thought that this was a part of the Contract, not just a paragraph.

Mr. MCCRERY. It is part of the Contract and we look forward to having your support for it. If you would like to try to separate it, you can do that later on as we go through this.

Mr. RANGEL. I was under the impression, and this may help all the Members, majority and minority, that when this turkey is cooked, we have to vote up or down, that we won't be able to splice off the parts that we like.

Mr. MCCRERY. That is the way we would prefer it and that is probably the way we will vote.

Mr. RANGEL. This may be a good provision for the IRAs.

Mr. MCCRERY. We appreciate your endorsement.

Now, I will get back to my questioning of the witnesses.

Mr. RANGEL. All right. Thank you for your consideration.

Mr. MCCRERY. Sure.

Mr. Gale, I guess you don't agree with the Feldstein's analysis there, based on your testimony.

Mr. GALE. That is right.

Mr. MCCRERY. What about Mr. Steffens' comment, which struck me as making a lot of sense, just plain old common sense. I am not an economist and not a finance major; I am just a country lawyer, but sometimes something that somebody says just kind of makes sense to me.

Mr. Steffens said that if you create opportunities for Americans to save, easy opportunities like IRAs, things that everybody can understand, it creates a culture of saving, and he thought that was important to create that culture of saving in the American society. Do you put any credence in that at all?

Mr. GALE. I think if we could create a culture of saving that that would be a great thing to do, primarily because I think raising the saving rate would be a wonderful thing. But the so-called culture of savings started in 1982. It was alive and well through 1986, allegedly, when the regulations were changed; and just for the record, the saving rate fell between 1981 or 1982 and 1986.

Mr. MCCRERY. Well, there is a lot of reason for that.

Mr. GALE. Right. But there are also lots of potential ways IRAs can work. The culture of saving idea is one idea, the asset shifting

idea is another idea, and there is no reason to think that the culture of saving is the way things work.

Mr. MCCRERY. But you do think Mr. Steffens is right. If we could create a culture of savings in this country, would it be a good thing?

Mr. GALE. Absolutely, but I would underline the "if," and I would also note that it doesn't seem to me that we know how to do that yet.

Mr. MCCRERY. There are a lot of things that we are not real sure about.

Mr. BRENNAN. Mr. McCrery, may I comment on that? One of the things we have proven time and again is that education about savings has a tremendous impact on people's behavior, whether it involves a company-sponsored retirement plan or something else. Mr. Steffens mentioned earlier the kind of marketing and education that would go on with the advent of a renewal of interest in IRAs; and there is documented proof that in site-specific examples, education works. It raises participation rates in defined contribution plans. This results just simply from making people aware of the benefits of the plan. So I would be much more in your camp as to what the prospects for additional savings would be if we were to broaden awareness of the subject.

Mr. STEFFENS. Mr. McCrery, yes. You know, it is interesting to know that in 1986 $38 billion went into IRA accounts; after they changed the law, it dropped to $14 billion and then to $8 billion. Our estimates are that had they left the law as it had been, we would have had $50 to $60 billion at a minimum going into IRAs annually today. Savings rates came down slightly during the IRA period, but they plummeted from 1986 to the present. Some 40 percent of this decline in savings rate could in fact be justified by the simple decline in the IRA area. So it is pretty clear to us that taking away IRAs produced a dramatic, immediate decline in the savings rate.

Mr. MCCRERY. Thank you, Mr. Chairman. I want to thank Mr. Steffens and Mr. Brennan for injecting a little common sense into this debate.

Mr. THOMAS. Mr. Ensign.

Mr. ENSIGN. Thank you, Mr. Chairman. I want to explore just a little further the culture of savings in our country.

Having my own profit-sharing plan in my small company, I remember when I dissolved it, and one of the reasons that I dissolved it was what you talked about, Mr. Brennan—they were going to be changing the rules, they were going to be taxing these things in the future. And I think that one of the incentives that we need to build in this country is stability, where the rules aren't going to change and a system that is very easy to use.

In my profit-sharing plan, I had no idea what they were doing with it. I had to rely on somebody else to set this up for my savings as well as my employees.

But I also want to get to a further point, and that is people that are about my age or younger, or maybe even a little older are looking at Social Security as not being there in the future. Mr. Gale, I disagree with some of what you said because I don't think you are taking into account the bigger picture of what we need to do.

I think we need to educate the whole of America, because reality is, Social Security, if it is there, is going to be very little. We need to take personal responsibility for ourselves. It is going to be easier; and as Congress, we have to set up a program that is easy to use, that is not going to change.

Mr. Brennan, your comments.

Mr. BRENNAN. Well, I think your point is very well taken. First, complexity is intimidating and complexity is a deterrent. People who could make aftertax contributions to IRAs today are not doing so; they are intimidated because it involves another tax form to fill out, not like a simple $2,000 deduction. We believe wholeheartedly that we can get good results if we accomplish the two things you have talked about—one, allowing people to have some comfort that they have control over their own financial future, a tremendous advantage of an incentive to save; and two, that the deal is not going to change. And people—I imagine we are not so far off in age—worry a lot about the rules changing as they relate to Social Security. It is one of the important concerns that our investors and the public at large have, a changed deal specifically as it relates to Social Security. Anything we can do to give people an incentive to control their own financial future, I think, is of tremendous benefit to America. I believe it will pay dividends, not in a way that is forecastable in an econometric model precisely, but if you believe in the human spirit and the American spirit, people will save—and we will create jobs, we will create capital which will pay for itself over the long haul.

Mr. ENSIGN. We are a little further apart in age. Since I have been here, I have aged about 15 years in the time I have been here.

Mr. Gale, your comments.

Mr. GALE. From 1982 to 1986, we had universal IRAs, we had very heavy advertising from the brokerage industry and the financial industry generally, and this is what contribution rates looked like 5 years after that: 2 percent of the people in the bottom third contributed to an IRA in 1986, 9 percent in the middle third, and 33 percent in the top third, rising to 70 percent in the upper 1 percent of the income distribution.

The advertising can be thought of as partly educating people about the opportunities for and the need for saving. We did that for 5 years, we tried that experiment, and it didn't seem to have much effect on the bottom end of the income or the wealth distribution.

Mr. ENSIGN. Do you think that at that time the realities had set in about Social Security?

Mr. GALE. Actually, I guess I would disagree with that. There was a Social Security Commission in 1983 that substantially raised taxes. That was a bipartisan commission on reform. So Social Security was actually very much in the news at that point.

Mr. ENSIGN. No, I know it was in the news, but I don't think that people had the realization that it wasn't going to be there.

Mr. GALE. I don't think anyone believed that that solution was a long-term solution, and it was certainly in the papers a lot.

Mr. ENSIGN. OK.

Mr. Steffens.

Mr. STEFFENS. A couple of things: 75 percent of all of the contributions that went into IRAs in 1986 were from people that earned under $50,000. I also think that if you take a look at savings, it is certainly a fact that 100 percent of the savings in this country come from people that earn over $28,000. And so clearly, when you look at the absolute bottom quartile or bottom quintile of the American population in terms of income, they are having a very difficult time paying their bills and buying food and providing the absolute necessities of life. So to look at this in terms of the absolute bottom, IRAs probably are not going to work directly. But the jobs that they help create and their positive impact on the economic environment will be a benefit for all Americans, regardless of their income level.

Mr. ENSIGN. Thank you, Mr. Chairman.

Mr. THOMAS [presiding]. Thank you very much.

Mr. Levin.

Mr. LEVIN. Thank you. Let me follow up, because I am trying to reach a conclusion and haven't on this proposal. What percentage of the tax earners today more or less qualify for an IRA?

Mr. STEFFENS. Thirty-eight percent, and it is declining.

Mr. LEVIN. Qualify.

Mr. STEFFENS. Thirty-eight percent. And it is declining; basically, as incomes rise, it is declining every year because in 1986 income caps were not indexed for inflation.

Mr. GALE. Just one comment on that. All people who earn money are eligible for an IRA, the question is whether you get the deduction at the beginning or the end of the——

Mr. LEVIN. Right. So what percentage of people who would benefit from investment in an IRA taxwise today participate?

Mr. GALE. Of the 38 percent, if that is the right number of people who are eligible for deductible IRAs, participation is down around, I think, about 6 to 10 million tax returns, which suggests about one-fifth or one-sixth of the people that are eligible to participate.

Mr. LEVIN. Because the testimony that comes later says over 90 percent of those eligible to utilize the tax-deferred IRA choose not to do so. So I am not sure we can figure out in the next few minutes the exact percentages we are dealing with, but it seems to be clear that a very large percentage of those who are now eligible do not utilize the IRA. Isn't that true? I mean, it is way more than half?

Mr. GALE. Yes, true, definitely.

Mr. STEFFENS. That is true. But I think you also have to look at the income makeup of the eligibility. Since they have reduced the income levels to that extent and you take a look at the $40,000 joint cap and the $25,000 circumstance, when you begin to take a look at those individuals that are in those income brackets, many simply are not net savers at the present time. So current IRA limits exclude the heart of the middle class, two-income families in the $50,000 to $75,000 range, that would, in fact, be significant participants in a new IRA program.

Mr. GALE. But this is the whole point. People that don't save in other forms also don't save in IRAs. The people that save a tremendous amount in other forms also do save in IRAs.

Ms. MOHR. If I could respond, Congressman.

Mr. LEVIN. That is the issue, it seems to me, whether Dr. Gale is right or wrong, because you seem to say that most of the earning—most of the savings will come from those in middle or higher brackets.

The reason that IRAs aren't working now is because those who are eligible for the best benefit don't have the money to save. So then the question becomes whether there will be a tremendous influx from people who are between $50,000 and $75,000 and what the evidence is that they are the ones who would really invest; or whether more of the investment would come from those in much higher income brackets who already have an array of investment opportunities, and whether you are not just moving their investments from one place to another. It seems to me that is the issue, isn't it?

Mr. GALE. The evidence is overwhelming that in any income category it is the people with a lot of other assets that then also contributed to IRAs.

Mr. BRENNAN. I think whatever the evidence showed, it is historic evidence—and I think one of the points that is very important to make is that we face a new situation. The baby boom generation is a very important part of this issue, and they are now 10 years older, roughly, than when IRAs were universally available. The issues facing that generation are very important. And I think Mr. Steffens would agree that this generation is one of the key target markets for us as an industry, but one of the key target beneficiaries as well. They are 50, or approaching 50, and that is——

Mr. LEVIN. And they are in what income brackets, $50,000 to $75,000?

Mr. BRENNAN. No, no, 50 years old.

Mr. LEVIN. But what income brackets?

Mr. BRENNAN. The administration proposes raising the cap for deductible IRAs to $80,000, so you are raising the potential beneficiaries of a deductible IRA significantly. And I think it is important to recognize that the makeup of that marketplace has changed dramatically in those 10 years; that baby boom generation is rushing toward retirement.

Things are very different than they were in 1982 when the universal IRA came in the first time. So I think a lot of the statistics, while I am sure are valid, because they are done by credible people, may or may not be predictive of future behavior. I don't think we can forecast behavior with accuracy. We have to rely on the marketplace to tell us what will happen.

Mr. THOMAS. The gentleman's time has expired.

Does the gentleman from Virginia wish to inquire?

Mr. PAYNE. Thank you, Mr. Chairman. I want to thank the panel. I think you have done a good job of explaining the various proposals, and the IRA proposal in particular. I think you make a good case concerning education and concerning the tax incentives and the resulting savings rate increase.

I am somewhat puzzled, though, by some information; and I would like to, if I could, Mr. Steffens, ask you about your testimony on the first page. You have a chart that shows the U.S. personal savings rate.

Mr. STEFFENS. Yes.

Mr. PAYNE. This personal savings rate concludes the U.S. personal savings rate has fallen 50 percent since 1970 and demonstrates that phenomenon. And what this shows is, from 1970 to 1984, that the rate is up and down, but around 8 percent.

Then, in 1984, there is a fairly precipitous decline until the year 1987, and it drops from actually 8 percent to roughly 4 percent; and then from that time, 1987, to present it stayed pretty much at 4 percent.

The decline, it seems, began in 1984, and that is at the same time that the data on the next page says that the very highest amount of IRAs were sold. In 1984, 1985, and 1986, sales were $35 billion, $38 billion and $38 billion respectively. Are there other things going on that we should be considering in terms of personal savings that would have occurred that would have made this change in 1984 as dramatically as it did occur?

Mr. STEFFENS. I think that the data in part reflects other economic factors at that particular time and that these impacted savings rates. But I believe the primary decline shown on those charts came after 1986, and so they had declined to about 6.5 percent in 1986, and then it went down some 40 percent from 1986 to the present time, where it has stayed somewhere in the 4 to 4.5 percent range. So the changes that came about in 1986 clearly had a significant impact on what happened, and as I said before, some 40 percent of that decline could be represented by the decline in IRA contributions alone.

Mr. PAYNE. So then the change from 1984 to 1986 of 1.5 percent, you would see that being related to economic conditions at the time?

Mr. STEFFENS. Yes.

Mr. PAYNE. And then beyond that, these changes, to some great extent, were due to the change in the law as it related to the deductibility of the IRA investments?

Mr. STEFFENS. Yes, sir, that is correct.

Mr. PAYNE. Let me ask Dr. Gale one question having to do with IRAs and tax policy in general. Clearly, it seems that you are not advocating IRAs as a good tax policy in terms of inducing increases in savings. Are there tax policies that you would recommend to increase our savings rate which could occur not at the expense of increasing the deficit?

Mr. GALE. There may not be tax policies, but there may be other policies, in particular regarding pensions, that could use some improvement and, I think, would have a potential to raise the saving rate with little or no impact on the budget deficit.

Mr. PAYNE. But you are not making any recommendation about anything that should be done in the Tax Code that could encourage personal savings and not hurt the deficit?

Mr. GALE. I think ultimately the Tax Code is a very weak way to affect personal saving. The saving rate has declined for a number of reasons for a number of years in many countries. It has to do with things like liberalization of credit markets, the slowdown in wage and income growth, increasing transfers to the elderly; and tax policy is a very small part of that, either positive or negative, in terms of generating solutions.

If we are going to raise the saving rate, ultimately it will have to be done through the pension system, since saving for retirement is the biggest component of saving. Pensions are different from saving incentives in that pension participation is less optional, so you force low savers to save, and in that pension balances are less liquid so that the money can't be taken out before people retire, so you get more saving per initial contribution. But I am not sure if you want to call that a tax policy question or pension policy question.

Mr. PAYNE. One last comment. Were you aware that when the Treasury looked at the first 5 years, they said there would be no impact on the Federal budget deficit as a result of this proposal we are talking about today?

Mr. GALE. Of the backloaded IRAs?

Mr. PAYNE. That is correct.

Mr. GALE. Yes. Backloaded IRAs are all fiscal time bombs. It is important to note that when we say something is paid for in Washington, we mean it is paid for for the first 5 years. You could pay for frontloaded IRAs just by not enacting them until 5 years from now, and then there would be no budgetary costs for the next 5 years, but everyone would recognize that as a budget gimmick.

The backloaded IRA has costs that are all in the future and the budget doesn't require you to take account of the costs. So I think the true revenue costs are much, much bigger than the 5- or even the 10-year estimates.

Mr. PAYNE. Thank you, Mr. Chairman.

Mr. THOMAS. Thank you very much. Let me thank the panel and tell you that there is an ongoing frustration of members of the tax committee—did you want to make a comment?

The gentleman from New Jersey.

Mr. ZIMMER. Thank you, Mr. Chairman. I would like to ask a couple of questions of Mr. Steffens, and the first one comes right off the comment that was just made.

Mr. Steffens, other than the scoring issue in terms of budgetary projections, do you see any significant benefit of a backloaded IRA as contrasted to a frontloaded IRA?

Mr. STEFFENS. Well, I think that if you take a look at the backloaded IRA, it clearly provides a tax benefit to the savings that come from the amount of money, dividends, interest, capital gains, et cetera, that an individual would put into that program. In our research, Americans have viewed it two different ways. In one case, they worry about whether government policy would let the back-end incentive stand. More importantly, people are concerned about rising tax rates in the future, so there is clearly an incentive to save in a back-end account since there would be no taxes on that money no matter what happened to tax rates in the future.

Mr. ZIMMER. So you think there is independent merit to backloaded IRAs beyond the budgetary scoring and the question of the budget window?

Mr. STEFFENS. I think that there is a benefit, not only from that standpoint. Budget scoring deals with the cost on the one hand, but it doesn't talk about the benefits. And as I have said, there are numerous benefits in terms of helping people find the dollars that they are going to need 20 years down the road, in retirement. We

don't have nearly enough in the way of savings to do that currently.

Second, the impact on the economy from a jobs creation standpoint, a competitive standpoint, and the reduction in interest rates would be very positive.

Mr. ZIMMER. Could you please elaborate on the part of your testimony that addresses the important issue of whether IRA tax incentives create new savings, or merely reshuffle existing savings? That is really a critical issue to many of us.

Mr. STEFFENS. There were a number of studies done. Venti and Wise basically looked at this issue and came to the conclusion that 66 percent of the money that went into IRAs was in fact new savings. There have been other studies done at places like Harvard and MIT and Dartmouth, as well, reinforcing those findings, that in fact the IRA created and stimulated new savings.

Mr. ZIMMER. In your testimony you also note that the provisions of the 1986 act that restricted IRAs actually curtailed the total amount of IRA assets by about $400 billion. Could you briefly tell the committee how that figure was arrived at?

Mr. STEFFENS. Yes. In 1986 IRA contributions were about $38 billion. It declined to about the $14 billion level and now has declined to about $8 billion. So the shortfall has been $25 billion a year or more since 1986. If this money, plus the interest that would have been earned, had been in an IRA, approximately $400 billion of additional IRA saving would be available today for investment in the U.S. economy.

Mr. ZIMMER. Do you have an estimate of how much of that $400 billion is simply not being saved?

Mr. STEFFENS. Well, it is difficult obviously to determine the number exactly, but a simple review of the U.S. saving figures shows that some 40 percent of the decline of personal savings from 1986 to 1994 can be accounted for by the decline in the IRA savings alone.

Mr. ZIMMER. Thank you very much.

Thank you, Mr. Chairman.

Mr. THOMAS. Does any other member wish to inquire?

Getting back to the general frustrations, I want to thank the panel for their testimony, because you shared with us the concerns that I and other members have had. Oftentimes, we will lecture the private sector on their quarter-to-quarter decisionmaking, and that they ought to focus on a longer term decisionmaking pattern, and yet we deal with a societal decision on what amounts to a quarter-to-quarter decision on, as Mr. Gale indicated, a 5-year window. It is quite clear that in terms of dealing with the IRA, it is pay-me-now or pay-me-later, but it is always dealing with that 5-year frame, and it is very frustrating for us.

I know in the last Congress, dealing with preventive care in the health care area, you run into the same profile of trying to make decisions that clearly are going to have an impact on the society for several decades. The tools that we use for examining it, from a budget scoring point of view, I believe are inadequate for an actual assessment. I know it is difficult talking about 10, 15, 20 years out, but I think there are some basic truths that you can deal with.

In addition, the gentleman from New York's comments about the fact that it is going to be a loss to the Federal Government, I appreciate, Mr. Hazen, your immediate response that it might deal with government bookkeeping impact, but society at large would benefit. Individuals would benefit following that policy. It is true that interest payments are moving ahead of defense shortly as the second largest item of Federal payments. But number one is payments to individuals, and this obviously would hopefully affect, over the long run, government's payments to individuals by virtue of individual savings.

There is a larger question, and I want to ask it in a general sense. In trying to put together packages which might get people to change behaviors—and I think, Dr. Gale, I agree with you that perhaps the Tax Code is not the best way to change behavior in these areas, but it is one of the ways that we can do it—that you have to put together a package that gets people to respond who have grown up in significantly different periods. It is not, to me, just an age difference between people who grew up in the Depression versus people who grew up in the postwar years, but it is a mental set about what tomorrow is going to bring and that any single response is not going to be universal in terms of behavior types.

I also think that government decisions in the late eighties, and now the early nineties, do not give folks confidence that if they begin to make life plans based upon government's decision today, that government won't necessarily change that in the 1986 tax bill in a retroactive way, which destroys people's ability to plan for their own future based upon the certainty of a government decision.

Any reaction from any of you in terms of that kind of policymaking?

Mr. Feltman.

Mr. FELTMAN. Mr. Chairman, you are correct, our research shows a great deal of skepticism among taxpayers. They are concerned about changes coming in the future that will wipe out everything that they have done, and one of their reactions to that is to say, I need to take greater control of my own destiny. We see this manifested when we hear that the baby boomer generation and generation X doesn't think that Social Security will be there when they get there. But it is manifested also in employees asking whether I can take early retirement at age 60 and be sure that I will continue to get my Social Security, or if when I am 63 or 64, Social Security is bankrupt, will it go away from me, too? So if people are trying to make decisions on when they retire, based on a fear about Social Security, we do have a great deal of anxiety out there.

Mr. THOMAS. Ms. Mohr.

Ms. MOHR. Mr. Chairman, I would also like to say that representatives of industry, and particularly the members of the Savings Coalition, we would very much like to form a partnership with your committee in terms of whatever law is passed, to have education, to have vehicles by which we can educate consumers.

I was very active between 1981 and 1986 in putting forth for my company a major national sales campaign on the IRA, as were many of the organizations represented here today. The IRA was

simple. People could understand that if they put $2,000 in on April 15, they would see an immediate tax return.

We have talked here today about the back-ended IRA. It is a little more complicated, but with the help of industry, we believe that we can put that forward as a way for aging baby boomers to save for their retirement. Clearly, as an aging baby boomer, I am looking at my 76-year-old mother and my 75-year-old father, who are living on Social Security; and I feel as if my contribution out of my paycheck every 2 weeks goes directly to support them.

I also have an 11-month-old son, and I am thinking about how long will I have to work to fund his education 18 years from now? And this type of squeeze, as well as planning and saving for my own retirement, certainly hits a lot of aging baby boomers. We believe, as representatives of the industry, that we can work with the tax committee to put forth simple agendas and help middle-class America.

Mr. THOMAS. Thank you.

Dr. Gale, in your testimony on IRAs and the 401(k)s, you indicated that you have done quite a bit of work, and it is apparent with your testimony. To what extent have you focused that investigation on these back-ended IRAs, which I believe are relatively new approaches?

Mr. GALE. It is hard to do empirical work on back-ended IRAs because they haven't been around very long, and the back-ended IRAs that are around really aren't like the ones that have been proposed. In some of the simulation models that we have done, where you can make up your own IRA and make up your own data, you get pretty much similar long-term effects from frontloaded and backloaded.

Mr. THOMAS. Mr. Steffens, obviously the testimony that you gave indicates that you have done some research, and apparently you are cutting edge on this; and I would ask that if you have any back-ended research that isn't covered in your testimony, that you would make it available to us, because I think this is an area obviously that the committee wants to explore.

I thank all of you for your testimony. I appreciate it very much.

[At the time of printing, no information was received.]

Mr. THOMAS. I would ask that the next panel come forward—John Bachmann, Raymond McKee, Paul Reid, and I believe it is Jay Buchert—if you could come forward, please. I will tell all of the panel members that, without objection, their written testimony will be made a part of the record, and that you may proceed however you wish in informing the committee for your 5 minutes. And I will move from my right, your left, across the witness table, and I will begin with Mr. Reid.

STATEMENT OF PAUL S. REID, PRESIDENT-ELECT, MORTGAGE BANKERS ASSOCIATION OF AMERICA, AND PRESIDENT AND CHIEF EXECUTIVE OFFICER, AMERICAN HOME FUNDING, INC., RICHMOND, VA.

Mr. REID. Mr. Chairman and members of the committee, I am Paul Reid, president and CEO of American Home Funding, based in Richmond, Va. I am also currently serving as president-elect of

the Mortgage Bankers Association of America, known as MBA. We very much appreciate the opportunity to appear here today.

The principal objective underlining H.R. 6, that of helping families attain their version of the American dream, is one that is shared by MBA and its members. Without a doubt, one of the key elements of that dream for tens of millions of Americans, is the ability to own a home.

MBA believes H.R. 6, the American Dream Restoration Act, would help accomplish that objective. In fact, we believe it would greatly assist in efforts to bring the dream of home ownership within the grasp of tens of thousands of Americans for whom it is still beyond their reach. As such, MBA is very supportive of your efforts.

MBA and its members are dedicated to financing home ownership throughout the United States. In fact, last year alone, MBA's members financed the first homes purchased by over 700,000 families.

Yet home ownership rates are falling, rents are increasing and government assistance for housing is being cut. That is why the American Dream Restoration Act is so important at this time. Only by increasing the rate of savings can we make the dream of home ownership a reality for tens of thousands of would-be home buyers.

MBA believes that Federal tax policy can help in this regard by accomplishing two objectives. First, it should do more to encourage savings by a broad spectrum of the population. This will help decrease the cost of mortgage credit, thereby making housing more affordable.

Second, it should permit the use of savings for certain critical purposes, such as the purchase of a first home. For most Americans, buying a home is the single largest purchase of their lifetime. It also proves to be one of their most important savings vehicles. In fact, home equity buildup ranks behind only pension funds as the source of individuals' accumulated wealth. This type of investing should be strongly encouraged by Federal tax policy.

We believe creation of ADS accounts will encourage savings. Further, early withdrawal provisions will encourage young Americans to begin to save before they might otherwise, providing more opportunities to invest in their futures through the purchase of a first home.

MBA's research shows that the problem of assembling the downpayment and related closing costs poses the principal barrier to home ownership for those trying to purchase their first homes. The explanation for this fact is Americans' failure to save.

As I explain in greater detail in my written comments, there is a clear need for new and expanded sources of capital that young Americans and those living on low and moderate incomes can tap to assist in their first purchase of a home. We believe the proposal to create American dream savings accounts will help in this regard.

Despite the many positive attributes of the proposed legislation, we believe it can be improved. With that thought in mind, let me make the following four recommendations:

First, we strongly recommend that you waive the 5-year withdrawal restriction for funds that have been transferred from an existing IRA account. MBA estimates that if the median first-time

home buyer were able to access an additional $5,000, as many as 491,000 more households would qualify to purchase a home. Yet, many are unable to do so, making home ownership an impossible dream.

Research shows that approximately two-thirds of people currently renting would like to eventually own a home. Of these, about 234,000 would like to become homeowners within the next 5 years. However, failure to expand the withdrawal provision to permit use of funds already held in an IRA account will deny them the opportunity to use their savings now to fulfill their dream of home ownership.

Second, we strongly encourage you to permit taxpayers to withdraw their ADSA funds, or their existing IRA deposits when transferred to an ADSA account, to help a child or a grandchild make a downpayment to purchase a first home.

The assistance of family members is often required for an individual purchasing their first home. Studies have shown that, on average, 15 percent of each first-time home buyer's downpayment was made by a relative of the purchaser. Clearly, there is a tremendous desire on the part of many individuals to assist family members purchase their first home.

The ADSA proposal already permits individuals to use their savings to assist family members. Expanding the existing language would greatly improve the act and help assure its success.

Third, MBA believes the legislation could be improved by offering taxpayers the option of taking an up front deduction, and paying taxes upon withdrawal. This would provide the greatest amount of flexibility for taxpayers, and provide the greatest incentive for new savings. Options on this approach should be explored.

Finally, other Members of Congress have already introduced and are currently contemplating various alternatives to the proposal contained in H.R. 6. One of these would permit an IRA custodian to use funds as a loan or equity investment for the downpayment on the purchase of a first home. We encourage you to seriously consider this and other proposals when deliberating the final form of the proposed legislation.

In conclusion, MBA believes that the purchase of a home is one of the most important and frequently used forms of long-term savings made by Americans. As such, we strongly support your efforts to increase the level of savings through the creation of American dream savings accounts, and the use of such funds for the purchase of a first home. Without a doubt, the proposal will significantly help many Americans attain their version of the American dream.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF PAUL S. REID, CMB
President and CEO, American Home Funding, Inc.
on behalf of
The Mortgage Bankers Association of America

Mr. Chairman and Members of the Committee, I am Paul S. Reid, President and C.E.O. of American Home Funding, Inc., based in Richmond, Virginia. I am also currently serving as President-Elect of the Mortgage Bankers Association of America (MBA).[1] Accompanying me today are Michael J. Ferrell, MBA's Senior Staff Vice President and Legislative Counsel, and Robert G. Josephs, MBA's Director and Associate Legislative Counsel.

MBA very much appreciates this opportunity to appear before you in support of the proposal to create American Dream Savings Accounts (ADSAs). MBA would like to commend Chairman Archer for holding these hearings, and commend Representatives Crane, Nussle, Salmon, and their more than 110 co-sponsors, for introducing HR 6, the "American Dream Restoration Act" (the "Act"), in which the proposal is incorporated.

The principal objective underlying HR 6 -- that of helping families attain their version of the American dream -- is one that is shared by MBA and its members. Without a doubt, one of the key elements of that dream for tens of millions of Americans, is the ability to own a home. It is far and away the possession that is the most valued in our society. Surveys and opinion polls repeatedly attest to this. When asked what they want most -- more money, a better job, -- Americans overwhelming say they want to own their own home. It is also the best way that average families can accumulate wealth and ensure financial security. It's their nest egg. It allows them to look toward the future, to fund their children's educations or their own retirements. Home ownership empowers people. It is regarded as one of the ultimate achievements of the American way of life.

MBA believes HR 6 would help accomplish these objectives. In fact, we believe it would greatly assist in efforts to bring the dream of home ownership within the grasp of tens of thousands of Americans for whom it is still beyond their reach. As such, MBA is very supportive of your efforts.

II. MBA'S ROLE IN FINANCING HOME OWNERSHIP

MBA and its members are dedicated to financing home ownership throughout the United States. Mortgage bankers serve a critical role in this process. By linking capital sources with demand for financing, our members have made housing affordable and available for all people across the economic spectrum. We have made home ownership possible for millions of Americans who would otherwise be unable to achieve it.

Our role has been of critical importance, especially for undeserved areas and populations, including minorities, those living on low- and moderate-incomes, and first-time homebuyers. We have provided financing to 52 percent of American families purchasing a home in each of the past two years. In 1993, MBA's members financed first homes purchased for over 700,000 households. Beginning in the late 1960s, we have also been involved in financing and producing the great majority of low-income housing units in this country. And today, we are renewing our commitment to take a responsible role in addressing the very difficult problems of providing home ownership opportunities for these target populations.

III. AMERICAN DREAM SAVINGS ACCOUNTS

Despite the efforts of MBA, and others dedicated to providing the opportunity of home ownership to all Americans, much more can and should be done. Home ownership rates are falling for the next generation of young Americans, for low- and moderate-income households, and for minority populations. At the same time, the stock of affordable rental housing is decreasing, leaving available only higher rental units. In spite of these statistics, government subsidy and assistance programs, already able to serve only a small percentage of those in

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[1] MBA is the national association representing exclusively the real estate finance industry. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership prospects through increased affordability; and to extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters excellence and technical know-how among real estate finance professionals through a wide range of educational programs and technical publications. Its membership of nearly 2,900 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, life insurance companies and others in the mortgage lending field.

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need, are being scrutinized by Congress with the thought of cutting back or eliminating programs to divert funds for other purposes.

That is why the American Dream Restoration Act is so critical at this time. Only by increasing the rate of savings can we make the dream of home ownership a reality for tens of thousands of would-be homebuyers. MBA believes that Federal tax policy can help in this regard by accomplishing two objectives. First, it should do more to encourage savings by a broad spectrum of the population. Americans' rate of savings is lower than that of any other industrialized nation. Encouraging savings will ultimately help decrease the cost of mortgage credit, thereby making housing more affordable. This will ultimately bring the dream of home ownership within reach of millions of American families.

Second, it should permit the use of savings for certain critical purposes, such as the purchase of a first home. For most Americans, buying a home is the single largest purchase of their lifetime. It also proves to be one of their most important savings vehicles. In fact, home equity buildup ranks behind only pension funds as sources of individuals' accumulated wealth. This type of investing should be strongly encouraged by federal tax policy. By building incentives into the U.S. Tax Code that encourage people to save, and permitting the use of such savings to purchase a home or other essential items, Congress can accomplish the primary objective of this legislation and assure its success.

The provisions in the Act creating ADSAs would help accomplish both of these important objectives. We believe creation of ADSA accounts will encourage savings that would not otherwise occur by permitting deposits to accumulate tax-free, and by permitting their tax-free withdrawals at prescribed times and under prescribed circumstances. Further, allowing the early tax- and penalty-free withdrawal of ADSA funds for the purchase of a first home will encourage young Americans to begin saving earlier they might otherwise. This will provide them with more opportunities to use such savings to invest in their futures through the purchase of a first home.

IV. LACK OF ADEQUATE SAVINGS

The principal barrier to home ownership for those who would like to purchase their first homes is that of assembling the downpayment and related closing costs associated with the acquisition.[2] Yet, the evidence is clear that a tremendous number of Americans are not able to save adequately to pay for their retirement, or other critical needs, such as the purchase of a home. In fact, the rate of savings in America has dropped substantially since 1986. For example, the average personal savings rate dropped in 1993 to about 4.1 percent of disposable income,[3] well below the amount that many financial advisers and analysts recommend as necessary to provide adequately for retirement,[4] and 32 percent below 1986 levels. Indeed, the average rate of personal savings has dropped by about 55 percent during the 20 years from 1973 to 1993.

V. IMPACT ON POTENTIAL HOMEBUYERS

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[2] The costs associated with purchasing the median price starter home ($94,200) include the following:

Downpayment	$9,420
Loan Fees	$1,130
Title Charges	$1,525
Recording Fees	$ 650
Home Inspection	$ 265
Advance Interest and Insurance Premium	$2,968
TOTAL	$15,958

Note: Closing costs vary widely by state

[3] "Survey of Current Business." Bureau of Economic Analysis, U.S. Department of Commerce.

[4] Dr. B. Douglas Bernheim of Princeton University stated his belief in a recent study, that most households headed by individuals age 35 to 45 years old generally need to save 9 to 19 percent of their after-tax income in order to achieve a standard of living after retirement comparable to that enjoyed by their household in pre-retirement years. These numbers increase to between 13 and 25 percent for those who do not expect to be covered by an employer-sponsored pension plan upon retirement. "Is the Baby Boom Generation Preparing Adequately for Retirement?," January 15, 1993.

MBA believes the low savings rate experienced in most age categories is a significant cause of the current decline in home ownership rates. Nowhere has this correlation between low savings rates and low rates of home ownership been more pronounced than among our country's future potential homebuyers, those age 25-34, who comprise the largest percentage of those purchasing their first homes, and those younger than 25. For example, a recent study by the Joint Center for Housing Studies of Harvard University[5] indicates that home ownership rates have dropped during the 20 years from 1973 to 1993 for all age categories younger than 55. Yet the drop was most dramatic for those in the 25-34 year old age categories, whose rate of home ownership fell throughout the 20 year period. Indeed, home ownership for 25-29 year olds during that period fell 20.6 percent, and home ownership among 30-34 year olds dropped 15.2 percent. Not surprisingly, the savings rates, as of 1993, for these two age categories, were almost negligible.

We believe the principal reason why low savings rates are so directly correlated to low rates of home ownership is that inadequate savings prevent young Americans, and those living on low- and moderate-incomes, from obtaining enough money to make the downpayment for a house and pay the settlement costs. In fact, studies by MBA, other trade organizations, and non-partisan policy research groups have repeatedly identified this as the number one impediment to home ownership for young Americans.

To gauge the extent of this problem better, MBA recently hired the Gallup organization to conduct a nationwide survey of Americans' perceptions regarding their ability to purchase a home. Among other issues, the survey sought to identify the most significant impediments for individuals in obtaining a mortgage loan. Not surprisingly, the lack of savings for a downpayment was identified as the number one problem. Of those surveyed, 55 percent said it would pose a problem. Of these individuals, 20 percent believed this problem would be insurmountable, and 8 percent were not certain if the problem could be overcome.

Steadily rising housing costs, and incomes that continue to trend downward relative to the cost of living, make it even more difficult for would-be homebuyers to overcome these barriers to home ownership. Studies have repeatedly shown that the relationship between income and home prices is the most important factor affecting individuals' ability to find the funds to make a downpayment and pay for closing costs. Historically, these costs have remained high relative to income, and remain so today. This is due, in large part, to the significant housing price inflation experienced in the 1970s and 1980s. To this day, the incomes of first-time homebuyers, as adjusted for inflation, are 17 percent lower than in 1972. At the same time, today's home prices, adjusted for inflation, are 10 percent higher than in 1972. To this day, there is little movement toward an equilibrium of housing prices and income. Thus, home ownership has remained unattainable for thousands of Americans.

This obstacle has remained the most pronounced for families surviving on low and moderate incomes. In 1993, the average cost of a home was $94,200. Using a typical downpayment of 10 percent, and total average closing costs as a model (see footnote 2 above), a potential purchaser would have to raise approximately $15,958 to purchase such a home in 1993. Downpayment and closing costs together represent a startlingly high 64.3 percent of a first-time buyer's annual income. This percentage has changed very little since 1987, and represents a significant increase since the 1970s. And data indicate that incomes are still about 17 percent less than what is currently needed to purchase a first home and pay the mortgage.

VI. THE NEED FOR NEW SOURCES OF CAPITAL

The information described above leads MBA to the conclusion -- that there is a clear need for new and expanded sources of capital that young Americans, and those living on low- and moderate-incomes, can tap to assist in their first purchase of a home. This can be accomplished in two ways. First, the U.S. Tax Code should be modified to permit would-be home purchasers to gain access to existing pools of capital that are currently unavailable until retirement. Second, incentives should be provided to encourage savings that can expand available capital sources.

The ADSA proposal would go a long way towards accomplishing these objectives. First, permitting taxpayers to roll over their existing Individual Retirement Accounts (IRA's) into their new ADSA accounts will help many taxpayers to tap existing sources of capital for a first-time home purchase. Although many taxpayers in the 28 percent or higher marginal tax brackets may prefer to retain their IRA accounts in order to pay less taxes at what will likely be a lower post-retirement rate, this option may be especially attractive for those who pay taxes currently at a lower marginal rate. Second, permitting earnings to accumulate tax-free, and allowing early (pre-retirement) withdrawal for special purposes, such as purchasing a first home, will also expand the sources of capital that might not otherwise be available to many taxpayers.

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[5] "The State of the Nation's Housing 1994," the Joint Center for Housing Studies of Harvard University.

VII. IMPROVING THE ADSA PROPOSAL -- MBA RECOMMENDATIONS

Despite the positive attributes of the proposed legislation, more can and should be done to assure the Act obtains its objectives. In short, although MBA supports the ADSA proposal, we believe it can be improved. With that thought in mind, we respectfully submit the following recommendations for your consideration.

1. Waiver of the Five-Year Moratorium On Use Of Funds When Transferred From IRA

First, we strongly recommend that you waive the five-year withdrawal restriction for funds that have been transferred from an existing IRA account. Such a requirement may unnecessarily forestall thousands of potential homebuyers from purchasing their first home. MBA estimates that if the median first-time homebuyer were able to access an additional $5,000, as many as 491,000 more families would immediately qualify to purchase a home. Yet, for those unable to raise the funds necessary to make a downpayment this goal becomes impossible to attain. Surveys also indicate that approximately two-thirds of renter households would like eventually to own a home. Of these two thirds, 70 percent would like to purchase their first home within the next five years. If able to do so, approximately 234,000 more households could become first-time homeowners within this period. However, failure to expand the withdrawal provision to permit use of funds already held in an IRA account will deny them the opportunity to use their savings to fulfill their dream of home ownership.

Some have suggested the five-year holding requirement, included in the current proposal, improves its budget projections for the critical five-year period following authorization, because taxes must be paid on amounts rolled from IRA into ADSA accounts. However, permitting use of rolled-over funds need not cause any loss of revenues if a withdrawal is permitted only after paying all taxes owed. Imposition of a five-year waiting period, therefore, will only serve to prevent, or unfairly delay many low-, moderate-, and middle-income Americans from buying their first home.

2. Allow Parents To Use Funds To Help With Children's or Grandchildren's First Home Purchase

The current ADSA proposal would permit an individual to make a penalty- and tax-free withdrawal of ADSA funds to pay for a child's or grandchild's higher education expenses. MBA agrees with, and commends you for permitting the use of savings to pay for a higher education. However, MBA strongly encourages expansion of this provision to permit taxpayers to withdraw their ADSA funds, or their existing IRA funds immediately upon transfer to an ADSA account, to help a child or grandchild make a downpayment to purchase a first home.

The assistance of family members is often required for an individual purchasing their first home. For example, data in a home purchase settlement transaction survey conducted by the Chicago Title Insurance Company, indicate that on average, 15 percent of each first-time homebuyer's downpayment was made by a relative of the purchaser. Clearly, there is a tremendous desire on the part of many individuals to assist family members purchase their first homes.

Also, most individuals who are forming their own families, and trying to join the ranks of this country's homeowners, are past the age at which they are studying for a higher educational degree. Thus, their parents and grandparents will be beyond the point at which they can help pay for college or graduate school. Such individuals may very much hope, however, to assist a family member in purchasing their first home.

We also believe that allowing savings to be used in this manner is entirely consistent with current tax policy. There are many instances where Congress has directed that the Tax Code help families help each other. For example, personal exemptions and those for dependants, are intended to assist individuals who provide and care for their children. The same can be said for provisions that permit taxpayers to deduct allowable medical expenses incurred in caring for children and dependants. These laws recognize the financial responsibility parents assume in caring for their offspring. Many provisions, including the ADSA proposal that allow individuals to withdraw ADSA funds to provide for childrens' and grandchildrens' higher educations, recognize that this responsibility is willingly assumed by parents long after children reach the age of majority.

Permitting the use of funds, in the manner we recommend, would increase the ability of the Act to achieve its principal objective. We, therefore, strongly encourage you to expand the early withdrawal provisions to permit the use of ADSA funds by parents to assist with childrens' and grandchildrens' first-time home purchases.

3. Deductibility

MBA also believes the legislation could be improved by offering taxpayers the option of taking an up-front deduction, and paying taxes upon withdrawal. This would provide the greatest amount of flexibility for taxpayers,

and provide the greatest incentive for new savings. Such an option would truly provide a considerable benefit to working Americans.

We recognize, however, that such an approach may not be possible under current budgetary conditions. We, therefore, strongly encourage you, when preparing your final version of the legislation, to consider variations on the full deductibility option, that might not pose as significant a burden on the U.S. budget. One alternative might be to means test deductions by limiting their availability to individuals with incomes below a certain level.

4. Other Alternatives

Other Members of Congress have already introduced, and are currently contemplating various alternatives to the proposal contained in HR 6. One such alternative, introduced in past Congresses by Republicans and Democrats alike, would permit the custodian of an IRA, at the owner's direction, to use funds to make a downpayment for the purchase of a first home as a loan or as an equity investment. The IRA could also be used to make a loan to a child or grandchild for the same purpose. The funds must be restored to the IRA through repayment of the loan or equity investment when the home is eventually sold.

If such an option were created for existing IRAs, and limited to funds already deposited at the time of enactment of the legislation, Congress could make an existing source of capital available for this important purpose without much additional cost to the Treasury. After all, IRA funds can already be used for the purchase of mutual funds that invest in Government National Mortgage Association (GNMA) mortgage-backed securities -- instruments that are backed by thousands of mortgages on other peoples' homes. This investment option should be expanded to allow the use of such funds to acquire (or make a loan) for investment in the IRA holder's own home, or that of his or her family members.

VIII. CONCLUSION

MBA firmly believes that Congress should do more to encourage savings by the widest range of Americans possible. MBA also believes that the purchase of a home is one of the most important, and frequently used forms of long-term savings made by Americans. As such, we strongly support your efforts to increase the level of savings through the creation of American Dream Savings Accounts, and the use of such funds for the purchase of a first home. Without a doubt, the proposal will significantly help many Americans attain their version of the American dream.

Mr. THOMAS. Mr. Bachmann.

STATEMENT OF JOHN W. BACHMANN, MANAGING PRINCIPAL, EDWARD D. JONES & CO., ST. LOUIS, MO.

Mr. BACHMANN. First of all, thank you for giving us the opportunity to be here on this important topic. I am John Bachmann, the managing principal of Edward D. Jones & Co., and we are based in St. Louis. We represent approximately 1.8 million individual investors in all 50 States. We serve 3,350 communities in the United States, as well as 10 in Canada. Our customers are exclusively individual investors, so this is the only business we know.

We, in talking to them, think we have some sense of what some of the concerns are in that particular area, the people who actually sit down and talk about their feelings and emotions when they discuss investments. And there are some things, some conclusions that we are able to reach.

Savings rates are at an all time low. They are concerned about Social Security and the future problems it faces. They are concerned about their children and, in many cases, their grandchildren's lives; will life be as good for them as they were—the opportunity that they saw? They are bombarded with these topics daily.

As we look at the subject of retirement, there are three components that we see in retirement savings. Social Security, employee-sponsored plans and individual plans. The problems of Social Security are well documented. We have gone from beginning with 42 people supporting 1 person receiving benefits to about 3.5 today and that will be less than 2, based on demographics in the year 2035.

We recognize that our customers, we believe, recognize that for Social Security to survive, it is going to require dramatic changes—either a sharp increase in rates, increase in the retirement age, or some sort of a means test. In any of those cases, they see it as less important in terms of what they can count on in their future.

Employee-sponsored plans are important, but they too are becoming less important, meaning that in the final analysis, people increasingly have to look to themselves to take care of their savings and investment needs. The reality is that people save not only—the importance is not only for their own personal reasons, but for the economy as a whole.

Savings and investment are the fuel for capital formation, economic growth and job creation. The problems we face are not unlike those of all of the Western countries coming out of World War II, where the demographics are surprisingly similar. The World War II baby boom has really affected much of the Western World.

We are here today because we believe that, at least at our firm, that our retirement system is on shaky ground. It needs to be clarified. People need to know what they can look forward to. We think that the first step is to find ways to incent savings and investment, and we can think of no better way than to restore the tax-deductible IRA. Our experience was, it was the greatest experiment in savings for a firm that goes back to 1871 that we ever saw, and people responded when it was implemented and they responded again when it was changed, and they responded by, as was said

earlier, by opening accounts and doing business; and then they stopped doing business that way in all too many cases when it was removed. We believe people do need to be encouraged to save, and a tax deduction is a very strong savings.

I was surprised when I heard some speakers say that this is not necessarily strong policy or a way to go, because our experience is that people react very strongly to even subtle changes in the tax laws. We believe in our experience that many of the people making contributions to IRAs were not the very wealthy, but were people of moderate means, kind of at the edge where that initial incentive would cause them either to act or not to act. We think that they understand the importance of investing, and they recognize that by putting a small amount away on a regular basis, it becomes a very large amount; $2,000 a year starting at age 22, at 7 percent, brings about a half a million dollars or more in retirement benefit for these people.

So once we saw the tax deduction eliminated, many of the people just dropped. It was a dramatic drop.

We have seen the studies that suggest IRAs are merely a shift in savings. We have also seen studies that say they create new savings. The truth is, we are not certain that there was enough of an experiment in the IRA to really know what long-term impacts are. There are too many—there is too much static, too many factors that intervened at that time. I can tell you from our own experience and from those of our investment representatives, that more of our clients, particularly younger people, responded when IRAs were tax deductible, and as I said, responded again when they were removed.

Among the proposals, there is a question of front-end and back-end IRAs. It is our view that probably an attractive compromise that we think would make a great deal of sense would be to put a front-end incentive on people who are putting money into IRAs who are under 45 years old, and above 45, to shift to a back-end incentive. We think that young people need a jump start, need a jolt to get started. And the sense of urgency created by that loss of benefit on April 15 is a strong incentive.

By the same token, as people grow older, we know that once the children are out of the home, that the three main concerns are family, health, and independence and freedom in retirement. So we believe that the back-end incentive would be sufficient there. So after age 45, we would suggest that.

I do appreciate the opportunity to provide the committee with our view and what we believe to be the views of many of our clients, and hope you agree that it is time to restore the IRA for American investors.

Thank you.

[The prepared statement follows:]

TESTIMONY OF JOHN W. BACHMANN
MANAGING PRINCIPAL, EDWARD D. JONES & CO.

Before the U.S. Congress Ways and Means Committee
January 31, 1995

Mr. Chairman, I am John Bachmann, the managing principal of Edward D. Jones & Co. I appreciate the opportunity to appear before this Committee to present the views of Edward D. Jones & Co., and more importantly to communicate what we believe to be the views of our clients on the restoration of the tax-deductible IRA.

Edward D. Jones & Co. is an investment firm based in St. Louis, Missouri. We currently have 3,378 Investment Representatives in 3,350 communities across the United States and Canada and serve in excess of 1.8 million customers in the United States. Our firm is unusual, in that our customers are individual investors exclusively. We do not serve institutional clients nor do we cater to clients with very large portfolios, "the rich and famous" if you will. Our clients invest for primarily one reason, to save for their future retirement or to maintain their standard of living in retirement. As you might suspect, they are keenly interested in the savings crisis this country faces.

Our customers read newspapers, watch the news and watch you on C-SPAN. They've heard all the same facts you have...our savings rate is at an all-time low, Social Security is facing future problems and our children's futures may not be as promising as they once were. They are bombarded with these topics everyday. Our clients don't expect the government to take care of them in retirement, but rather they expect the government to allow them, their children and grandchildren to effectively save for retirement. They expect fair treatment.

Let's start with a brief discussion of the problems our clients face.

There are three components to retirement savings. The first is Social Security; the second is an employer-sponsored retirement plan; and the third component is the individual's own personal savings. Over the years, two of these have played a smaller role in providing retirement income.

Currently, Social Security is the largest source of income for many retirees, however, this can't possibly last. The Social Security System will face some significant strains in the years to come. As the baby boomers age, the number of individuals paying into Social Security will continue to decrease and the number of people receiving benefits will increase. When Social Security first began, 42 workers were paying into the system for every one recipient. Right now, 3.4 workers support each recipient. By the year 2035, the ratio will be 1.9 workers per recipient.[1] In addition, people are living longer, which means Social Security benefits must be paid for a longer period of time.

Even though this is not a popular statement, most of our customers believe that Social Security will survive but only be available to those who most need it. They expect changes will be made. Will this mean a dramatic increase in Social Security taxes, an increase in the retirement age, or that Social Security will have to become means tested? Regardless, none of these decisions will be popular.

The second component, employer-sponsored plans is still a good source for retirement income...for some people. With all the down-sizings and corporate restructurings, many people are finding themselves without a job or working for an organization that no longer has the means or the desire to make contributions to a retirement plan on their employees' behalfs. Only about 50 percent of the population is participating in an employer-sponsored retirement plan.[2]

Finally, the third component is personal savings. Unfortunately, the U.S. savings rate is at an all-time low. Who's to blame for this? Are we truly a nation of consumers who cry "SPEND SPEND SPEND" or, rather, does our tax system encourage spending and discourage saving? The reality is people need to save, not only for their own personal reasons but for the economy as a whole. Savings and investment are the fuel for capital formation, economic growth and job creation. Many foreign countries face the same demographic challenges we do and while they have experienced a decrease in personal savings it has not dropped as significantly as in the United States. Perhaps these countries have found a way to incent individuals to save.

I think we would all agree that our retirement savings system is on shaky ground today. So what should be our first step to incent savings and investment?

Quite simply, restore the tax-deductible IRA. Why?

People need to be encouraged to save. A tax deduction does just that. I remember the flood of IRA contributions we use to receive each year from January to April 15. The people making these contributions were not the rich but rather were people of moderate means who knew the importance of saving for retirement. We saw young people saving in record numbers. They understood the value of setting aside money each year for the future. They understood the benefit of tax-deferred compounding, and each and every year they made the decision to set aside $2,000. They understood that by setting aside $2,000 each year from age 22 to age 65; assuming a 7 percent interest rate; would result in more than a half a million dollars for their retirement. After the tax deduction was eliminated for many individuals, the number of people making contributions dropped dramatically. Yes, they still understood the need to save and the value of compounding tax deferred, but they quite simply needed the nudge that a tax deduction gave them.

We have all seen studies that suggest IRAs are merely a shift of savings. We've also seen the studies that suggest IRAs create new savings. The reality is, the tax deductible IRA probably did not exist long enough to make either argument conclusively. I can tell you from my own experience and from those of our Investment Representatives that more of their clients, particularly younger people, responded when IRAs were tax deductible and responded again when the tax incentive was removed!

I know there are a variety of proposals currently being discussed that will effect IRAs, but our clients tell us offering a tax deduction initially will be a great incentive to save. I also understand the revenue costs of restoring the tax deduction and would suggest that if an up-front tax deduction is not possible that a back-loaded IRA will get us on the right track to encourage people to save for their future.

If an up-front tax deduction is impossible, I suggest a compromise. As people age, saving for retirement becomes more of a priority. Around the age of 45, when retirement is actually no longer a dream but fast becoming a reality, people tend to save more. They don't necessarily need as great of a tax incentive to start saving. Their age is incentive enough. Young people, on the other hand, need a tax incentive to save, so perhaps a solution is to offer a tax deductible IRA for those individuals 45 and younger. After the age of 45, the tax deduction would no longer be available but distributions from the account would be tax free. This form of IRA would incent both groups to save and also minimize the amount of lost revenue.

Edward D. Jones & Co. is committed to helping our clients prepare for a comfortable retirement. Each year we bring a group of our Investment Representatives to Washington, D.C., to express the views of our clients. These Investment Representatives are not paid lobbyists; they work with individual investors, a number of whom are your constituents, and bring to the nation's capital a first-hand knowledge of what their clients want and need. Because of this, for three out of the past four years, this trip has centered on the importance of restoring the tax-deductible IRA. We believe the national interest is served by increasing the amount people save and invest. We believe "A penny saved is a penny earned."

I sincerely appreciate the opportunity to provide this Committee with our views and the views of our clients. I hope you agree it's time to restore the tax deductible IRA to encourage Americans to save.

I'd be happy to answer any questions at this time.

ENDNOTES

1. Securities Industry Trends: An Analysis of Emerging Trends in the Securities Industry; "Retirement Savings: A Time to Act," February 28, 1994.

2. Employee Benefit Research Institute: Issue Brief; "Pension Coverage and Participation Growth: A New Look at Primary and Supplemental Plans;" December 1993.

Mr. THOMAS. Thank you very much, Mr. Bachmann.
Mr. McKee.

STATEMENT OF RAYMOND W. McKEE, SENIOR VICE PRESIDENT AND GENERAL TAX COUNSEL, BANK OF AMERICA, ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION, WASHINGTON, D.C.

Mr. MCKEE. Mr. Chairman and members of the committee, I am Ray McKee, senior vice president and general tax counsel of the Bank of America. I am appearing today on behalf of the American Bankers Association in my capacity as chairman of the association's taxation committee.

I appreciate the opportunity to speak to the committee today to offer the banking industry's support for efforts to revitalize individual retirement accounts. We are particularly pleased that the concept of a tax-advantaged savings vehicle appears to have strong bipartisan support.

As you have been told, the personal savings rate in this country has trended down over the past several decades. According to the Department of Commerce data, the personal savings rate has dropped from an average of 7.8 percent in the seventies to only 4.7 percent in the nineties. This declining trend in personal savings means that individuals will be less well prepared to meet a variety of financial needs they are likely to encounter during their lives; and because savings and investment are critical ingredients in economic growth, a declining savings rate also has negative implications for the future of our economy.

Federal Reserve Board Chairman Alan Greenspan has stated that the single most important long-term issue for this country is inadequate savings. We simply cannot afford to ignore this problem. An increased pool of long-term savings is essential to support job creation, opportunity and economic growth. Clearly, revitalizing IRAs will not solve all of our problems, but it is an important first step toward recognizing that we must provide incentives to encourage individuals to save more for their own good and for the good of the economy.

The challenge then is to develop an appealing IRA to attract a wide range of individuals to participate. To be successful, an IRA must meet three criteria. First, it must be simple enough to be easily understood by consumers; second, eligibility criteria must also be sufficiently inclusive to provide for broad participation; and third, it must be flexible enough to be responsive to the financial needs of today's consumers.

Mr. Chairman, let me elaborate on these three points. First, simplicity.

The rules for determining eligibility for today's IRAs are simply too difficult to understand. Millions of consumers have been so confused about the tests, eligibility determinations and income limitations that many eligible individuals do not participate. We cannot stress too much the importance of simplicity.

Second is eligibility. In 1981, almost all working Americans were eligible to participate, and IRAs became immensely successful. However, the 1986 Tax Reform Act changed the rules to significantly reduce eligibility, and contributions have continued to

shrink every year since then. For a tax-favored savings incentive to be effective in generating new savings, the pools of those eligible to participate in the plan should be as wide as possible.

Our third criteria is flexibility. The lack of flexibility is probably the main reason why people have been reluctant to establish IRAs. Individuals are understandably concerned about sinking their money into a totally illiquid account from which funds can only be retrieved at retirement or with significant penalties, or at death. People need a comfort level that even long-term savings can be available for certain important expenditures.

The indexing of contribution limits is another flexibility issue. In 1981, the maximum permissible contribution to an IRA was $2,000 per person, which today is only worth about $1,273. Indexing contribution limits would eliminate the need to adjust the law in the near future.

IRAs should also provide a range of options to the consumers such as offering frontloaded and backloaded alternatives, since individuals' preferences may differ. The American dream savings account is a positive step and has many important characteristics. It is simple to understand, its eligibility requirements provide for a much greater number of participants than current law allows and it is generally flexible with its qualified withdrawal feature and indexing of contributions. Adding the frontloaded choice would make the proposal even more attractive and, hence, more effective in increasing long-term savings.

In conclusion, we support legislative efforts to restore tax-favored retirement vehicles for individuals at all income levels. If IRAs are too complicated to understand, people will be discouraged from participating. If eligibility is limited by income level or dependent on whether an individual is covered by another pension plan, fewer people will be able to use the product. Without flexibility, including the ability to withdraw funds for important purposes without significant tax penalties, savers will be reluctant to put the money aside in the first place.

We urge that legislative efforts to revitalize the IRA be built on these three criteria. We are confident that the result will be a generation of new savings by individuals and a positive impact on the national savings rate.

Thank you for the opportunity to present these views, and I await your questions.

[The prepared statement follows:]

Statement of Raymond W. McKee
on behalf of the American Bankers Association

Before the
Committee on Ways and Means
United States House of Representatives

January 31, 1995

Mr. Chairman and members of the Committee, I am Ray McKee, Senior Vice President and General Tax Counsel of the Bank of America. I am appearing today on behalf of the American Bankers Association, in my capacity as Chairman of the ABA's Taxation Committee.

The American Bankers Association is the only national trade and professional association serving the entire banking community, from small community banks to large bank holding companies. ABA members represent approximately 90 percent of the commercial banking industry's total assets, and about **94 percent of ABA members are community banks** with assets less than $500 million.

I appreciate the opportunity to speak to the Committee today and to offer the banking industry's support for efforts to revitalize individual retirement accounts (IRAs). We are particularly pleased that the concept of a tax-advantaged savings vehicle appears to have strong bi-partisan support.

Mr. Chairman, as you well know, the personal savings rate in this country has trended down over the past several decades. During the 1970s, individuals saved 7.8 percent of their disposable income; in the 1980s, the personal savings rate declined to 6.5 percent; for the first half of the 1990s, individuals saved only 4.7 percent of their disposable income.

This declining trend in personal savings means that individuals will be less well prepared to meet a variety of financial needs they are likely to encounter during their lives -- including buying a home, paying for college, covering medical emergencies and providing an adequate retirement income. And because savings and investment are critical ingredients in economic growth, a declining savings rate also has negative implications for the future of our economy and for our ability to create new jobs.

Clearly, revitalizing IRAs will not solve all of our problems. But it is an important first step toward recognizing that we must provide incentives to encourage individuals to save more -- for their own good and for the good of the economy.

The concept of an IRA is appealing to individuals for their retirement savings, primarily because of the tax incentive. That tax advantage is often viewed as a supplement to savings, making the IRA an appealing product for an individual's long-term savings growth. Individuals who are concerned about the availability of retirement funds can appropriately complement social security and other retirement savings vehicles with IRAs. Once an IRA has been established, the tax implications that accompany early withdrawals provide further encouragement to save for the long-term.

The challenge, then, is to develop a viable IRA product with sufficient appeal to attract a wide range of individuals to participate. We believe that, to be successful, an IRA must meet three criteria:

- first, it must be simple enough to be easily understood by consumers;
- second, eligibility criteria must be sufficiently inclusive to permit broad participation; and

- third, it must be flexible enough to be responsive to the financial needs of today's consumers.

If those criteria are met, we believe that individuals will view the new and improved IRAs as valuable tools for long-term savings, and that the product will be far more successful than the IRA vehicle that is currently available.

Mr. Chairman, let me elaborate on these three points.

SIMPLICITY

One problem that has diminished the effectiveness of the current version of the IRA for bank customers is its complexity. In particular, the rules for determining eligibility for today's IRAs are simply too difficult to understand. Millions of consumers have been so confused about the tests, eligibility determinations, and income limitations, that even when they are eligible, many individuals do not participate in IRAs. The problem has been exacerbated by the changes, and by constant discussions of changes, in IRAs. We cannot stress too much the importance of simplicity. We strongly recommend that any new proposal be simple to understand in its terms and conditions.

We believe that the American Dream Savings Account is simple in its terms, conditions and design, and meets the simplicity test.

ELIGIBILITY

In 1981, almost all working Americans were eligible to participate, and IRAs became immensely successful. However, after the 1986 tax reform act, the eligibility rules were changed dramatically -- individuals covered by private pension plans were no longer eligible and the income limits established ($25,000 for individuals and $40,000 for couples) significantly reduced eligibility. Participation declined dramatically, and contributions have continued to shrink every year since 1986.

Inflation also contributed to the decline in the effectiveness of IRAs. Many in the low to middle income bracket that remained eligible under the 1986 tax reform act have gradually been forced out of eligibility simply because of inflation-based pay increases. Going forward, inflation will continue to shrink the base of those eligible to invest unless some type of indexation is permitted under the statute.

How can tax incentives work to continuously generate new long-term savings if the pool of eligible contributors is steadily shrinking? For a tax-favored savings incentive to be effective in generating new savings, the pool of those eligible to participate in the plan should be as wide as possible.

In the American Dream Savings Account, there are no income limits. Similarly, it does not eliminate those individuals covered by another pension plan. Therefore, a much greater number of individuals and households may participate in this proposed IRA than current law allows.

FLEXIBILITY

If there is any single reason why people have been reluctant to establish IRAs, it is probably the lack of flexibility. Individuals are understandably concerned about sinking their money into a totally illiquid account from which funds can not be retrieved without significant penalties -- except by crossing the retirement age threshold. For a savings incentive to work, people need to have a certain comfort level that their savings can be accessed for emergencies and for certain other important expenditures of their lives.

In our opinion, the provisions in the American Dream Savings Account offer that flexibility and will eliminate much of the anxiety that younger investors experience when they

consider putting their money into what is perceived, by some, as almost a lifetime investment.

Another flexibility issue that may be important over time is the indexing of contribution limits. In 1981, the maximum permissible contribution to an IRA was $2,000. However, that $2000 is only worth $1273 in today's dollars. A plan that protects the contribution limits from such erosion by the effects of inflation may be desirable so that the maximum contribution will not need to be adjusted by law in the near future.

The American Dream Savings Account includes this indexing feature for contribution limits.

We also believe that a plan should be flexible in offering a range of options to the customer. Many of the current savings proposals differentiate between whether the IRA is "front-loaded" or "back-loaded". With a front-loaded IRA, the taxpayer may take a tax deduction for the amount of the contribution. Alternatively, with a back-loaded IRA, there is no tax deduction for the contribution; instead, all earnings and contributions from the investment can be withdrawn tax-free for qualifying expenditures. A tax-favored savings plan should be flexible enough to offer both options to customers, since the decision as to which plan would be preferred may differ among individuals.

The American Dream Savings Account offers individuals the back-loaded choice only. We think that opening up the options to allow for the front-loaded choice would make the proposal even more attractive and, hence, more effective in accomplishing the desired goal of increasing long-term savings.

ECONOMIC BENEFITS OF AN EXPANDED IRA

By following our suggested criteria -- simplicity, eligibility, and flexibility -- we believe that a new IRA product will be successful in increasing individual savings and will benefit the economy as a whole. A properly designed retirement savings instrument will result in higher usage by individuals and more long-term savings.

There is general agreement that the level of national savings in this country has reached historic lows. Federal Reserve Board Chairman Alan Greenspan has stated that the single most important long-term issue for this country is inadequate savings. Savings promote capital formation, which is essential for job creation, opportunity and economic growth.

Today's low savings rate suggests that people are not preparing adequately for the future. A recent study by Merrill Lynch looked into the question of whether the baby boomer generation was saving enough to be adequately prepared for retirement and found that it was not. In fact, that generation is only saving one third of what it should be saving. In other words, the typical baby boom household should triple its rate of savings to be adequately prepared for retirement.

The study goes on to suggest that this statistic is probably greatly underestimated since many will have to use retirement savings to pay for purposes other than retirement, such as increased costs of health care and long-term care for the aged, compounded by the reality that people are living longer.

To help address concerns about the inadequate level of savings by individuals, today's IRAs must be updated. The American Dream Savings Account is a positive step toward creating a useful IRA product. It has many of the characteristics that we believe are important to attract individuals to contribute to IRAs.

CONCLUSION

In conclusion, we support legislative efforts to restore tax-favored retirement vehicles for individuals at all income levels. In order to encourage people to return to a routine, long-term savings plan, we need an attractive product that meets the tests of simplicity, eligibility, and flexibility.

If the rules for IRAs are too complicated to understand, people will be discouraged from participating. If eligibility is limited by income level or dependent on whether an individual is covered by another pension plan, fewer people will be able to use the product. Without flexibility, including the ability to withdraw funds for important purposes without significant tax penalties, savers will be reluctant to put money aside.

We urge that legislative efforts to revitalize the IRA be built on these three criteria. We are confident that the result will be the generation of new savings by individuals and a positive impact on the national savings rate.

Thank you for the opportunity to present these remarks. I will be happy to answer any questions you may have.

Chairman ARCHER [presiding]. Thank you, Mr. McKee.
Mr. Buchert.

STATEMENT OF JAY BUCHERT, PAST PRESIDENT, NATIONAL ASSOCIATION OF HOME BUILDERS, WASHINGTON, D.C.

Mr. BUCHERT. Thank you, Mr. Chairman. I am Jay Buchert, a homebuilder from Cincinnati, Ohio, and past president of the National Association of Home Builders. It is a pleasure to be here today to represent the 180,000 small firms which are located throughout the country that make up the National Association of Home Builders. We applaud the Chairman's willingness to hold these hearings and appreciate the opportunity to be here today.

Mr. Chairman, homebuilders have been long-term supporters of many of the proposals contained in the Contract With America. In fact, we just, at our convention in Houston, Tex., Chairman Archer's hometown, passed a resolution overwhelmingly supporting the Contract.

We are particularly proud of our long-term support for Chairman Archer's capital gains proposals, and we thank him for his continued effort in that area over the years.

My testimony here today will address the tax provisions of the Contract, which we fully support, and my oral statement will be limited to the American dream savings account.

Mr. Chairman, we support the use of IRA deposits for the downpayment on a first home, and respectfully suggest a simple modification of this provision to better accomplish its stated purpose. Downpayment and closing costs are still the primary barrier for young people in the purchase of a first home. Even with low downpayment requirements under lending programs such as FHA, the GSEs and the Federal Home Loan Bank System, it is still difficult for young households to accumulate the cash needed to make that first step toward home ownership, considering the small amounts that they have in their IRA accounts, repayment of their student loans, financing an automobile and the cost of starting a family. I witness this situation personally time and time again as young people attempt to make the important leap into home ownership while visiting my subdivisions in Cincinnati, Ohio.

May I suggest, to maximize the investment of IRAs, the proposal be modified to allow withdrawals of parents and grandparents from their IRA accounts in the form of a loan. This alternative should be treated as an investment for their tax-deferred account rather than a penalty-free withdrawal.

Mr. Chairman, NAHB estimates that this alternative provision would generate annually an additional 36,000 first-time home purchases and an additional 20,000 jobs that will accompany those purchases.

Mr. Chairman, the premise that there is a cost to this alternative of the IRA investment, we feel is unfounded. The premise assumes that parties using this provision would otherwise be cashing in portions of their IRAs and paying either the taxes or the penalties. We feel that that is very unlikely. We see this provision as an alternative investment with little effect on the Federal Treasury.

Mr. Chairman, I would like to discuss further this proposal in the question and answer period. I would like to thank the members of the committee very much for our opportunity to make these recommendations, and we look forward to working with you and your staff on these and other issues in the coming years.

[The prepared statement follows:]

TESTIMONY OF THE NATIONAL ASSOCIATION OF HOME BUILDERS BEFORE THE HOUSE COMMITTEE ON WAYS AND MEANS JANUARY 31, 1995

Mr. Chairman, members of the committee, my name is Jay Buchert I am a home builder from Cincinnati, Ohio and am a past president of the National Association of Home Builders. On behalf of the National Association of Home Builders (NAHB) and its 180,000 members, I congratulate you for holding this hearing and appreciate the opportunity to appear here today. At the outset, let me state that NAHB has long been supportive of many of the proposals contained in the Contract with America. We are particularly proud of our long-standing support of your capital gains proposals, Mr. Chairman, and we thank you for your continued efforts throughout the years.

OVERVIEW

The Contract with America's provisions contain a number of proposals and ideas which NAHB has supported and advocated over the past few years. Specifically, the tax and penalty-free use of IRA funds for first-time home purchase, reinstatement of a capital gains rate differential, clarification of the home office deduction rules and other small business incentives have been a part of the established policy of NAHB for quite some time. Our testimony here today will address those specific proposals and offer our suggestions for improvement, where appropriate.

AMERICAN DREAM SAVINGS ACCOUNTS

NAHB supports expansion of tax-deferred retirement savings and use of IRA deposits for down payment on a first home. The proposal currently before the committee would create a new IRA (American Dream Savings Accounts), and allow the tax and penalty-free distribution of funds from that account for first-time home purchase. NAHB supports this legislation and suggests modification of its provisions to better accomplish its stated purposes.

Accumulating the downpayment for the purchase of a first home is the primary barrier to home ownership for many young households. Even with lower downpayment requirements under FHA and special affordable housing programs from Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System, first-time home buyers find it difficult to accumulate the cash necessary to make the leap into home ownership. The U.S. Census Bureau and the Harvard Joint Center for Housing Studies have recently reported that down payment remains a serious barrier to home ownership for young renters.[1] Approximately nine-out-of-ten young renters cannot afford to purchase even a modest home in their area.

Increasing housing costs add to the housing affordability problem in this country. From World War II until 1980 homeownership rates in the U.S. increased. Since that time homeownership rates overall have declined. Particularly hard hit are those in the prime home buying age of 25-34. The homeownership rates of those in the age group 25-29 dropped from 43.3% to 34.6% and those in the 30-34 age group dropped from 61.1% to 51%. This trend is of significant concern.

Homeownership Rates (Percent)

Age	1980	1983	1986	1990	1993
25-29	43.3	38.2	36.1	35.9	34.6
30-34	61.1	55.7	54.1	51.5	51.0
35-39	70.8	65.8	64.2	63.1	62.9
40-44	74.2	74.2	69.3	70.4	68.7
45-54	77.7	77.1	75.6	76.1	75.2
55-64	79.3	80.5	81.0	80.4	79.6
65-74	75.2	76.9	77.6	78.7	79.9
75+	67.8	71.6	70.3	71.0	74.0

There are many factors that contribute to the housing affordability problem we are facing in this country. Certainly a factor has been increasing housing costs. Higher mortgage interest rates and general economic inflation have also been factors. The National Association of Home Builders believes government over-regulation is a significant contributor to increased land development and housing costs. The Kemp Commission on "Removing Barriers to Affordable Housing" identified numerous government regulations that add to the problem. We strongly urge Congress to make an aggressive review of these regulations and eliminate or change those that are unnecessary, costly and counter productive.

WHY IT IS IMPORTANT TO PROMOTE HOME OWNERSHIP

NAHB urges Congress to pass the American Dream Savings Act to create an incentive which will promote savings and encourage homeownership. Mr. Chairman, your American Dream Savings Act will make it possible for thousands of young working families to obtain the American Dream of homeownership. In turn, the construction of their homes will create jobs and the expansion of our economy. Equally important the expansion of homeownership contributes to the social/political stability of our society.

HOUSING - ITS ECONOMIC IMPACT

Housing construction contributes jobs, taxes, and economic activity to the U.S. economy. Each year, nearly 3 million jobs are created in the construction of new homes. These jobs create $78 billion in wages and $ 44 billion in federal, state and local taxes on that wage and business income. Even greater economic activity is created as the income generated in the construction, manufacturing, and sales jobs spread throughout the rest of the local economy.

NAHB estimates that housing, including new construction, remodeling, repairing and maintenance, and the value provided by existing homes accounts for 13 percent of the U.S. economy. This on-going benefit provides most American home owners and renters with decent, safe affordable housing.

		Single Family		Multi-family	
Industry Group	**Avg Annual Wage**	**Number of Workers**	**Wages (1,000s)**	**Number of Workers**	**Wages (1,000s)**
All Industries		2,097	$60,495.0	800	$23,297.3
Construction	$29,222	1,194	34.901.1	453	13,237.6
Onsite	29,222	1,015	29,660.3	398	11,630.4
Offsite	29,222	179	5,230.7	55	1,607.2
Land Development	29,222	100	2,922.2	50	1,461.1
Other Industries		803	22.681.7	297	8,598.7
Mfg	32,370	335	10,844.0	152	4,920.2
Trade, Transp, and Services	26,808	261	6,996.9	84	2,251.9
Mining	23,386	207	4,840.9	61	1,426.5

HOMEOWNERSHIP - IT'S IMPACT ON OUR SOCIETY

Homeownership truly is a fundamental part of the American Dream. Getting a good education, working hard, practicing thrift so that home ownership can become a reality, has been a motivating force for millions of Americans. NAHB's surveys show that 80 to 90 percent of all Americans want to become home owners. Recent studies by Fannie Mae have demonstrated the goal for home ownership is strong among all age and income groups. We believe that a goal seeking, motivated population is an essential element of a stable, productive society.

Homeownership not only allows families to establish roots in their communities, but it strengthens neighborhoods, expands participation in civic, religious, and community activities. It is what ties our neighborhoods together.

Homeownership provides financial security. It is the largest single asset of most Americans. For millions it represents a nest egg for retirement which has provided the elderly a strong supplement to social security. Many point to the low rate of per capita savings in the United States. However, if the equity in the homes of individuals were calculated, our per capita savings rates would be dramatically higher.

Homeownership also is the tax base for our public schools and community services. It provides a safe haven, a sanctuary, a secure place for families to live, grow and prosper. This environment is essential for the development and growth of our children. How can a child study properly, develop family values, excel and expand their goals and dreams without the proper environment? Homes are what provide that secure, protected and nurturing environment for millions of Americans. We should strive to do what is possible to provide this opportunity, homeownership, for more young families, and that Mr. Chairman is what the American Dream Savings Account will do.

IRA SAVINGS FOR DOWNPAYMENT

IRAs could be a useful resource to assist in first-time home purchase. IRAs already have substantial deposits. Total assets held in IRAs and Keogh plans (retirement plans for the self-employed) reached $773 billion at the end of 1992. Another $230 billion is invested in salary reduction plans (401(k), 457 and 403(b) tax deferred employer and employee contribution retirement plans) and $304 billion is invested in the federal government retirement plan for civil servants[2]. Collectively, these retirement plans could provide up to 1.3 trillion dollars.

Current Proposals. A number of proposals have been made to increase the potential use of retirement accounts for first time home purchase down payments. Proposals for use of existing "front-end" accounts typically propose penalty-free withdrawal of funds from the IRA for specified purposes. However, the tax that was deferred when the deposit was originally made must be paid at the time of withdrawal. Accordingly, withdrawal would be relatively expensive, especially if the funds were deposited at a time when the taxpayer's marginal tax rate was lower.

In this connection, we commend to your attention a bill entitled the "Savings and Investment Incentive Act of 1995", S. 12, introduced by Senators William Roth (R-DE) and John Breaux (D-LA). That bill would restore the IRA deduction and adjust the $2,000 deductible amount for inflation. It would also create nondeductible tax-free IRAs called "IRA Plus" accounts. Under the provisions of S. 12, distributions may be made free of penalty if used for first-time home purchase by the individual, their spouse, child, grandchild or ancestor.

The American Dream Savings Account (ADS) would provide an incentive to use IRA funds for a first-time home purchase. However, as currently crafted, the proposal's impact on home ownership would be minimal. The proposed ADS rules would require that the funds be maintained on deposit at least 5 years prior to withdrawal. First time home buyers are typically in their early 30s and currently have small account balances in tax-deferred retirement accounts. The long waiting period coupled with the first-time purchaser's paucity of funds defer and diminish the stimulative impact of the proposal. Although the ADS would increase the incentive to save, resulting in greater participation, the likelihood of generating substantial savings is small.

NAHB suggests that the ADS proposal be modified to allow home purchase withdrawals to be made from parents and grandparents accounts and that the waiting period be eliminated for first-time home purchase. The reason that this is important is because the very individuals this is targeted to assist, those young working families that are recently out of college trying to pay off student loans, or finance a car, have precious little left over for a retirement account.

Program Design. In designing a successful proposal for using retirement funds for down payments, there are three important components: 1) The use must be considered an alternative investment rather than a withdrawal; 2) Eligibility must be open to parents and grandparents of first time home buyers as well as the buyer; and 3) Eligible plans must include IRAs, Keoghs, 401(k) and other salary reduction plans, and the federal government retirement system. In the alternative, an attractive and economical proposal would allow down payments for first home purchase to be treated as an **investment** for tax deferred accounts rather than as a penalty-free withdrawal. Withdrawing the funds also subjects the taxpayer to implicit penalties in that the account holder's investments in tax deferred assets are reduced. From the point of withdrawal on, interest on withdrawn funds would be taxed at current marginal tax rates, again often higher than those anticipated during retirement. Treating the down payment as an alternative investment would avoid both explicit and implicit penalties.

The ability to use tax deferred retirement accounts for a down payment must be open to parents and grandparents because few young people have sufficient retirement savings to be useful. Table 1 shows participation rates by age of employee in employer pension plans. Table 2 shows account balances by age for salary reduction plans, chiefly 401(k) plans. Employees between 25 and 30 years old have the lowest participation rate in retirement plans and an average account balance of $5,185. A 10 percent down payment and associated closing costs on a median priced existing home sold would require cash in the amount of $13,000[3].

On the other hand, the parent of a potential first time home buyer is at least 45 years old, with an average IRA balance of approximately $16,380. Grandparent IRAs are most likely to have sufficient balances to provide down payment support in that workers between 60 and 64 years old have average IRA balances of $25,011.

Under current law, IRAs are primarily alternative forms of retirement savings when the saver's employer does not offer a retirement account, the saver is not self-employed, or the saver's income is under $40,000. About 20 percent of all workers have IRAs compared to 53 percent who participate in some employer pension plan. In order to have any significant impact, the first-time home purchase provision should also apply to other retirement accounts.

Expanding the eligible investments of a tax deferred retirement account to include qualified first time home purchases will have very little impact on federal tax receipts in the near term. The transfer of funds across investment opportunities is already a frequent occurrence and has no federal tax implications. The ability to use retirement funds for first time home buyer assistance may increase the desirability of saving in this form, both for potential first time home buyers as well as their parents and grandparents. Any increase in tax deferred savings because of the expanded options would decrease federal tax revenues over a longer period of time as deposits increased.

Table 1
Participation in Employer Pension Coverage

Age	Percent of All Workers Who Participate
25 - 30	40.9
31 - 40	53.3
41 - 50	62.6
51 - 60	60.0
61 - 64	54.2
65 & Up	27.5
All	53.3

Source: Employee Benefit Research Institute, Issue Brief, December 1993, p.5.

Table 2
Average Account Balance
Among Salary Reduction Plan
Participants

Age	Average Balance
25 - 30	$5,185
31 - 40	$10,207
41 - 50	$16,380
51 - 60	$20,456
61 - 64	$25,011
65 & Up	$13,953

Source: Employee Benefit Research Institute, Issue Brief, December 1993, p.18.

In this regard, we recommend that such use (by either the buyer, parents or grandparents of the buyer) be deemed an eligible investment of the IRA. Roughly 15 percent of potential first-time home buyers have invested in IRAs and another 9 percent have invested in 401(k) plans [4]. NAHB estimates that allowing a first-time home buyer's purchase to be a qualified investment within the plan would create 20,000 jobs and generate 36,000 additional home purchases.

CAPITAL GAINS

The Contract would provide three capital gains incentives: (1) a 50 percent capital gains reduction, (2) indexation of the basis of capital assets to eliminate inflationary gains, and (3) a capital loss deduction for homeowners.

NAHB supports reinstatement of a capital gains rate differential for real estate and other assets and their indexation for inflation. More favorable capital gains treatment would not only encourage purchases of existing properties, but would also encourage investment in new construction, rehabilitation and remodeling. It would also reduce required rents on new construction. For example, taxation of capital gains at 50% of ordinary income rates would eventually reduce all rents by 5%. This represents a tax cut for the middle class and those struggling to become middle class. Yet another example of why a capital gains tax break is not for the wealthy.

NAHB believes that taxation of assets held for one year or more at a lower rate than ordinary income encourages investment and savings. However, taxation of realized gains on long-held assets at ordinary income rates (i.e. on sale or transfer) reduces the economic incentives to invest in the most efficient, highest return opportunities. Removal of the retardant effect of current law taxation would allow taxpayers to place their capital in the most promising sectors of the economy. More efficient capital flows would create jobs and stimulate the economy.

A capital gains tax cut would not benefit only higher income taxpayers. One-half of the 1991 tax returns claiming a capital gain or loss reported incomes below $60,000. Furthermore, encouraging investment through reduced taxes on the gains from that investment would create jobs and economic activity at all levels of income.

With respect to real estate, a capital gains preference would increase investors and owners incentives to purchase, rehabilitate and operate rental housing. Part of the total return

to investors who own rental housing is property appreciation. The greater the owners after-tax income from the appreciation portion of their return, the less income required from rents to achieve the same earnings. Reducing capital gains tax rates will reduce residential rents. Since much of the appreciation in housing is due to price inflation, adjusting the gains for inflation will reduce rents even more.

We must insist however, that any capital gains incentive include real estate. Just as real estate served as the engine to lead the economic recovery, so it must be included in any capital gains reduction in order to maximize the dynamic economic impact of the proposal. Indeed, inclusion of real estate effectively rebuts any argument that a capital gains tax cut would favor only wealthy taxpayers. Mr. Chairman, I know this has been a long standing position of yours.

The capital loss deduction provision would allow taxpayers to get out of homes that have fallen in value. For taxpayers who may be hesitant to move to another dwelling, the provision would help to soften the financial repercussions of taking the loss on their current home. NAHB supports allowance of a capital loss deduction for sale or disposition of a principal residence.

HOME OFFICE DEDUCTION

The United States Supreme Court's Soliman decision effectively eliminated the home office deduction for the real estate construction industry. NAHB fully supports the proposal to clarify the standards for claiming a tax deduction for maintaining an office in the home.

Home building is dominated by small firms, many of which use home offices as their primary administrative location for doing business. Eighty percent of NAHB's builder-members construct fewer than 25 homes a year and most of these firms do not maintain a separate office. Many operate out of their homes, making necessary contacts with subcontractors and customers, and where, very often other family members assist in the administrative and clerical duties of the business.

The Contract proposal will help reduce housing costs by reducing builder/remodeler's costs. Because of the highly competitive nature of the construction business and the number firms available to perform services, the reinstatement of the home office deduction will translate into lower house prices. For an average builder who constructs 10 homes a year, and uses his home as the center of operation, the savings could be several hundred dollars per home.

INCREASED DEPRECIATION DEDUCTIONS AND NEUTRAL COST RECOVERY

NAHB supports adjusting real estate depreciation to account for inflation.

The Contract would allow taxpayers to adjust real estate depreciation amounts to reflect inflation. The inflation adjustment would put depreciable assets on an equal footing with expensed items. Currently, a business that purchases a piece of depreciable machinery can deduct a certain percentage of that machine each year, based on the principle that each year some of the machine is "used up". However, as inflation further erodes the value of the capital asset, the residual value of the asset is lessened. Expensed items, on the other hand, because they are purchased in the year of deduction, already reflect inflation.

Inclusion of real estate in the neutral cost recovery provision is particularly important in that the straight-line depreciation periods are long, and more directly impacted by inflation. Further, real estate can not be "expensed" as with business equipment.

INCREASE IN UNIFIED ESTATE AND GIFT TAX CREDITS

As pointed out above, home building is dominated by small firms which very often are family owned and operated. The current estate and gift tax laws operate to destroy family-

owned businesses by imposing a tax upon the inter-generational transfer of the business. Moreover, the economic impact of the tax increases from year to year because of inflation. NAHB fully supports increasing the amount of the unified credit to $750,000 and indexing that amount for inflation.

CONTRIBUTIONS IN AID OF CONSTRUCTION

As the Contract moves towards passage, there may be some opportunity to include additional provisions in the tax package. In that event, NAHB would urge that you amend the Internal Revenue Code to remove the tax on contributions-in-aid-of-construction. NAHB considers this to be a "tax" levied on home builders and, in-turn, home purchasers.

As you are no doubt aware, the 1986 Tax Reform Act repealed Internal Revenue Code section 118(b) with respect to corporate regulated utilities. The tax imposed on utility companies is grossed-up and passed on to developer-builders who must increase the cost of each home to cover this cost. The additional amounts resulting from CIAC adds from $2,000 to as much as $5,000 to the cost of each home sold, depending on the area of the country affected.

MORTGAGE INTEREST DEDUCTION

NAHB would strongly resist any tampering with the mortgage interest deduction, which we maintain is the cornerstone of housing policy and the principal government policy that changed this nation from one of renters to one with 65% home ownership.

Conclusion

For the reasons stated above, the National Association of Home Builders believes that the proposals contained in the Contract with America would be beneficial to the home construction and remodeling industry. The Contract would provide much needed tax relief and begin to bring the Internal Revenue Code into accord with economic reality and taxpayer fairness. As we have stated, we suggest that certain proposals be modified to have a more meaningful and immediate impact.

Once again Mr. Chairman, NAHB thanks you for this opportunity to present our recommendations. We look forward to working more closely with you and your staff in the coming years.

END NOTES

1. *The State of the Nation's Housing 1993*, Joint Center for Housing Studies of Harvard University and *Who Can Afford to Buy in House in 1991*, Current Housing Reports H121/93-3, Bureau of the Census.

2. Employee Benefit Research Institute, EBRI Notes, November 1993 and Issue Brief, December 1993.

3. The median existing home sales price for the first half of 1993 was $106,000 and closing costs for an FHA loan are about 2.5 percent of the mortgage amount. Hence, cash required is $10,600 for the 10 percent down-payment and $2,456 for closing costs on a 90 percent mortgage plus the 3 percent up-front insurance premium.

4. "Down Payments for Retirement Accounts", Housing Economics, March 1991.

Mr. THOMAS [presiding]. Thank you very much, Mr. Buchert.

I thank all of the panel. Does any member on the majority side wish to inquire?

Mr. Collins.

Mr. COLLINS. Mr. Chairman, I really don't have any questions for the panel, but we sure do appreciate your taking the time to come here in support of this effort, in support of trying to increase the savings across this Nation. We all feel like that is something that we must do if we are going to have the capital needed for investments.

Mr. THOMAS. Thank you very much.

Ms. Dunn.

Ms. DUNN. Mr. Chairman, thank you. I would just make the same remark and underscore what Mr. Collins said and also let you know, panel, that it is not that we don't have any questions, it is that we agree with almost everything you have said. Thank you for coming.

Mr. THOMAS. Thank you.

I do have some questions. As a person who has been involved for a long time with IRAs in previous Congresses, I want to get your reaction to an idea that we have been discussing. I found several of your testimonies interesting because you are beginning to focus on the fact that over a wide age group, the same program may not be as useful a tool, and you might want to structure it for different age groups.

I had, from the very beginning, a provision allowing withdrawals—that is why we call it the super IRA—for a number of reasons, not only first-time home buying, but also the ability to assist a child or grandchild in purchasing the home. In recent discussions, we focused on the fact that if you were more elderly, if you simply created an ability to fund a child or a grandchild, this would in essence be passing that wealth down a generation, and making you less well able to take care of yourself, and therefore, potentially more of a burden on society.

Have any of you discussed or thought about the idea that below a certain age level—and I don't know whether it would be 50 or 55, but it would have to be around there in terms of generating a young person who is of a home buying age themselves—that you could follow the historic pattern and allow that money to be used; but above, say, age 50 or 55, that it would be required to be in a loan structure, rather than an outright gift, so that the younger person would have an obligation to pay back that portion, and therefore, assist in old age, which is one of the main reasons for an IRA?

Any discussion by any of you about the idea of making that home purchase available above a certain age of the IRA recipient into a loan?

Mr. BUCHERT. Mr. Chairman, we have had discussions at NAHB along that line, just to address the particular situation that you brought up and the concern of many that you are diminishing the ability of the elderly, if they are giving it away to their grandchildren, because many of them are very generous—I know my parents are with my children and the other eight grandchildren that they have through my two sisters.

I think you are right. I think it solves that problem, and it is a reasonable approach. And it is also a good assumption that that is exactly what would take place.

Mr. THOMAS. OK. Let me ask you then a more difficult question.

All of you are in favor of creating incentives for people to put money away for various uses, one of which is home buying, and I think I understand that and I am trying to get a relative worth of this kind of a vehicle.

Mr. Buchert, you testified that you didn't believe the revenue estimates. I have difficulty, as I said earlier, in terms of short-term versus long-term payouts and the rest. But the powers that be tell us that certain styles of IRA, principally the frontload, do cost money in the short run. I am looking for relative worth of this product versus other products in the Tax Code.

Would any of you be supportive of a modest or appropriate reduction in the mortgage deduction level, from the $1 million down to a lower level, to fund the offset for the creation of the IRA; or is the mortgage far more valuable than the IRA? That is a tough question, I know, but frankly, those are the kinds of decisions that we are going to have to be dealing with in terms of tradeoffs in a given area. I would just like to know, if you are able to react, or if your associations will allow you to react to that kind of a tradeoff.

Mr. REID. That is a good question you are asking.

Mr. THOMAS. Mr. Reid.

Mr. REID. I think the income tax deduction for home ownership needs to remain intact, but I think there are maybe some other ways we can look. I think in our proposal we talk about a $500-per-child tax deduction, and I think that that might be something that should be considered as a tradeoff for the IRA situation to go through.

Mr. THOMAS. Thank you very much.

Any other volunteers?

Mr. BUCHERT. I think we also agree that it is a very good question, but a legitimate question. First I would like to respectfully submit that I have two college-age children—well, two out of college and one in college and one in high school now; and my wife and I have an IRA, and for all of the reasons previously mentioned, we haven't contributed to the IRA since the change of the Tax Act. We have just gone about doing things differently. And I think it is just two accounts that are set aside as far as we are concerned at our age, which is the early fifties.

I think the premise that we would cash in that money or cost the Treasury money, or I mean—excuse me, cost them—or pay, for example, a penalty in taxes is unfounded. However, if we thought we could help our four children over the next 5 or 10 years get into a home, which we think would be important, even in the form of a loan where they would have to pay it back, there really wouldn't be any cost.

I think the idea of people saying, oh, I will just go ahead and cash this in or do something different isn't really going to happen. So the legitimacy of the idea of addressing the mortgage interest deduction, it has been the cornerstone of home ownership in this country for years. You know, you work hard, you get a good edu-

cation, you buy a home for your family. It has made stable communities and it has brought society together and it has really been what has made us what we are. The idea of tampering with that begins to, I think, fly in the face of that whole premise.

I know there is even a provision—they say, well, how about second homes? A lot of people think that second homes, for example, are just for the people who appear on "Lifestyles of the Rich and Famous." The truth of the matter is, I was making a list up earlier today. When you take a look at my State, Ohio, most second homes are in the north along the lake, Lake Erie, and they are also in the same place in Michigan. You know, second homes are in the Poconos in Pennsylvania, they are in the Cumberlands in Kentucky, they are on lakes in Minnesota and Wisconsin. They aren't all in Palm Springs and also in Hilton Head.

Those second homes affect those communities. You know, most of them are owned—because we are builders, and we produce them—by blue collar workers who have looked at them as an investment, as a place for them to live under retirement, as a place for them to take their family while their family is still with them. And then the effect of those homes in each of these communities, whether they be in Gatlinburg, Tenn., or wherever they are, those second homes bring employment, bring stability and bring really the base—economic base that those communities need to exist too.

So I think once we begin to tinker with the mortgage interest deduction, we are beginning to tinker with something that has really been sacred and has really made this whole concept.

I know when I watch young people try to qualify—and I don't sell large custom homes; I sell production-type homes to mainly first-time buyers and young couples. When I watch them sit and tick down through what it takes to qualify, that mortgage interest deduction is very, very important; and I think once we begin to eat away at it, we have done a disservice. Because the inflation I have seen in my 50-some years, you know, I can imagine what it is going to be; and some day we are going to hit that ceiling that we think is so high.

You know, I started out building $19,000 houses and today, who would have imagined we would build half-a-million-dollar and million-dollar houses on a regular basis in most of the communities we live in.

Mr. THOMAS. I thank the panel.

The point you didn't make that I think we need to stress is that it would not be a dollar-for-dollar exchange because the super IRA would allow for a number of other activities, including medical college education, as was expressed earlier by the Senators, so you wouldn't get a dollar-for-dollar exchange.

I just wanted to test the waters. I thank the panel very much.

I would ask that the next panel come forward—Manuel Mehos, Paul Yakoboski, and James E. "Tom" Sawyer.

I will tell the panel that, without objection, your entire written testimony will be made a part of the record, and that you may be able to proceed for 5 minutes' time in any way you see fit to inform the panel. And once again I will start from my right and move to my left.

Mr. Yakoboski, you have 5 minutes.

STATEMENT OF PAUL J. YAKOBOSKI, RESEARCH ASSOCIATE, EMPLOYEE BENEFIT RESEARCH INSTITUTE, WASHINGTON, D.C.

Mr. YAKOBOSKI. Thank you very much. I am pleased to appear before you this afternoon to discuss the ADSA proposal. My name is Paul Yakoboski. I am a research associate at the Employee Benefit Research Institute, a nonprofit, nonpartisan, public policy research organization based here in Washington.

EBRI has been committed since its founding in 1978 to the accurate statistical analysis of economic security issues. Through our research, we strive to contribute to the formulation of effective and responsible health, welfare and retirement policies. Consistent with our mission, we do not lobby or advocate specific policy solutions.

The ADSA proposal creates a new type of less-restrictive individual retirement account. While this proposal creates a new savings vehicle for individuals to utilize, I would like to raise a few issues for consideration by the committee. One is the implication of such a saving vehicle for retirement income security, and more fundamentally, whether the objective of ADSAs is increased retirement saving or increased savings in general.

If the objective is increased savings in general, the question to be asked then regards the degree to which individuals are likely to utilize the newly created vehicle, and this then feeds into the question of whether it would generate additional savings. The longer the investment horizon of an individual, the more attractive will be saving through an ADSA.

For example, an individual in the 28 percent tax bracket saving $2,000 a year for 5 years, say, toward a downpayment on a first home, would have $600 more in an ADSA than if he saved on a non-tax-deferred basis; I am assuming a rate of return of 6 percent annually. However, given that the ADSA account cannot have a balance that falls below $1,000 with a distribution, he would actually have $400 more at his disposal by saving outside the ADSA.

Take the same individual now saving at the same rate for 18 years instead of 5, say, in this case, for a child's education. He would have $65,500 in the ADSA, compared with $55,100 by saving on a non-tax-deferred basis. Given the above, it is not clear how advantageous someone with a relatively short savings horizon would actually find such a savings vehicle. But an investor with a longer saving horizon is likely to find it very attractive.

If, on the other hand, the objective is increased savings for the purpose of retirement income, the proposal does increase the incentive to save for retirement through an IRA-type of vehicle by allowing the individual access to the money before retirement should it be needed for qualified purposes.

Over 90 percent of those eligible to utilize a tax-deferred IRA choose not to do so. It is often speculated that this is due to a lack of money and a reluctance to put savings in a vehicle where it is beyond one's reach without significant tax penalty should it be needed before retirement. The ADSA proposal would ease such concerns by allowing access to the money after 5 years for first-time home purchase, education expenses or medical expenses. This should result in increased IRA participation through ADSAs. But

again, the question is by how much, given that the money is locked up for 5 years and then only accessible for certain purposes.

Finally, the ADSA proposal would allow individuals with an existing IRA to roll over their IRA into an ADSA. Income tax would be paid on the rollover amount at the time of rollover, the future earnings would accrue tax free and any distribution would not be taxed if used for a qualified purpose. Such rollovers would be permitted whether the source of the IRA money was regular tax-deductible contributions, or the rollover of a lump sum distribution from an employment-based retirement plan such as a 401(k). This means that literally hundreds of billions of dollars in retirement savings would be eligible for rollover into ADSAs.

Over the period 1977 to 1992, almost 120 million tax filers claimed a deduction for IRA contributions and the amount claimed was over $252 billion. IRA rollovers are even more significant. In the 4-year period, 1987 through 1990 alone, there were over 11 million rollovers totaling $220 billion.

For some individuals, the tax gain from such a rollover would create a strong incentive to take advantage of the opportunity. However, none of the money rolled over would represent new additions to savings; it would all merely be a shift of existing savings from IRAs to ADSAs. These rollovers would generate tax revenue for the government at the time of a rollover, but would mean less tax revenue in the future.

Under the proposal, significant sums of money that have been accumulated in a tax-deferred vehicle earmarked for retirement would become available for other purposes. This would represent a dramatic change in policy objectives which should be recognized and understood in evaluating the proposal.

Thank you.

[The prepared statement follows:]

STATEMENT OF PAUL J. YAKOBOSKI
RESEARCH ASSOCIATE
EMPLOYEE BENEFIT RESEARCH INSTITUTE
BEFORE THE COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
JANUARY 31, 1995

I am pleased to appear before you this morning to discuss the proposal for creating American Dream Savings Accounts (ADSAs) found in H.R. 6. My name is Paul Yakoboski. I am a research associate at the Employee Benefit Research Institute (EBRI), a nonprofit, nonpartisan, public policy research organization based in Washington, DC.

EBRI has been committed, since its founding in 1978, to the accurate statistical analysis of economic security issues. Through our research we strive to contribute to the formulation of effective and responsible health, welfare, and retirement policies. Consistent with our mission, we do not lobby or advocate specific policy solutions.

The American Dream Savings Account proposal creates a new type of tax-preferred saving vehicle for individuals. As proposed, an ADSA is a less restrictive type of individual retirement account (IRA).[1] Anyone may make a contribution of $2,000 annually, irrespective of income or pension participation status. The contribution is with after tax dollars, but investment earnings accrue tax free subject to conditions. All distributions from such an account are tax exempt if they occur at or after age 59 1/2 or the account has been open for at least five years and the distribution is used for first time home purchase, education expenses, or medical expenses.[2,3] Furthermore, money in an existing IRA (whether the result of regular tax deductible contributions or of the rollover of a lump-sum distribution from an employment-based plan such as a 401(k)) would be eligible for rollover into an ADSA.[4] Income tax would be paid on the rollover amount at the time of rollover, but future earnings would accrue tax free and any distribution would not be taxed if qualified as outlined above.

While this proposal creates a new option for individuals to utilize in saving, both for retirement and other designated purposes, I would like to raise a few issues for consideration by the committee. One is the implication of such a saving vehicle for retirement income security, and more fundamentally whether the objective of ADSAs is increased retirement saving or increased saving in general?

Assuming for the moment an objective of increased saving in general, a question to be asked then regards the degree to which individuals are likely to utilize the newly created vehicle and this feeds into the question of whether it would generate additional saving. If an individual were to save $2,000 a year for five years on a nontax preferred basis, say toward the down payment on a first home, he would have $11,400 (assuming a 6 percent rate of return and a 28 percent tax bracket). If the same saving was done through an ADSA, the individual would have $12,000 at the end of five years in his account, a gain of $600. The question then is whether such gain is sufficient incentive for individuals to tie up their money in an ADSA? If the money is needed before five years, it would be inaccessible without tax penalty. In addition, the individual could actually withdraw only $11,000 from the ADSA since the account balance is not allowed to fall below $1,000 with a withdrawal.[5] Therefore, more money that can actually be used toward a down payment would be available by saving outside the ADSA ($11,400) than within the ADSA ($11,000) in this instance.

However, with a longer investment horizon, such as one may have when saving for a child's college education, the financial advantage of saving through an ADSA would increase. Assume an individual again saves $2,000 per year, only now he saves this amount for 18 years. (Again, he is in the 28 percent tax bracket and earns a rate of return of 6 percent.) In this instance, the individual would have $65,500 in the ADSA after 18 years, compared with $55,100 by saving on a non tax-preferred basis. The advantage of such a saving vehicle becomes more pronounced as the time horizon of the investor increases. Given the above, it is not clear how advantageous someone with a relatively short saving horizon would actually find such a saving vehicle, but an investor with a longer saving horizon is likely to find it very attractive.

Now, instead assume an objective of increased saving for the purpose of retirement income in the future. The proposal does increase the incentive to save for retirement through an IRA-type of vehicle by allowing the individual access to money before retirement should it be needed for qualified purposes. In 1993, among the 53.6 million civilian workers not participating in any type of employment-based retirement plan, only 6.3 percent reported having contributed to an IRA in the previous year. Therefore, 94 percent of those eligible to utilize a tax-deferred IRA choose not to do so. It is often speculated that this is due to a lack of money on the part of lower income workers, but these results hold across different levels of income. Only 2 percent of those eligible for a tax deductible contribution in the lowest earning bracket (under $5,000 annually) contributed to an IRA. While the contribution rate among eligible higher earners is greater, the vast majority still do not participate. Seventy-six percent of those with earnings of $50,000 or more and not participating in an employment-based plan did not contribute to an IRA.

An additional reason hypothesized for low participation rates among those eligible is that individuals, especially lower income individuals, are reluctant to put their saving in a vehicle where it is beyond their reach (without significant tax penalty) should they need it before retirement age. The ADSA proposal would ease such concerns by allowing access to the money after five years for first time home purchase, education expenses, or medical expenses. This should result in increased IRA participation through ADSAs, but again the question is by how much? This is very hard to predict with precision. Again, the fact that individuals are only allowed to withdraw money without tax penalty under a limited number of circumstances, and then only after five years, may still discourage these types of individuals (current eligibles choosing not to participate) from participating in an ADSA.

Any worker is currently allowed to make an after-tax contribution of up to $2,000 to an IRA as now structured. Earnings accumulate tax deferred and income tax is not paid on them until distribution. While hard data on the use of IRAs on an after-tax basis are lacking, it seems that such behavior is relatively rare. The existence of ADSAs would create an increased incentive for such saving as the mechanics are essentially the same with the added bonus that the earnings are not taxed, even at distribution (and there is also the availability to withdraw the money before age 59 1/2 for qualified reasons).

Finally, the ADSA proposal would allow individuals with an existing IRA to roll over their IRA into an ADSA. Income tax would be paid on the rollover amount at the time of rollover, but future earnings would accrue tax free and any distribution would not be taxed if qualified as outlined above. (It is not clear how the rollover of IRAs consisting of after-tax contributions would be treated for tax purposes.) Such a rollover would be permitted no matter what the source of the IRA money, whether the result of regular tax-deductible contributions or of a rollover of a lump-sum distribution from an employment-based retirement plan such as a 401(k). This means that literally hundreds of billions of dollars in "retirement savings" would be eligible for rollover into ADSAs. Over the period 1977-1992, almost 119 million tax filers claimed a deduction for IRA contributions and the amount claimed for deduction was over $252 billion. Rollover contributions to IRAs are even more significant in terms of dollars. In the 4-year period of 1987-1990 alone, 11.2 million rollover contributions were made to IRAs, totaling $220 billion.

For some individuals, the tax gain from such a rollover would create a strong incentive to take advantage of the opportunity. Among those with such an incentive would be individuals who already planned to tap into the IRA in the future for one of the qualifying reasons, for example, a parent who planned to access some of their account in 10 years to finance a child's education. By rolling over into an ADSA, they would avoid the 10 percent penalty tax at the point they took money out for the education expenses.

IRA participants must commence benefit payments by April 1 of the calendar year following the calendar year in which they reach age 70 1/2. The penalty for failure to make a required distribution of (at least) the correct amount is a nondeductible excise tax of 50 percent of the difference between the minimum required amount and the actual distribution.[6] An individual who did not want the money till a later age would find it to his advantage to roll the money into an ADSA where it would grow tax free (after payment of income tax at the time of rollover) till the time of distribution. There would be no penalty for funds left in the account after age 70 1/2. This is better than taking a distribution at

age 70 1/2, paying income tax on it, and then investing it on a non-tax sheltered basis till the money is needed.

There is currently an excise tax of 15 percent on any income from tax-preferred retirement plans combined in excess of $150,000 annually (indexed for inflation). Individuals expecting to be impacted by this excise tax would have the incentive to roll any IRA funds into an ADSA. They could then make withdrawals from the ADSA at their discretion so as to not incur the excise tax on this amount.

Beyond these three scenarios, the advantage of a rollover depends upon what one anticipates happening to their tax rate between now and retirement age. If one expects to be in a lower tax bracket in retirement, then one would be better off leaving the funds in the existing IRA. If, however, one anticipates tax rates increasing over time, then it would make sense to roll over into an ADSA.

None of the money rolled over would represent new additions to saving. It would all merely be a shift of existing saving from IRAs to ADSAs. These rollovers would generate tax revenue for the government at the time of rollover but would mean less tax revenue in the future. Such a shift would have potentially noteworthy implications for retirement income security. After five years, such money would be available tax free for the qualifying purposes. To the extent that such withdrawals occurred, it would be at the price of future retirement income. This represents a dramatic shift of policy objective away from saving for retirement income security to saving in general. Under the proposal, significant sums of money that had been accumulated in tax-preferred vehicles earmarked for retirement income would be made available for other purposes. It can be argued that some of the spending, such as a home purchase or additional education for the owner, would enhance retirement income security; however, the shift in emphasis from retirement saving to generic saving remains important because of the potentially dramatic implications for retirement income in the future.

Conclusion

The American Dream Savings Account proposal creates a new type of tax-preferred saving vehicle for individuals. As proposed, an ADSA is a less restrictive type of individual retirement account (IRA). The longer an individual's investment horizon, the more attractive will be saving through an ADSA. In addition, individuals eligible to make tax-deductible IRA contributions, but who have not done so in the past, may find the ADSA option attractive since it allows access without tax penalty to the savings before retirement if the money is used for a qualifying reason (first time home purchase, education expenses, and medical expenses). Finally, the ADSA proposal would allow individuals with an existing IRA to roll over their IRA into an ADSA, meaning that literally hundreds of billions of dollars in "retirement savings" would be eligible for rollover into ADSAs. This represents a dramatic shift of policy objective away from saving for retirement income security to saving in general, with potentially dramatic implications for retirement income in the future.

Endnotes

[1]Under current law individuals who are not active participants in a qualified employment-based retirement plan can make fully tax-deductible contributions up to a $2,000 maximum per year to an individual retirement account (IRA). Individuals who are active participants or whose spouse is an active participant in a qualified employment-based plan and whose adjusted gross income (AGI) does not exceed $25,000 (single taxpayers) or $40,000 (married taxpayers filing jointly) may make a fully deductible IRA contribution. Individuals who are active participants or whose spouse is an active participant in a qualified employment-based plan and whose AGI falls between $25,000 and $35,000 (single taxpayers) and between $40,000 and $50,000 (married taxpayers filing jointly) may make a fully deductible IRA contribution of less than $2,000 and a nondeductible IRA contribution for the balance, as follows. The $2,000 maximum deductible deduction is reduced by $1 for each $5 of income between the AGI limits. Individuals who are active participants or whose spouse is an active participant in a qualified employment-based plan and whose AGI is at least $35,000 (single taxpayers) or at least $50,000 (married taxpayers filing jointly) may only make nondeductible IRA contributions of up to $2,000; earnings on the nondeductible contribution are tax deferred until distributed to the IRA holder. IRAs can also be established as rollover vehicles for lump-sum distributions from employment-based pension plans or other IRAs.

[2]Distributions from an ADSA would also be tax exempt in the event of the death or disability of the account owner.

[3]Distributions from IRAs are taxed as ordinary income in the year received, except for the portion of the total IRA distribution that is attributable to nondeductible contributions, which are excludable from gross income. Taxable distributions prior to age 59 1/2 are subject to a 10 percent penalty tax, unless they are taken as part of a series of equal payments made for the life (or life expectancy) of such employee and his or her beneficiary, or the IRA owner dies or becomes disabled.

[4]It is not clear how the rollover of IRAs consisting of after tax contributions would be treated for tax purposes.

[5]H.R. 6 stipulates that for a distribution to be a "qualified special purpose distribution," it shall not include any payment or distribution to the extent such payment or distribution reduces the balance of the amounts in ADS accounts of the taxpayer below $1,000.

[6]The minimum amount that must be paid each year is determined by dividing the account balance by the applicable life expectancy. The applicable life expectancy is the life expectancy of the employee, or the joint life expectancies of the employee and the employee's designated beneficiary, if any. The life expectancy of the employee and/or the employee's spouse can be recalculated annually; however, the life expectancy of a beneficiary other than a spouse cannot be recalculated.

Chairman ARCHER [presiding]. Thank you very much, Mr. Yakoboski.

Mr. Mehos.

STATEMENT OF MANUEL J. MEHOS, CHAIRMAN, CHIEF EXECUTIVE OFFICER AND PRESIDENT, COASTAL BANC SAVINGS ASSOCIATION, HOUSTON, TEX., ON BEHALF OF SAVINGS & COMMUNITY BANKERS OF AMERICA, WASHINGTON, D.C.

Mr. MEHOS. Thank you, Mr. Chairman.

My name is Manuel J. Mehos; I am chairman of the Coastal Banc Savings Association of Houston, Tex. I am testifying today on behalf of a national trade association representing more than 2,200 community financial institutions whose members focus on providing real estate, finance and community financial services. Until yesterday, the name of my trade association was the Savings & Community Bankers of America. Yesterday, our board of directors voted to change the name of the association to America's Community Bankers to better reflect our emphasis on community banking.

Thank you for this opportunity to appear today in support of the American dream savings account and the need to expand the ability of Americans to save for their own retirement. We commend you, Mr. Chairman, and the other members of the committee for working to provide incentives for Americans to increase their savings.

In addition to encouraging retirement saving, the American dream savings account would also make it easier for Americans to save for their first homes, pay educational and medical expenses, and purchase long-term care insurance. The members of America's Community Bankers are focused on home mortgage lending, and we strongly support all efforts to make housing more affordable. But we believe that more needs to be done to encourage retirement savings.

America's low level of saving contributes to a chronic budget deficit that requires foreign capital to finance. The low level of retirement saving by the baby boom generation has put them on a collision course with their own retirement needs. The retirement needs of the baby boomers will be even greater than those of the current generation of retirees, because their life expectancies may be greater and because their Social Security benefits will very likely have to be reduced.

It now appears that the Social Security Trust Fund will have insufficient funds when the baby boom generation retires to maintain the current level of benefits without increasing taxes. We believe that one of the best vehicles ever created to increase individual retirement saving is the deductible IRA. We disagree with those who say that participants in deductible IRAs just shift assets from taxable accounts to their IRAs. There is a wealth of significant analysis proving that IRAs significantly increased saving during the early eighties, when their availability was expanded.

We respectfully request that the committee consider expanding the American dream savings account to include a deductible IRA feature that would be available to all workers and their spouses. We strongly support the Savings and Investment Incentive Act of

1995, just introduced by Congressmen Thomas and Neal of the committee, and the corresponding Senate bill introduced by Senators Roth and Breaux. The Savings and Investment Incentive Act of 1995 includes a deductible IRA and additional features very similar to the American dream savings account.

This morning, I listened to my esteemed Senator from Texas, Kay Bailey Hutchison, whom I strongly support. I believe homemakers' daily duties and responsibilities are infinitely more difficult than my own—that is a personal opinion—and they certainly should be treated the same as a wage earner. Therefore, I am confident that I speak for my colleagues when I say that we support Senators Bailey Hutchison's and Mikulski's bill, which allows equal IRA contributions for homemakers.

We understand that enactment of a deductible IRA may require the Congress to come up with offsetting revenue in the form of tax increases and spending cuts—or spending cuts. The Congress is committed to cutting government spending already, and it would make sense to, in effect, use some of that saving to enact an expanded IRA.

Reliable studies have shown that for every dollar of tax revenue given up in the form of an IRA deduction, a much larger amount of new savings is created. We think that the tradeoff is worth it for the long-term good of this country. IRAs are good for America and we hope that their availability and flexibility will be expanded.

Thank you, Mr. Chairman, for permitting me to appear here today. I very much appreciate your efforts to increase savings and will be happy to answer any questions at the conclusion of the panel.

[The prepared statement follows:]

TESTIMONY OF MANUEL J. MEHOS
SAVINGS & COMMUNITY BANKERS OF AMERICA

Mr. Chairman and members of the Committee, thank you for this opportunity to appear today. My name is Manuel J. Mehos, and I am the Chairman, President, and Chief Executive Officer of the Coastal Banc Savings Association in Houston, Texas. I am here today testify on behalf of Savings & Community Bankers of America (SCBA), of which Coastal Banc Savings is a member. SCBA is a national trade association representing an industry of more than 2,200 savings and community financial institutions with more than 16,000 offices, 285,000 employees and nearly $1 trillion in assets. Its members focus on providing real estate finance and community financial services.

Mr. Chairman, SCBA commends you and other Members of Congress for advancing a proposal that would encourage saving by Americans – The "American Dream Savings Account." The American Dream Savings Account would, if enacted, help and encourage Americans to save for those events that, next to retirement, are the most expensive they will face -- the purchase of a first home, a family's higher education expenses, and medical expenses, including purchases of long-term care insurance.

The ADSA could be set up in addition to an Individual Retirement Account and, although contributions could only be made with after-tax dollars ("back-loaded"), the earnings on the account would be tax-free. The annual contribution limit would be the lesser of $2,000 or the participant's annual compensation. Unlike a regular IRA, the compensation of married couples could be aggregated to permit a $4,000 contribution by the couple, even though only one partner worked, and the annual contribution limit would be adjusted annually for inflation. The IRA rule that requires contributions to cease and distributions to commence at age 59 1/2 would not apply and contributions could be made after 70 1/2. No penalty would apply to ADSA amounts withdrawn after five years for any of the three nonretirement expenses mentioned previously. Individuals would have a one-time opportunity to convert their IRAs to ADSAs and spread the income tax due on the amount transferred over four years.

The savings institutions industry, the primary function of which is lending to homebuyers, strongly supports the creation of a savings vehicle that will bring home ownership within reach for more Americans. Using IRA funds for this purpose merely converts one type of long-term investment into another.

The other goals of the ADSA are likewise worthwhile. Only by making higher education affordable for more Americans can we compete successfully in a global economy. Permitting Americans to use their savings without being subject to a tax penalty in the event of serious illness is also sensible.

The greatest threat to our future competitiveness and prosperity is our low rate of accumulation of financial assets for long-term retirement savings. The dramatic decline in discretionary private savings has been widely reported and analyzed.[1] The American people are not saving adequately, in general, and, in particular, their

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[1] The U.S. "personal savings rate" dropped from 5.6% during 1981-5 (the period of expanded IRA availability) to 3.4% during 1986-94 (Department of Commerce Bureau of Economic Analysis, National Income Accounts. Update prepared by the American Council for Capital Formation Center for Policy Research, December 1994). According to the Congressional Budget Office, the "national savings rate" dropped from 3% during the period 1981-93 to 1.7% in 1993 (statement of Senator William Roth, Congressional Record, January 4, 1995).

retirement savings relative to their retirement needs are woefully inadequate.[2] Contractual savings in the form of employer-sponsored plans, which have long been a growing and dominant feature of our total savings, cannot be expected to fill all our future needs. The insufficiency of individual retirement saving is being accompanied by the steady elimination or radical restructuring of traditional, private sector employer pension plans. Moreover, when the "baby-boom generation" retires, its members cannot count on as generous a level of inflation-adjusted Social Security payments as received by current retirees. At that time, the then-current work force may very likely be unable and/or unwilling to pay taxes at the level required to make good on the vast unfunded liabilities bequeathed to them in the form of Social Security, Medicare, and federal pension benefits owed to the baby boomers.

The savings goals of the ADSA are commendable, but more needs to be done. The critical lack of retirement savings in this country must also be considered when evaluating the merits of tax-advantaged savings plans for individuals. It is the view of SCBA that the tax-deductible Individual Retirement Account is one of the most effective means ever devised of encouraging individual retirement saving. IRAs were created in 1974 for workers who were not participants in employer-sponsored retirement plans. The Economic Recovery Tax Act of 1981 made it possible for any wage earner to establish an IRA and increased the limit on deductible annual contributions from $1,500 to $2,000 ($4,000 where both spouses worked and $2,250 where only one did).

The Tax Reform Act of 1986 limited the deductibility of the $2,000 contributions where the individual or spouse is a participant in an employer's plan. The deduction is phased out for such individuals who have adjusted gross income from $25,000 up to $35,000 (between $40,000 and $50,000 for married individuals). Amounts withdrawn from an IRA before age 59 1/2 are subject to a 10 percent premature distribution penalty, unless the distribution is due to death, disability, or in the form of an annuity.

SCBA maintains that when the Tax Reform Act of 1986 reduced availability of IRAs, a very important incentive for retirement saving was eliminated, one that had a significant impact on long-term capital formation. It is our position that enactment of S.12, the "Super IRA," more commonly referred to as the "Roth-Breaux IRA," would be the best possible way to increase long-term retirement saving, while providing considerable flexibility to participants.

The Roth-Breaux IRA combines both the traditional IRA and a short-term savings vehicle called an "IRA Plus" Account, which accepts after-tax contributions and permits them and their earnings to be withdrawn penalty-and-tax-free after five years. Both the regular IRA feature and the IRA Plus Account permit withdrawals: to buy a home; pay education expenses; pay catastrophic health care costs; or to meet expenses during a period of long-term unemployment. Conversions from IRAs to IRA Plus Accounts will be permitted without penalty and, if the conversion is made before 1997, the income tax owed may be spread over four years.

SCBA strongly recommends that the Congress enact the Roth-Breaux Super IRA as the best possible means to increase the nation's long-term savings. There is no question that from 1981 through 1986 -- the period of existence of the universal IRA -- the savings rate of this country significantly increased. It is the strongly-held belief

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[2] See, e.g., Is The Baby Boom Generation Preparing Adequately For Retirement? Report prepared by B. Douglas Bernheim, Ph.D., (Princeton University), January 15, 1993, Sponsored by Merrill Lynch & Co., Inc.

of our members, based on their own experiences, that the expansion of the availability of IRAs caused this increase in saving.

Nevertheless, an argument often made is that the availability of deductible IRAs results principally in a shift of existing savings from the taxable accounts of the participant. Chairman Alan Greenspan, in his testimony before the Finance Committee on the predecessor of the Roth-Breaux Super IRA -- the Roth-Bentsen Super IRA, S.612 -- noted that the many analysts believed that during the 1982-86 IRA experience "little, if any, of the money flowing into the accounts represented new saving -- a perception that undoubtedly contributed to the scaling back of IRAs as part of tax reform in 1986." He continued, however,

> Since then, many new data have become available, and several studies of the IRA experience have been carried out. These studies provide a wealth of information, but again, the results are inconclusive. Some essentially confirm the "conventional wisdom" that IRAs involved primarily a shifting of saving from one pile to another, without much effect on the total. But others suggest that IRAs provided a substantial boost to overall saving and that their effectiveness would have grown over time as people exhausted their opportunities to shuffle existing assets.[3]

We find the latter group of studies far more compelling based on their consistency with the experience of our member financial institutions. The individual authors reached their conclusions -- that IRAs do stimulate new saving -- by means of a variety of analytical techniques, not the least important of which appears to be common sense.[4]

It is uncertain based on our experience with the currently available back-loaded IRA whether the ADSA will be as effective at stimulating saving as a tax deductible IRA. Those of our customers who have lost eligibility to make deductible IRAs have, in general, shown relatively little interest in making the after-tax IRA contributions, despite the opportunity to defer tax on the earnings of the account. Professor Steven F. Venti, in his testimony before the Senate Finance Committee on December 7, 1994, speculated that a combination of tax deduction psychology and institutional promotion may have helped to make deductible IRAs so popular when they were available to all workers.

Obviously, there has been a significant reduction in IRA advertising since 1987. The sense of our members, however, is that ability to actually see a reduction in tax liability on their tax returns created an even more powerful psychological impetus in favor of IRA participation among our customers. The fact that the ADSA cannot tap into this psychology will make it less attractive than a regular IRA, although the fact that an ADSA's funds are not "locked-up" by the IRA premature distribution rules will to some extent create a countervailing psychological effect. The ADSA, quite obviously in our view, will not be as effective as the Roth-Breaux Super IRA in

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[3] Testimony of Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, before the Committee on Finance, U.S. Senate, May 16, 1991.

[4] See, e.g., Testimony of Steven F. Venti, Professor of Economics, Dartmouth College, to the Senate Finance Subcommittee on Deficits, Debt Management, and Long-Term Growth, December 7, 1994; Testimony of Richard H. Thaler, Professor of Economics, Cornell University, to the Senate Finance Subcommittee on Deficits, Debt Management, and Long-Term Growth, December 7, 1994; Stephen F. Venti and David A. Wise, The Evidence on IRAs, Tax Notes, January 25, 1988, at p. 411; Martin Feldstein, The Effects of Tax-Based Savings Incentives on Government Revenue and National Saving, National Bureau of Economic Research, Working Paper No. 4021, March 1992.

stimulating long-term saving.

The Super IRA, however, may well be "scored," as costing considerably more in anticipated lost revenue than the ADSA under the current Congressional budget procedures. Thus, the Super IRA may be politically less feasible. Nevertheless, the impact of a budgetary evaluation that occasionally appears artificial should not prevent us from considering other views of the economic impact of deductible IRAs. Quite simply, because the increase in personal savings significantly exceeds the resulting decline in tax revenues, in our view, the Super IRA is worth doing. Professors Steven F. Venti of Dartmouth College and David A. Wise of Harvard University, for example, have concluded that each marginal dollar of deductible IRA contribution is financed by a more than 50 cent reduction in consumption, a 20 to 30 cent reduction in taxes, and a reduction of other savings of 20 cents or less.[5]

We completely concur with the views of Harvard Professor Lawrence H. Summers, now on leave as U.S. Treasury Undersecretary for International Affairs:

> The weight of the available evidence suggests that IRAs generated a significant amount of saving that would otherwise not have taken place. If [deductible] IRAs were reinstated under current law, the government would lose about twenty-five cents for each one dollar of contribution. If more than one-fourth of the money contributed to IRAs represents new saving, IRAs will increase private saving by more than their revenue cost. If this condition is met, the case for reinstating IRAs is clear. Even if it is not, there is still a strong case for saving incentives given that the restoration of IRAs would be likely to come at the expense of other tax breaks rather than at the expense of larger deficits.[6]

The last sentence of Undersecretary Summer's statement makes a point that is applicable in the context of an analysis limited by Congressional budgetary procedures. Assuming the data does show that the increase in invested capital created by deductible IRA contributions would be significantly greater than the resulting decrease in tax revenue, this would be, in our view, a compelling reason for reinstating deductible IRAs. In any case, the constraint imposed by Congressional budgetary procedures would compound the benefit of enacting deductible IRA legislation. If deductible IRA legislation were enacted with the loss of tax revenue being offset by corresponding cuts in federal spending, a very powerful means of increasing the supply of domestic funds available for investment would be created.

At the very least, we would advocate the untrammelled availability of deductible IRA contributions for those employees who are participants in a defined benefit plan but who have not yet reached the vesting threshold for those benefits. Under current rules, it is possible for a worker, who is continuously employed and a participant in defined-benefit pension plans at every employer, to never qualify for a dollar's worth of defined benefits if he or she switches jobs every three years. The availability of an unrestricted IRA would so something to fill that gap.

In summary, we are very appreciative of the opportunity for increasing saving, both for retirement and certain worthwhile expenditures, represented by the proposed

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[5] See Stephen F. Venti and David A. Wise, The Evidence on IRAs, Tax Notes, January 25, 1988, at p. 415.

[6] Lawrence H. Summers, Stimulating Personal Savings in The U.S. Savings Challenge: Policy Options for Productivity and Growth, Edited by Charles E. Walker, Mark A. Bloomfield, and Margo Thorning (Boulder, Colorado: Westview Press, 1990), at p. 170.

American Dream Savings Account and we strongly urge the Congress to pass this important part of the Contract With America. As we have said, however, more needs to be done to address the critical lack of retirement saving and investment in America. That is why we urge the Committee to consider adopting, as an expansion of the concept of the American Dream Savings Account, the additional provisions of S. 12, the Roth-Breaux Super IRA. I would be pleased to answer any questions.

Thank you.

Mr. THOMAS [presiding]. Thank you, Mr. Mehos.

The Chair would note, a former member of the committee, the Governor of Tennessee, who is with us.

Mr. Sawyer, you may continue.

STATEMENT OF JAMES E. "TOM" SAWYER, CHAIRMAN OF THE BOARD, AMERICAN ASSOCIATION OF ENGINEERING SOCIETIES, WASHINGTON, D.C.; AND SENIOR VICE PRESIDENT, GREINER, INC., TAMPA, FLA.

Mr. SAWYER. Mr. Chairman, my name is Tom Sawyer. I am from Tampa, Fla., where I have practiced civil engineering for 40 years. I am here to represent the Engineers' Public Policy Council of the American Association of Engineering Societies. Our organization represents 800,000 professional engineers and 28 engineering societies, and our policy regarding pensions has been developed by the Engineers and Scientists Joint Committee on Pensions, which has 32 societies as its membership.

We are concerned about our members and about those that practice our profession, and that is the reason I am here to testify. We are concerned that we want them to be able to continue to contribute to the quality of life of my grandchildren and yours and, sometime, wind up with an economically secure future upon retirement.

Many engineers started work in their profession with a concept of lifelong employment. I have worked for one firm for 39 years; that will never happen again. Engineers are globally competitive; we have to go where the technology is needed and where it is required. There are frequent job changes.

There is considerable spotty unemployment in the various professions of engineering, particularly when the focus changes from space to infrastructure and so forth, and it is increasingly difficult for engineers to save for their future. And yet we are all contributing to the technology that makes the information highway possible, improves the quality of life.

I am testifying on behalf of the proposed American dream savings account for several reasons. First of all, it would permit individuals to make a $2,000 contribution, after they have paid taxes. But second, it would recognize that my wife, who is a homemaker, elected that as a career, is equal in importance to me and gets her $2,000 advantage.

We think that it is a good idea for the amounts in the ADSA to be available for retirement, or for a first-home purchase, or for postsecondary educational and medical expenses, but we hope that you will include provisions that will regard this preretirement expenditure as a loan that could be repaid and preserve the advantages.

There is an important feature of the ADSA that has some level of excitement, and that is, it does not permit the government to benefit from the devaluation of currency. Many of us have saved all of our lives and have a lot more dollars now, but the dollars we put in were quite valuable and hard to come by and the ones we are getting back don't buy very much. I think this is a poor concept, and I hope you will consider it as you deliberate amongst the options.

It is important for government to adopt policies that encourage individual responsibility, that encourage me to save for my future, my retirement. My mother saved very hard-earned dollars, and the government took them away from her because, when she got ready to go into a retirement home, the cost was an incredible amount to her. I think the ADSA would not cost the government over the life cycle of the government, because I think you would have fewer people in nursing homes on welfare and at government expense. My mother paid her last nursing home bill with her last dollar, but most of the people in the nursing home were there at my expense as a taxpayer.

So I don't think you need to look at this as revenue-neutral, because I think you will get the money back. Let's face it. When I leave this Earth, the government is going to get a whole lot more of my money than my grandchildren will anyway. You will get it one way or another.

We do strongly support the flexibility of savings and savings options. We certainly hope that as you consider the ADSA that you won't modify the provisions of the 401(k)s, the IRAs, or other retirement plans. We are committed to you in enhancing the portability of retirement plans, and we encourage you to consider that the middle class deserves the incentive and the commitment to valued savings that this bill would provide.

That concludes my testimony, and I would be glad to answer any questions.

[The prepared statement and attachment follow:]

STATEMENT OF JAMES E. SAWYER
AMERICAN ASSOCIATION OF ENGINEERING SOCIETIES

Good afternoon, Mr. Chairman and Members of the Committee.

On behalf of the Engineers' Public Policy Council of the American Association of Engineering Societies (AAES), I am pleased to have this opportunity to testify before you today on the American Dream Savings Account. My name is James E. Sawyer, and I am the Chairman of the Board of AAES. I am a senior vice president of Greiner, Inc., in Tampa, Florida. AAES is a multidisciplinary organization dedicated to coordinating the collective efforts of over 800,000 members represented by 28 engineering and scientific societies to advance the knowledge, understanding and practice of engineering. (A list of AAES member societies is attached to our statement). AAES activities on retirement income issues are coordinated by the Engineers and Scientists Joint Committee on Pensions (ESJCP). ESJCP consists of 32 engineering and scientific professional societies. In the past, ESJCP has been active on issues such as pension portability and Individual Retirement Accounts (IRAs).

Background

AAES is committed to improving opportunities for engineers and other workers to earn retirement income that will enable them to remain economically secure at the conclusion of their working lives. As the 21st century approaches, demographic and economic changes are imposing severe strains on the nation's retirement income delivery system. For most workers, including engineers, career-long employment with one company is a thing of the past. The engineering community is on the cutting edge of advancements which are rapidly altering the global workplace. Engineers are already experiencing periodic unemployment, frequent job changes, and increasing reliance on part-time, temporary, or contract employment. These changes not only affect workers' current livelihood, but their future retirement income security as well. We are also concerned that declining rates of personal savings, including retirement savings, are having adverse affects on the availability of capital for productive investment in the national economy.

AAES believes that access to retirement income plans is a fundamental economic problem that will reach crisis proportions within the next two to three decades if it is not addressed soon. In the twenty years since enactment of the Employee Retirement Income Security Act of 1974 (ERISA), the American economy has embarked on a period of extraordinary change. Technology, which produces untold benefits for society, is evolving at such a rapid pace that it has indirectly contributed to widespread corporate restructuring and downsizing at a time when other countries increasingly compete with the U.S. in the global marketplace.

The end of the Cold War has brought massive defense downsizing.

In today's unsettled environment, U.S. employers are transferring greater responsibility for retirement planning and saving to employees -- but most workers are not preparing adequately for the future. Fewer than half of all workers have access to or are covered by employer-provided pension plans, and worker mobility reduces the value of these benefits for many of them. Few workers are saving enough on their own to ensure secure retirement, and changing demographics threaten the Social Security system.

Over the next few decades, record numbers of people will be retiring as the post World War II generation reaches retirement age. A coherent national retirement income policy is needed to respond to this reality.

American Dream Savings Account

The proposed American Dream Savings (ADS) account could serve as a pillar of a national retirement income policy. Section 4 of H.R. 6, the American Dream Restoration Act would:

* Permit individuals to make taxed contributions of up to $2,000 a year ($4,000 for couples) to new ADS accounts, irrespective of personal income or pension status. Contribution limits would be indexed for inflation beginning in 1997.

* Provide that amounts held in ADS accounts for at least 5 years could be withdrawn (tax and penalty free) to pay for retirement, a first home purchase, post secondary educational expenses and medical expenses, including long-term care.

* Provide that within 2 years of the enactment of the ADS, current IRA participants could cash out their current IRA and pay the tax due (tax liability could be spread over 4 years) on it without having to pay any penalty, provided the money is transferred to an ADS. The rollover could be made without regard to the $2000/$4000 limitation.

It is important for federal, state, and local governments to work toward an environment which would enhance and encourage individual retirement income planning and savings. Individuals have a responsibility to save for their own retirement, and the ADS account would be a positive step in encouraging this action. The ADS account would provide an additional incentive to begin a personal savings account to provide for retirement income for workers who are not able to accumulate retirement benefits. The ADS account is, therefore, an effective expansion of current retirement income choices, and we commend the legislators who developed this proposal.

We strongly recommend, however, that this account should not in any way supersede or replace any existing retirement savings options such as 401(k)s or IRAs. It should act as a supplement to other available means of savings for retirement and as an enhancement to an individual's options for retirement income.

Additionally, while we recognize the options available within the ADS account for purposes such as saving for a first-time home purchase and the payment of higher education costs, we feel it is important to note that if an individual elects to use this account for retirement savings, withdrawals for other purposes should be made cautiously, and the individual should be encouraged to repay his or her own account. This could be accomplished through loans that one would repay to one's own account as is currently allowable under 401(k)s, in order to preserve retirement savings.

Other Elements of a National Retirement Income Policy

The establishment of ADS accounts would be a welcome addition to national retirement income policy. Other changes are necessary, however. AAES recently issued a statement on national retirement income policy to help alert the nation to the dimensions and magnitude of the impending crisis and to contribute to the development of effective solutions. In that statement, AAES calls upon business and industry; federal, state, and local governments; educational and financial institutions; labor organizations; professional and technical societies; and, other voluntary associations and concerned citizens to:

- Promote enactment of legislation to enhance and encourage retirement income planning and saving;
- Create a coherent national retirement income policy to facilitate thorough analysis and effective resolution of related problems; and
- Educate the public about retirement income needs and responsibilities.

Legislative Action

Recognizing the critical role of the federal government as a catalyst for change and a focal point for public debate about retirement income policy issues and the development of legislation needed to strengthen the nation's retirement income delivery system and increase savings needed for productive investments in the national economy, AAES calls upon the President and Congress to:

- **Improve employer-sponsored pension plans** by encouraging employers in the private and public sectors to sponsor and adequately fund pension plans for employees; reduce vesting requirements; guarantee portability of vested benefits when workers change jobs; and promote preservation of pension distributions for use in retirement.
- **Increase individual savings for retirement** by encouraging more employers to provide employees with voluntary retirement savings plans and by increasing opportunities for individuals to contribute to tax-favored retirement savings arrangements, including Individual Retirement Accounts (IRAs), and Keogh plans for the self-employed. As an objective, rules governing IRAs should be modified to: (1) encourage more individuals to participate; and (2) increase the IRA deduction limit and adjust it annually for inflation. **The proposed ADS account would be an effective servant of this objective.**
- **Strengthen the Social Security system** to ensure its continuing solvency and reliability as a source of income for retired workers and their families, for the survivors of deceased workers, and for disabled workers and their families.

National Retirement Income Policy

AAES urges the federal government to make a commitment to the retirement income security of the American people by developing a comprehensive national retirement income policy. The purpose of the policy would be to give high-level focus to this crucial issue. AAES envisions that such a policy would encompass both thorough analysis of these problems and a vigorous, fiscally responsible effort to resolve them.

AAES does not recommend a new government-funded entitlement program. It sees government's role as that of a facilitator -- developing consensus, cooperation, and appropriate incentives that will encourage employers to provide retirement savings opportunities and encourage individuals to save adequately for retirement.

Sustained commitment and leadership are essential if the nation is to meet this challenge. One way of achieving the desired result is to establish a federal commission on retirement income policy to analyze trends in savings, propose incentives to increase savings, assess alternative financing arrangements, evaluate the feasibility of occupational retirement plans, and recommend actions to achieve the needed reforms.

Public Education

We all must act now to assure the future ability of America's workers to remain economically secure in their retirement years. Government cannot do it alone. Meeting this challenge will also require the support of individual workers, their employers, and the voluntary organizations to which they belong.

All individuals must be encouraged to plan and save for retirement. To this end, AAES and its member societies will educate engineers and others about the need to save for retirement and encourage them to make needed financial preparations throughout their working lives.

Employers should be encouraged to provide retirement income savings opportunities for their employees. These options should be flexible and responsive to the changing needs and requirements of increasingly mobile workers. To this end, AAES encourages employers to adopt human resource strategies that will enhance the retirement income security of their workers.

The issue of retirement income policy has crucial long-term ramifications for all Americans. AAES recognizes the importance of cooperative action to avert an impending retirement income crisis. It accords this issue a high priority, and will work to mobilize members in support of appropriate legislative and regulatory actions, and to involve concerned citizens in cooperative efforts to develop a coherent national retirement income policy and strengthen the nation's retirement income delivery system.

In closing, we applaud the commitment of both the President and Congressional leaders to help more individuals and families save for retirement by strengthening incentives to invest. Under the broad-based IRAs contained in H.R.6 and the President's Middle Class Bill of Rights, certain tax advantages would accrue to those Americans who avail themselves of the savings opportunities these proposals provide.

Thank you for the opportunity to present our views to you.

1995

AAES Member Societies

American Academy of Environmental Engineers
American Indian Science & Engineering Society
American Institute of Chemical Engineers
American Institute of Mining, Metallurgical and Petroleum Engineers
American Institute of Plant Engineers
American Nuclear Society
American Society for Engineering Education
American Society of Agricultural Engineers
American Society of Civil Engineers
American Society of Mechanical Engineers
Institute of Electrical & Electronics Engineers
National Institute of Ceramic Engineers
National Society of Professional Engineers
Optical Society of America
Society of Fire Protection Engineers
Society of Hispanic Professional Engineers
Society of Women Engineers

Advisor/Observer

National Academy of Engineering

AAES Associate Societies

Association for International Practical Training
Federation of Materials Societies
INFORMS
National Action Council for Minorities in Engineering
NACE International
National Council of Examiners for Engineering and Surveying
Tau Beta Pi Association
The American Society for Nondestructive Testing, Inc.

AAES Regional Societies

District of Columbia Council of Engineering & Architectural Societies
Engineering Society of Detroit
Washington Society of Engineers

Mr. THOMAS. Thank you very much, Mr. Sawyer.

Does any member of the majority wish to inquire? Any member of the minority?

Mr. JACOBS. Thank you.

Mr. THOMAS. Let me just say briefly that one of the most frustrating things about trying to analyze the IRA in any kind of a real-world situation—I believe, Mr. Mehos, you touched on it—is that frankly it was in effect for so short a time that the effect in the business of trying to educate people about an instrument available to them and then having it taken away, does not give me a comfort level on anyone extrapolating from the time period when we saw it in effect to what could have happened to it and who may have made use of it.

Mr. Yakoboski, you indicated that 90 percent of those eligible don't do so. Do you have any evidence, even anecdotal, about the shortness of the time period, or the fact that people feel that they are a little more gun shy than they would be because of these stop-start offerings that government has made in terms of these kinds of proposals—any reaction at all?

Mr. YAKOBOSKI. I think it is fair to say that when the rules of the game are changed on a fairly regular basis that naturally the average person is confused; and as was raised earlier, maybe one of the reasons for low participation rates among those eligible, to make a tax-deferred contribution is potentially that they are not—they don't know necessarily that they are eligible.

On the other hand, the numbers I cited were those who do not have an employment-based plan and thus for whom an IRA was designed to provide a retirement plan and they are still not taking advantage of it. That ranges across the income spectrum, even among higher income individuals.

Mr. THOMAS. But are they aware that they could take advantage of the plan? Do you have any indication of how many of those who don't—10 percent do, 90 percent don't, but what is the information and the knowledge level among the 90 percent about the opportunity to do so?

Mr. YAKOBOSKI. I really don't have any feel for that.

Mr. THOMAS. That is part of my problem.

Mr. YAKOBOSKI. It is fair to say that in the heyday of IRAs, they were very widely pushed and marketed by the financial institutions.

Mr. THOMAS. The heyday was kind of like a rocket, wasn't it? It went up and came down.

Mr. Mehos.

Mr. MEHOS. I can comment on that a little bit. My bank has branches in many rural areas, as well as metropolitan Houston, and we found that in the rural areas they are much more popular and much more a part of their every-year financial planning, the IRAs. And a lot of that is because the rural communities tend to be an older community and they learned to invest in the early eighties when that window was there. They became creatures of habit in investing in an IRA.

The younger people today, even the ones that qualify in the metropolitan areas, I don't believe are really aware of it. They are aware of it, but they haven't become creatures of habit yet. So we

found that it is infinitely more interesting in the older communities and in the rural communities where the older people are.

Mr. THOMAS. Well, we are going to keep looking for solutions to the savings rate problem, but I think most members believe there is no silver bullet. We also don't want to continue programs that aren't producing a response for the cost of the program. Between those two points, it is frustrating, because you can't just have new plans be additive if the old plans aren't worth their salt in what you hope to produce. We will continue to look at models. We have one in front of us that we believe has promise, and we appreciate your testimony, indicating that you think it does as well.

Thank you very much.

Now I would ask the last panel to come forward—Martin Jaffe, Joel Snyder, and W. Thomas Kelly. Please come forward.

First of all, I want to thank the panel for its patience, and thank you, second, for your willingness to testify before us today. I will tell all of you that, without objection, your written testimony will be made a part of the record and that you have 5 minutes to proceed as you see fit to inform the Ways and Means Committee. And again, I would start on my right and move to my left, Mr. Jaffe, you have 5 minutes.

STATEMENT OF MARTIN JAFFE, CFP, CHIEF OPERATING OFFICER AND MANAGING DIRECTOR, WOOD, STRUTHERS & WINTHROP; AND PRESIDENT, INTERNATIONAL ASSOCIATION FOR FINANCIAL PLANNING, ATLANTA, GA.

Mr. JAFFE. Thank you, Mr. Chairman and members of the committee. I am Martin Jaffe, and I am the president of the International Association for Financial Planning. I am also chief operating officer and managing director of the investment advisory and planning firm of Wood, Struthers & Winthrop, a subsidiary of Donaldson, Lufkin & Jenrette.

The IAFP is the oldest and largest financial planning organization. Our over 12,000 individual and institutional members are dedicated to the concept that objective advice developed through the financial planning process is the foundation for smart, effective decisionmaking.

The financial planning process begins with a clear understanding of the client's goals and culminates with a plan of action to achieve those goals. Our members use this process to help over 1.3 million families achieve their financial goals.

The IAFP believes that public policy should enhance opportunities for Americans to achieve their financial goals through their own initiative and prudence; and tax and economic policies should promote savings, investment, capital formation and a vigorous free enterprise system.

In an IAFP commissioned nationwide survey recently conducted by the Wirthlin Group, nearly 60 percent of adults said they were concerned that they were not saving enough for their retirement. This is up sharply from 43 percent who experienced a similar concern just a few years earlier. And over 80 percent of adults want to retire before the traditional age of 65. This demonstrates our concern that many Americans have not taken the necessary steps to achieve their worthy financial goals.

We find that our clients are more knowledgeable and financially sophisticated than ever before, and they want to provide for their own well-being. Real incentives such as tax-deductible IRAs and the American dream savings account will work.

Also, an increasing number of adult Americans today are in a "triple-squeeze" situation where they are trying to put away money for their children's college, support their elderly parents, while at the same time trying to save for their own retirement. These Americans need additional incentives for these important needs. Also, they must know that any savings incentives will be left intact and not changed every few years. It must be simple and predictable.

This reminds me of the recently passed tax legislation that excludes the interest earned on Series EE savings bonds when the proceeds are used to pay tuition for the taxpayer or his or her children. This exclusion is eliminated in stages when adjusted gross income exceeds $60,000 and completely eliminated when it exceeds $90,000. The problem and the provision that renders this exclusion impotent as an incentive is that an individual has to decide now, at the decision point of buying the EE bonds, what his income level will be 10, 15 and 20 years from now. We just think that Congress needs to keep those kinds of things out of legislation and let people understand what they are doing and the implications of it.

During the last 10 years, the national savings rate has been cut in half. We believe that extended IRAs and the American dream savings account will encourage Americans to save more.

My over 30 years' experience as a financial planner indicates that for a number of wealthy Americans, contributions to IRAs and ADSAs will serve as a substitute for other investments; however, it is also my experience that a far greater number of middle-income Americans will utilize tax-advantaged IRAs and ADS accounts to make new investments of funds that might otherwise be consumed.

Expanded IRAs and the ADS account will help middle-income Americans become homeowners, send their children to college, support themselves in retirement, as well as be a buffer for unexpected health care costs.

For these reasons, we support legislation to create more attractive personal savings vehicles. Expanded tax-advantaged savings options, such as those contained in the American Dream Restoration Act, will greatly encourage our citizens to plan and to provide for their own financial future. We are particularly encouraged by the potential of the ADS account to provide citizens with a significantly better means of obtaining their intermediate as well as their long-term financial goals. In other words, we see a need for the ADS account for intermediate needs and the tax-deductible IRA for retirement needs.

We also support the capital gains reforms proposed in title I, the Job Creation and Wage Enhancement Act, in the Contract With America. We believe that the 50-percent exclusion for long-term gains and inflation of assets will free up many assets currently frozen by the pending capital gains tax where investors who were successful with their prior investments would rather avoid a tax on these mature investments by waiting until their death.

In conclusion, we need to encourage increased savings and promote capital formation and investment in the United States. Enhanced IRAs, the American dream savings account and reduced capital gains tax will contribute significantly toward these goals. We urge Congress to adopt legislation this year encouraging these savings and investment goals.

Thank you.

[The prepared statement and attachments follow:]

Testimony of

Martin Jaffe, CFP
President
International Association for Financial Planning (IAFP)

before the
House Committee on Ways and Means
regarding
Savings and Investment

Tuesday, January 31, 1995
Washington, D.C.

Mr. Chairman and members of the Committee, my name is Martin Jaffe, and I serve as the volunteer President of the International Association for Financial Planning (IAFP). I am also Chief Operating Officer and Managing Director of the investment advisory firm of Wood, Struthers & Winthrop, a division of Donaldson, Lufkin & Jenrette. Thank you for the opportunity to testify on savings and investment issues.

IAFP is the oldest and largest financial planning organization in the nation. We are dedicated to the idea that objective advice supports smart financial decisions. IAFP represents more than 12,000 individuals and institutions that believe the financial planning process is the foundation for effective decision-making. The financial planning process begins with a clear understanding of the client's goals and ends with a plan of action to achieve those goals. Our members use this process to help over 1.3 million clients achieve a variety of financial goals, which normally includes long-term savings plans.

As a new member of the Executive Committee of the Savings Coalition of America, IAFP has reiterated our commitment to supporting incentives to increase personal savings in the United States. IAFP believes that:

- public policy should enhance opportunities for Americans to meet their financial needs through their own initiative and prudence; and
- tax and economic policy should promote savings, investment, capital formation and a vigorous free enterprise system.

INDIVIDUAL RETIREMENT ACCOUNTS AND THE AMERICAN DREAM SAVINGS ACCOUNT

The need for Americans to significantly increase their savings was demonstrated dramatically late last year when IAFP commissioned The Wirthlin Group to conduct a nationwide consumer survey. Survey results indicated that:

- nearly 60 percent of adults are concerned that they have not provided sufficiently for their retirement (up sharply from the 43 percent who expressed a similar concern just five years earlier); and
- over 80 percent of adults want to retire before the traditional retirement age of 65.

These results indicate that many people have worthy financial goals but frequently have not taken the necessary steps to achieve them.

A secure retirement may be the ultimate long-range financial planning goal for most of us. But many other important financial needs surface throughout our lives. As financial planners, we believe that it is important that American taxpayers be empowered to take control of their long-term financial futures.

We find our clients to be more knowledgeable and more sophisticated than ever before. However, the current system does not provide adequate incentives for them to save and invest. Real incentives, such as tax deductible Individual Retirement Accounts (IRAs) and the American Dream Savings Account (ADS), will work.

In another survey commissioned by the IAFP several years ago, we found that many American families were faced with the dilemma of saving for their retirement, putting money away for their children's college education, and insuring adequate resources to care for their elderly parents. This "triple squeeze generation" needs additional incentives to save for these important needs. Furthermore, to provide greater certainty in planning to meet these financial goals, Americans need to know that savings incentives in the tax law will be left intact and not changed every few years.

In the last 15 years the average net national savings rate has been cut in half from 4.7 percent during the 1980s to 2.4 percent during the 1990s. Personal savings rates also declined significantly during the past 15 years from an average of 7.8 percent of personal income during the 1970s to only 4.5 percent in the 1990s.[1] It is imperative that Americans be encouraged to save more for their own personal retirement and to meet other personal goals, such as first home ownership, education of their children, and major health emergencies. Expanded IRAs and the ADS Account, in our judgment, will help encourage Americans to take the initiative to save for these significant events.

We are not suggesting that expanded IRAs will result in an immediate increase in the U.S. personal savings rate; however, it is a significant initiative to encourage individuals to increase their savings. I recognize that, based on my experience in the financial planning profession, for a few wealthier individuals, contributions to IRAs may serve as a substitution for other investments. It is also my experience, however, that a substantial number of middle income Americans will utilize tax-advantaged IRAs and the ADS Account to make new investments of funds that otherwise would be used for consumption.

The IRA program during the 1980s was very popular, particularly for middle income individuals. Once IRAs were restricted and the tax deductible features for most workers eliminated, many of these middle income individuals discontinued contributions for their personal savings. While some people attack IRAs as not contributing to new savings, the tax-advantaged IRA was in existence for such a short period of time that it is not possible to make reasonable judgments about their impact for the long term. It is our experience that tax-advantaged IRAs for everyone did change the savings habits of Americans and resulted in new savings.

We are also finding that company pension plans and social security benefits often are not enough to fund retirement needs. Furthermore, today many people find that their employers are having to cut back on their pension plan benefits and, in some cases, are forced to eliminate benefit plans.

The unprecedented uncertainty over the future now being experienced by middle income Americans is causing families to have concerns about their standard of living in their retirement years as well as an improved standard of living for their children and grandchildren. Expanded IRAs and the ADS Account can help middle income Americans become homeowners, send their children to college, support their aging parents, and support themselves in retirement as well as be a buffer for unexpected health care costs.

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[1] The Effectiveness of Savings Incentives: A Review of the Evidence by Dr. R. Glenn Hubbard and Dr. Jonathan Skinner, January 19, 1995, p. 1. A report publicly released on January 23, 1995 by the Securities Industry Association.

For these reasons, IAFP supports legislation to create more attractive personal savings vehicles. Expanded tax-advantaged savings options, such as those contained in the *American Dream Restoration Act, H.R. 6,* will greatly encourage our citizens to plan and to provide for their own financial futures. We are particularly encouraged by the potential of the ADS Account to provide citizens with a significantly better means of attaining their intermediate and long-term financial goals.

We also support enhancing traditional IRAs to provide incentives for Americans to save for their retirement. In this regard, we believe Congress should restore the up-front tax deduction on IRAs for all working Americans and increase the contribution limits for non-working spouses.

Attached as Exhibit 1 is a chart showing the benefits of a tax-advantaged IRA versus a non-IRA taxable investment over 30 years in five-year increments. The positive benefits of the IRA to provide increased income for retirement purposes is clear.

Exhibit 2 shows how a one-time $4,000 tax deductible IRA investment provides increased income versus a taxable investment.

CAPITAL GAINS TAX REDUCTIONS

IAFP also supports the capital gains reforms proposed in *Title I of H.R. 9, The Job Creation and Wage Enhancement Act,* part of the Contract with America. A 50 percent exclusion for long term gains and inflation indexing of assets would encourage capital formation, economic growth, job creation, and improved international competitiveness. It is important that capital be available to business, particularly venture capital for small businesses, for start-up and expansion purposes. Often, necessary capital for start-up companies and small businesses is available only at unreasonable terms or prohibitively high interest rates, if it is available at all. Many IAFP members serve clients who are small business owners who need access to affordable capital.

Capital gains tax reduction would benefit a broad spectrum of Americans. Lower capital gains taxes will help keep down the cost of capital and will free up money from "frozen assets" making it available for other investments, including providing the capital necessary for start-up companies and small businesses as referenced above. For example, many of my clients have chosen to hold onto securities and houses rather than suffer the consequences of a high capital gains tax. My experience is not unique; many of my colleagues could relate similar experiences.

CONCLUSION

We need to encourage increased savings and promote capital formation and investment in the United States. Enhanced IRAs, the American Dream Savings Account, and reduced capital gains taxes will contribute significantly toward these goals. We urge Congress to adopt legislation encouraging these savings and investment goals this year.

EXHIBIT 1

IRA vs. Non IRA Investment

	Original Investment 1/1/95	Value 1/1/00	Value 1/1/05	Value 1/1/10	Value 1/1/15	Value 1/1/20	Value 1/1/25
IRA Account							
Pre -Tax (1)	$4,000	$25,344	$62,582	$117,297	$197,692	$315,818	$489,383
Post - Tax (2)	$4,000	$17,741	$43,807	$82,108	$138,384	$221,072	$342,568
Taxable Investment (3)	$2,800	$16,535	$38,249	$73,848	$120,597	$181,985	$262,599

(1) Shows a $4,000 tax - deductible investment each year earning 8% per year.
(2) Shows the withdrawal value of the IRA account, assuming 30% tax rate, and no early withdrawal penalties.
(3) Shows the value of $4,000 in income which is set aside yearly in a taxable investmen account.

EXHIBIT 2

IRA vs. Non IRA Investment

	Original Investment 1/1/95	Value 1/1/00	Value 1/1/05	Value 1/1/10	Value 1/1/15	Value 1/1/20	Value 1/1/25
IRA Account							
Pre - Tax(1)	$4,000	$5,677	$8,636	$12,669	$18,644	$27,394	$40,251
Post -Tax(2)	$4,000	$4,114	$6,045	$8,882	$13,051	$19,176	$28,175
Taxable Investment(3)	$2,800	$3,677	$4,828	$6,340	$8,326	$10,933	$14,357

(1) Shows a one time $4,000 tax deductible investment earning 8% per year.
(2) Shows the withdrawal value of the IRA account, assuming a 30% tax rate, and no early withdrawal penalties.
(3) Shows the value of $4,000 in income, which is set aside in a taxable investment account.

Mr. THOMAS. Thank you very much, Mr. Jaffe.
Mr. Snyder.

STATEMENT OF JOEL B. SNYDER, VICE PRESIDENT FOR PROFESSIONAL ACTIVITIES, AND CHAIRMAN, U.S. ACTIVITIES BOARD, INSTITUTE OF ELECTRICAL AND ELECTRONICS ENGINEERS, INC., WASHINGTON, D.C.

Mr. SNYDER. Good afternoon, Mr. Chairman and members of the committee. I am Joel Snyder. I am a licensed professional engineer and a senior industry professor at the Polytechnic University in Brooklyn. I am also the owner of a small engineering consulting firm in Plainview, N.Y. I serve as the vice president for professional activities of the Institute of Electrical and Electronics Engineers, Inc. and am chairman of the IEEE–U.S. Activities Board.

With me today is George McClure of Orlando, Fla. Mr. McClure is an engineer, recently retired from a major aerospace firm and chairman of the IEEE–USA's Career Policy Council. We are pleased to appear before the committee to present IEEE–USA's views on the savings incentive provisions in section 4 of the American Dream Restoration Act, H.R. 6.

The IEEE is a transnational professional society and its U.S. Activities Board promotes a technology policy and professional interests of our 240,000 U.S. members. I will present a summary of our written statement that has been submitted for the record.

IEEE members and other engineering, scientific and technical professionals are very encouraged by the growing national consensus that many of the country's most important long-term economic problems are directly related to declining rates of investment and personal savings in the United States. Our primary concern is a decline of domestic investments in recent years.

Personal savings has also declined precipitously. Changes in tax policy are urgently needed to boost savings and investment. IEEE–USA calls for adoption of tax policies that will encourage businesses to take a longer term view of return on investments. We also support an improvement and expansion of tax incentives that will increase personal savings for productive investment in the Nation's economy.

Tax-deductible IRAs have long been one of the most effective of these incentives, especially for working Americans without employer-sponsored pensions. Personal savings are critically important, not only for economic growth and job creation, but to provide greater financial security for American workers and their families. Effective incentives to save are absolutely essential if our economy is to continue to grow and middle-income workers and their families are to be able to realize the American dream.

As we understand it, H.R. 6 will permit individuals to make nondeductible posttax contributions regardless of their income, pension or income tax status. In addition, moneys held for at least 5 years can be withdrawn without tax or penalties, provided they are used to help pay for retirement, first-home, postsecondary education expenses or major medical costs.

Other than providing easier access and greater flexibility in the use of account balances, proposed ADSAs offer few, if any, advantages over other nondeductible posttax savings incentives. Because

of their proven effectiveness as a stimulus to increased personal savings, IEEE–USA strongly supports the expansion of opportunities for average Americans to make tax-deductible contributions to individual retirement accounts, irrespective of their income, and irrespective of their pension participation or tax filing status. By providing immediate tax relief, tax deductibility offers a much greater incentive for individuals to save than nondeductible vehicles.

IEEE–USA is convinced that an expanded, frontloaded IRA will stimulate much more in new savings than the proposed backloaded ADSA. The needed incentive to increase personal savings can best be provided by eliminating current income ceilings and eligibility to make tax-deductible IRA contributions.

With downsizing by big businesses and outsourcing of work to small businesses and independent contractors, more and more workers will have to provide for their own retirement without the benefit of traditional employer-sponsored pension plans. Financial planners seem to agree that at least 70 percent of income is needed for retirement. IRA contribution limits must therefore be increased and increased substantially. We recommend that contribution limits of $5,000 for individuals and $10,000 for couples be established, at least for taxpayers who are not eligible to participate in employer-sponsored pension plans.

IEEE–USA also recommends that Congress substitute a low-interest loan provision for the penalty-free withdrawal option.

By linking easier access to repayment obligation, a loan provision will permit contributors to use their savings for purposes other than retirement while providing additional incentives for long-term savings retention rather than consumption.

An improved IRA will increase savings and will hold savings for a longer term because there would be no tax-free withdrawals. The new improved IRA will also generate more tax revenue when cashed out than the nondeductible ADSA.

We have prepared an example that demonstrates the advantages of a deductible IRA. With loan provisions, instead of penalty-free withdrawal it will result in increased savings, increased tax revenues, and greater preservation of assets for retirement.

I thank you.

[The prepared statement and attachment follow:]

TESTIMONY OF JOEL B. SNYDER
INSTITUTE OF ELECTRICAL AND ELECTRONICS ENGINEERS, INC.

Good Morning, Mr. Chairman and Members of the Committee. I am Joel Snyder. I am a Licensed Professional Engineer and a Senior Industry Professor at the Polytechnic University in Brooklyn. I am also the owner of a small engineering consulting business in Plainview, New York. I am the Vice President for Professional Activities of the Institute of Electrical and Electronics Engineers, Inc. and Chairman of IEEE's United States Activities Board.

With me today is George McClure of Orlando, Florida. Mr. McClure is an engineer, recently retired from a major aerospace firm, and Chairman of IEEE-USA's Career Policy Council. He also serves on IEEE's Individual Member Benefits and Services Committee as well as IEEE-USA's Engineering Employment Benefits Committee.

We are pleased to appear before the Committee to present IEEE-USA's views on the savings incentives provisions in Section 4 of the American Dream Restoration Act (H.R. 6).

IEEE-USA'S INTEREST IN SAVINGS INCENTIVES

The Institute of Electrical and Electronics Engineers, Inc. (IEEE) is a transnational professional society whose 320,000 members live and work in more than 130 countries throughout the world. IEEE's United States Activities Board promotes the technology policy and professional careers interests of IEEE's 240,000 U.S. members.

IEEE members, and other engineering, scientific and technical professionals, are very encouraged by the growing national consensus that many of the country's most important long term economic problems are directly related to declining rates of domestic investment and personal savings in the United States. We are hopeful that actions by the new 104th Congress will help to reverse these alarming trends.

Of primary concern is the decline in domestic investment in the United States. Recent statistics indicate that net private domestic investment, which averaged 7.4 percent of gross domestic product (GDP) between 1960 and 1980, has dropped from 5.5 percent of GDP in the early 1980's to 3 percent since 1991 - an alarming 59 percent reduction!

Personal savings has also declined precipitously. The personal savings rate has dropped from 5.6 percent of GDP between 1981 and 1985 to 3.4 percent today - a 40 percent reduction in the last 10 years! We are currently saving half as much as Germans and only 25 percent as much as the Japanese. If these trends continue, economists predict that there won't be enough savings to sustain a sufficient level of investment into the next century.

Changes in tax policy are urgently needed to boost personal savings and stimulate private domestic investment. We're very pleased that the Ways and Means Committee is devoting so much time to these critically important problems during the first 100 days of the 104th Congress.

IEEE-USA's current Federal Legislative Agenda calls for adoption of tax policies that will encourage businesses to take a longer-term view of return on investment and help to boost domestic investment in research and development. We also support the improvement and expansion of tax incentives that will increase personal savings for productive investment in the nation's economy. Tax-deductible IRAs have long been one of the most effective of these incentives, especially for working Americans without employer-sponsored pensions.

Personal savings are critically important, not only for economic growth and jobs creation, but to provide greater financial security for American workers and their families. Economic globalization, increasing foreign and domestic competition, and the end of the Cold War have been accompanied by wave after wave of downsizings by major corporations. Outsourcing of manufacturing, service and administrative jobs to part time, temporary and other kinds of contingent workers are changing the nature of employer-employee relationships throughout the economy. Real wages for most middle income Americans, including many engineers and scientists, continue to decline at the same time that housing, education, medical care and other basic necessities are becoming more and more expensive. All of these trends are making it harder and harder to save for retirement and other important purposes.

Personal savings and effective incentives to save are absolutely essential if the economy is to continue to grow and middle income workers and their families are to be able to realize the American Dream.

AMERICAN DREAM RESTORATION ACT PROVISIONS

As we understand it, the American Dream Restoration Act (H.R. 6) will permit individuals, including non-working spouses, to make non-deductible (post-tax) contributions of up to $2,000 ($4,000 for couples) to new IRA-like American Dream Savings Accounts (ADSAs), regardless of their income, pension or income tax filing status. In addition, monies held for at least five years can be withdrawn without tax or penalties provided they are used to help pay for retirement, a first home, post-secondary educational expenses or major medical costs, including long term care.

Other than providing for easier access to and greater flexibility in the uses that can be made of account balances, the proposed ADSAs offer few, if any, advantages over other non-deductible (post-tax) savings incentives that are currently available to taxpayers.

IEEE-USA COMMENTS AND RECOMMENDATIONS

1. Make Contributions Tax Deductible

Because of their proven effectiveness as a stimulus to increased personal savings by individuals and the accumulation of capital needed for productive investment in the nation's economy, IEEE-USA strongly supports the expansion of opportunities for individual Americans to make tax-deductible contributions to Individual Retirement Accounts, irrespective of their income, pension participation or tax-filing status.

Much more savings will result if all contributions, within certain stipulated dollar limits, are made tax-deductible. Such a change will also provide a positive incentive that will encourage more taxpayers to become savers.

In 1981, for example, 3.4 million taxpayers put $4.8 billion into IRAs. In 1982, after eligibility requirements were liberalized, the number of IRA contributors jumped to 12 million and their savings to $28.3 billion. In 1986, 16.2 million taxpayers made $38.2 billion in IRA contributions. When stricter eligibility requirements were re-established in 1987, the number of contributors dropped to 7.3 million. Contributions fell to $14.1 billion - a 63 percent decline in a single year!

By providing immediate tax relief, tax-deductibility offers a much greater incentive for individuals to save than non-deductible vehicles can ever do. Based on the experience of our own members, IEEE-USA is convinced that an expanded "front-loaded" IRA will stimulate much more in new savings than the proposed "back-loaded" ADSA.

2. Remove Income Eligibility Ceilings

The needed incentive to increase personal savings can best be provided by eliminating current income ceilings on eligibility to make tax-deductible contributions to Individual Retirement Accounts.

3. Expand Allowable Contribution Limits

With downsizing by big businesses and outsourcing of work to small businesses and independent contractors, more and more workers are faced with the challenge of having to provide for their own retirement without the benefit of traditional employer-sponsored pension plans. According to financial planners, IRA assets and Social Security should be capable of replacing up to 70 percent of pre-retirement income. To accomplish this objective, IRA contribution limits must be increased - and increased substantially.

Just to compensate for the adverse affects of inflation on their purchasing power since they were first established in 1981, the current $2,000 contribution limits should be boosted to $3300.

We recommend that contribution limits of $5,000 for individuals (and $10,000 for couples) be established - at least for taxpayers who are not eligible to participate in employer-sponsored pension plans or other voluntary, salary reduction savings arrangements where thay work.

4. Substitute Loan Provisions for Penalty-Free Withdrawals

In order to prevent the American Dream from becoming a nightmare as more and more middle income savers approach retirement, IEEE-USA also recommends that Congress substitute a low-interest loan provision for the penalty-free withdrawal option featured in current IRA reform proposals, and the American Dream Restoration Act.

By linking easier access to a repayment obligation, a loan provision will permit contributors to use their savings for purposes other than retirement while providing an additional incentive for long term savings retention rather than consumption.

SUMMARY AND CONCLUSIONS

Compared with the after-tax and penalty-free withdrawal features in the proposed American Dream Savings Account, an improved Individual Retirement Account, with tax-deductible contributions and fully taxable proceeds, including the interest earned on account balances, will provide a very powerful incentive for individuals to increase their personal savings. Such an incentive will also generate considerably more tax revenue when the accounts are eventually cashed out.

The simple example that we have prepared for inclusion in the hearings record demonstrates that an expanded, tax-deductible IRA will generate considerably more in the way of benefits for savers as well as tax revenue for the Treasury than the non-deductible ADSA proposed in the American Dream Restoration Act.

- End -

IEEE-USA
DEDUCTIBLE VS NON-DEDUCTIBLE SAVINGS INCENTIVES
January 31, 1995

Attachment A

The following example is intended to demonstrate the advantages of front-ended (tax-deductible) savings incentives over the back-loaded (non-deductible) option proposed in the American Dream Restoration Act.

Tom, a 25 year old (in the 28% tax bracket) wants to save for a down payment on a house. Assuming 3-4% inflation per year, the average price for a new home will be $120,000 in 1999. A 10% downpayment will require $12,000. If Tom starts saving $2,000 a year in 1995 in a non-deductible account that pays 10%, he will accumulate $12,210 in the account by 1999. Although he will have paid $2800 in taxes on the $10,000 as it was deposited in the account, $2210 in interest earnings will escape taxation when the account is withdrawn for the home purchase.

Tom's 25 year old brother Bob elects to save $2,000 a year on a tax-deductible (pre-tax) basis. In seven years, he will accumulate $18,974 in a 10% interest bearing account. When he withdraws the money, he will pay $5312 in taxes (at 28%), leaving $13,667 to apply toward his first home purchase.

After buying his first home at age 32 and having become used to saving $2,000 a year on a tax-deductible basis, Bob starts saving for his children's college education. If he saves $2,000 a year in an account that pays 10%, his college fund will grow to $49,000 in 13 years. If he takes the money out, he will pay $13,730 in taxes (at 28%) and have $35,310 left to help pay
for college educations.

Bob's brother Tom, who bought his house at age 30, also saves for college, but over a 15 year period via after-tax contributions to his back-ended account. Tom's college account will grow to $63,500. He will have paid $8,400 in taxes on the $30,000 he deposited in the account, leaving the $33,500 in interest earnings to escape taxation.

The total tax liability for these two cases (assuming a 28% income tax bracket) can be summarized as follows:

Examples	Post Tax Case (Back-Loaded)	Pre-Tax Case (Front-Loaded) Account)
5 years; first home	$2,800	
7 years; first home		$5,312
15 years; college	$8,400	
13 years; college		$13,730
Total Tax Receipts	$11,200	$19,042

In the tax deductible (front-loaded) option, the tax liability can be deferred further by borrowing the money from the account, at a low rate of interest, rather than withdrawing the money. Interest payments on the loan will further increase the size of the account and therefore the amount of the tax ultimately paid.

The goal is to provide appropriate incentives to savers to:

1) Increase his/her savings rate with the help of tax deferral on the contributed amount,

2) Encourage replacement of funds borrowed from the account for other important purposes before retirement, thereby helping to ensure that the funds will be there when needed for retirement,

3) And, coincidentally, increase the total amount of tax revenue ultimately paid on the proceeds of this account, normally when it is cashed in at retirement following the procedures now used for IRAs.

Mr. THOMAS. Mr. Kelly.

STATEMENT OF W. THOMAS KELLY, PRESIDENT, SAVERS & INVESTORS LEAGUE

Mr. KELLY. Thank you, Mr. Chairman. I am Thomas Kelly, the president of the Savers & Investors League. I thank you for inviting me to comment on those provisions of the Contract With America that are designed to encourage savings and investment.

The league's views may be summarized by three important points:

First, we support the Contract's American dream savings provision. It is certainly a move in the right direction. However, in our view, these provisions do not go far enough. Legislation should be adopted promptly to fully remove the ordinary income tax bias against savings. This cancerous tax bias is constant and progressive. It is a drain on the fiscal soundness of our government and on the economic growth of our Nation.

This tax bias must be removed totally. This total removal is accomplished by first allowing unlimited tax deductions and tax deferral of IRA-type saving.

Second, income taxes should be imposed only on any planned withdrawal at then-existing progressive income tax rates like wages.

And third, there should be no penalty taxes nor forced distributions at any time.

These three simple basic criteria are embodied in the bipartisan Individual Investment Account Act, H.R. 328, as sponsored by Mr. McCrery of this committee, and by S. 159 as sponsored by Senator Breaux of the Finance Committee.

Our second important point is that no consideration of how to improve our Nation's rate of saving can ignore the staff procedures for measuring alleged tax expenditure costs of IRAs. These staff procedures are so flawed that the committee's tax policy considerations are seriously compromised.

Even the Treasury Department's 1995 budget document for the first time ever disclosed that tax expenditure figures for IRAs were overstated by over three times when measured on a more rational, realistic basis. And even these severely reduced costs continued to reflect the self-defeating, second layer of tax on saving that should not be imposed upon our government, on our taxpayers, or on our Nation.

Much debate arises over static versus dynamic scoring of the alleged costs of IRA-type plans. Static scoring stands logic and sound tax policy on its head.

For example, it assumes that IRA tax deductions are an expense rather than creating a government asset. The dynamic scoring of IRAs is fiscally sound and entirely appropriate.

The dynamic scoring of H.R. 328 by well-respected economists shows that tax receipts grow quickly and become progressively larger each year over those otherwise collected under the ordinary income tax on saving. These increasing tax receipts reflect a growth in saving, in production, in GDP, and in jobs, and a resulting reduction in the cost of capital brought about by unlimited tax-deductible saving. And because of the gains arising from increased

capital flow in very large measure to labor, it is estimated that unlimited tax-deductible investment accounts will increase middle-income taxpayers' aftertax income by 12 to 23 percent within 6 or 7 years following enactment.

Our third important point is to recognize that unlimited, tax-deductible IRA-type plans are not tax loopholes for the rich. The full removal of the tax bias against savings not only restores the taxation of saving to one of proper neutrality in terms of saving versus consumption; it is also neutral in regard to the taxation of realized capital gain versus the taxation of dividend and interest income.

Unlimited, tax-deductible, tax-deferred saving is not a favoring of savers in any tax bracket. It is one of restoring fiscally sound tax neutrality to all tax brackets.

In summary, a removal of only a portion of the tax bias against saving, as found in the Contract's American dream savings legislation, is only a partial correction of the tax bias against saving when a full correction, as found in H.R. 328, is both imperative and sound. The unlimited, tax-deductible individual investment accounts of H.R. 328 are tax revenue gainers, not losers. Thus, there is no reason, other than an irrational, existing, static scoring dogma, to deny our Nation, including all taxpayers and our government, the singular advantages that will flow from this sound legislation.

The league urges the committee to thoroughly explore the economic growth and the rational tax revenue implications of H.R. 328.

I will be pleased to respond to any questions. Thank you.

[The prepared statement and attachments follow:]

WRITTEN TESTIMONY OF
W. THOMAS KELLY
PRESIDENT, SAVERS & INVESTORS LEAGUE
ON JANUARY 31, 1995
BEFORE THE WAYS & MEANS COMMITTEE
ON SAVINGS AND INVESTMENTS

Mr. Chairman, and members of the Committee. I thank you for your invitation to testify on the Contract With America provisions that are designed to encourage greater saving and investing. We support these goals. However, it is our strong view that the Contract does not go far enough to properly correct the existing, extremely serious tax bias against saving.

Others on this panel, as well as many other panels in many other Congresses, have made proper, impassioned pleas for Congress to restore and expand tax-deductible IRAs, as well as to reduce the negative impact of the capital gains tax on saving and investing. Basically, these pleas have been shunted aside by Congress for two erroneous reasons: (1) the allegation that they cost too much in lost tax revenue; and (2) they're perceived by some as tax loopholes for the rich.

In the League's judgment, both of these arguments are totally specious. These arguments are contrary to the government's own fiscal interests, as well as being contrary to the taxpayer's, and our nation's, financial well-being. Further, removing the income tax bias *against* saving does *not* mean that such removal is biased *for* saving. The resulting taxation becomes "neutral."

It is important to state at the outset that all economists agree that the ordinary income tax is biased against saving. The question is—how much bias? Is this bias harmful? To help understand this bias and its magnitude, Table 1 utilizes two tax brackets to better illustrate the impact of the ordinary income tax on saving, and how this cancerous tax eats away at the government's tax revenue. An actual mutual fund was used for this factual illustration.

The Impact of Income Tax Bias On Tax Revenues

- In Table 1, two taxpayers' $100 of income (wage) were taxed at 15% or 50%, respectively. The after-tax balance ($85 and $50) was invested in the mutual fund. Each end-of-year fund distribution was taxed to the taxpayer as shown, with the balance reinvested. This investment was maintained from 1926 to 1992, for a sixty-seven year duration. The investment and tax impact during similar durations in the future will not reflect a significant difference from those portrayed herein. Thus, the past is prologue.

Table 1

Ordinary Income Tax Revenues Derived From
$100 OF PRE-TAX INCOME
That's Saved And Invested In A Typical Mutual Fund On January 1, 1926
And Maintained For 67 Years Until Sold On 12/31/92

Year	Duration	Tax Revenues From Taxpayers In The 15% Tax Bracket (a)	Tax Revenues From Taxpayers In The 50% Tax Bracket (b)	Govt.'s Revenue Gain Or (Loss) From Taxpayer In Higher Tax Bracket (c = b - a)	Year	Duration	Tax Revenues From Taxpayers In The 15% Tax Bracket (a)	Tax Revenues From Taxpayers In The 50% Tax Bracket (b)	Govt.'s Revenue Gain Or (Loss) From Taxpayer In Higher Tax Bracket (c = b - a)
1926*	1	$15.90	$51.77	$35.87	1961	36	39.87	33.36	(6.52)
1927	2	.77	1.47	.70	1962	37	34.11	27.82	(6.29)
1928	3	.98	1.86	.88	1963	38	40.32	32.09	(8.23)
1929	4	1.22	2.28	1.06	1964	39	39.67	30.80	(8.87)
1930	5	1.25	2.32	1.07	1965	40	44.46	33.78	(10.68)
1931	6	1.30	2.37	1.07	1966	41	45.19	33.63	(11.57)
1932	7	1.14	2.03	.89	1967	42	73.44	53.51	(19.93)
1933	8	.81	1.41	.61	1968	43	70.98	50.31	(20.67)
1934	9	.79	1.36	.58	1969	44	67.51	46.74	(20.77)
1935	10	.80	1.38	.58	1970	45	46.09	31.14	(14.95)
1936	11	11.34	19.37	8.03	1971	46	62.68	41.61	(21.07)
1937	12	2.69	4.31	1.62	1972	47	74.23	48.29	(25.95)
1938	13	4.26	6.68	2.42	1973	48	54.43	34.69	(19.75)
1939	14	2.02	3.08	1.05	1974	49	37.19	23.26	(13.94)
1940	15	2.01	3.01	1.00	1975	50	42.71	26.24	(16.46)
1941	16	2.26	3.34	1.08	1976	51	55.02	33.31	(21.71)
1942	17	2.31	3.35	1.04	1977	52	62.72	37.39	(25.33)
1943	18	2.18	3.11	.93	1978	53	74.29	43.50	(30.79)
1944	19	5.68	7.99	2.32	1979	54	96.20	55.26	(40.94)
1945	20	11.56	15.88	4.31	1980	55	99.28	55.94	(43.33)
1946	21	15.51	20.48	4.97	1981	56	179.88	99.75	(80.13)
1947	22	5.68	7.09	1.41	1982	57	130.99	70.49	(60.50)
1948	23	5.50	6.72	1.23	1983	58	207.13	109.31	(97.82)
1949	24	11.02	13.23	2.21	1984	59	325.49	167.33	(158.16)
1950	25	9.94	11.57	1.63	1985	60	278.81	137.48	(141.34)
1951	26	20.22	22.98	2.77	1986	61	465.32	223.27	(242.05)
1952	27	23.29	25.46	2.17	1987	62	415.83	191.39	(224.44)
1953	28	11.97	12.56	.59	1988	63	465.41	206.82	(258.60)
1954	29	20.65	21.22	.57	1989	64	567.02	243.00	(324.01)
1955	30	33.11	33.10	0.00	1990	65	612.82	253.88	(358.94)
1956	31	41.79	40.22	(1.57)	1991	66	590.02	235.40	(354.61)
1957	32	23.43	21.54	(1.88)	1992#	67	2,885.25	1,443.79	(1,441.46)
1958	33	19.42	17.35	(2.07)					
1959	34	32.14	28.23	(3.91)					
1960	35	26.91	23.01	(3.90)					

* Includes the 1926 tax on income

\# Includes the 1992 tax on realized gain when the fund is sold

- Note that the long string of government tax collections from saving would never have occurred if the taxpayers had consumed (spent) their $85 or $50 net-after-tax income. It is this second tier of year after year taxation that produces the income tax bias against saving.

- Obviously, the taxes collected each year bounced around from year to year. This reflects the investment climate of the times, as the U.S. went through good times and bad times, including the worst depression and World War II.

- Note that as time went on, the expected larger tax revenues each year from the high bracket taxpayer vs. the low bracket taxpayer gradually narrowed. This narrowing spread of tax revenues from the higher and lower tax bracket taxpayers continued until the 30th year. *From that point forward, the government increasingly collected more tax revenue from the 15% bracket taxpayer then from the 50% bracket taxpayer!*

  These tax revenue losses from the high bracket taxpayer vs. the low bracket taxpayer continued to grow progressively from year to year, and culminated in an even larger loss when each taxpayer sold their fund in the 67th year, and the investment's unrealized gain was realized and taxed.

Valid Conclusions To Be Drawn From Table 1

- The income tax bias against saving is shocking. The longer you save, the worse it becomes, and the government's tax base related to saving gets smaller.

- There is no escape. Selling one investment to buy another usually triggers more tax. Thus, the government's tax base is reduced from that point forward, forever. And, the ever-diminishing tax base, over what it would be otherwise, is effectively passed on from one taxpayer to another as savings and investments are transferred.

- Don't be misled by the fact that when taxes are paid, the related savings or investment may or may not be liquidated to pay the tax. The source of funds to pay the tax may come from elsewhere. Regardless, the capital that's otherwise available for future taxation is reduced by the amount of the tax.

- By increasing tax rates on saving to escape this tax receipts dilemma, the government wipes out its tax base faster, thereby eventually collecting less and less tax revenue.

- This tax bias against saving occurs regardless of whether the return on saving is interest, dividends, or realized capital gain.

- Is it any wonder that our taxpayers and our government increasingly feel that they're on a fiscal treadmill that's always accelerating without forward progress? They are! Raising income tax rates on saving only makes the treadmill move faster, and the problem gradually gets worse.

- Taxpayers may come and go, but their year-by-year losses of capital due to the income tax on saving can never be replaced. Thus, the government's tax base related to saving perpetually shrinks from what it would otherwise be if this pernicious and needless tax bias were not present. Is it any wonder that governments gradually fail due to fiscal exhaustion? Ratcheting up taxes on saving only hastens the demise. *Think about it.*

If the facts in Table 1 don't make your hair stand on end, what happens to taxpayers' saving under the ordinary income tax will make your hair curl. See below.

The Impact of the Income Tax Bias On Saving

Having observed how taxes gradually gnawed away at the government's tax base over the past sixty-seven years, let's look at how each taxpayer's investment fared under the ordinary income tax over the same period of time.

Table 2

Taxpayers' After-Tax Mutual Fund Values On 12/31/92

15% Taxpayer	50% Taxpayer
$49,052	$4,598

In order to evaluate the impact of the income tax that created these after-tax values, it is proper to measure the value of each taxpayer's $100 of pre-tax income if it could have been invested in the mutual fund *without any tax*. This value then becomes a proper benchmark value against which the impact of any tax methodology may be measured.

Table 3

Benchmark Values

Each Taxpayer's Mutual Fund Values On 12/31/92 From $100 Investment Without Tax	$120,649

When one measures the taxpayers' after-tax values in Table 2 vs. the Benchmark Values of Table 3, each taxpayer's values are the following percentage of Benchmark Values (Table 2 ÷ Table 3):

Table 4

After-Tax Values As A % Of Benchmark Values

15% Taxpayer	50% Taxpayer
41%	4%

In short, the 15% taxpayer lost 59% of his benchmark values due to the ordinary income tax. That's four times his tax bracket! The 50% taxpayer lost 96% of his benchmark values! Such tax bias against saving amounts to outrageous, idiotic confiscation worthy of tax revolt! *It must be stopped immediately!* The tax grievances leading to the Boston Tea Party pale in comparison.

Clearly, the ordinary income tax is grossly biased against saving. If these taxpayers hadn't saved, their after-tax spending would have been 85% and 50% of their before-tax income, respectively, not 41% and 4% of their unbiased, benchmark values. Not only are taxpayers grievously abused by this income tax on saving, as shown above, the government's own tax base is needlessly and scandalously whittled away by the ordinary income tax, as shown in Table 1.

Tax-Deductible IRA-Type Plans

Now, let us measure the tax treatment of tax-deductible IRA-type plans.

Table 5

$100 Of Pre-Tax Income
That Is Deducted As An IRA Contribution
And Invested In A Mutual Fund On January 1, 1926

	15% Taxpayer		50% Taxpayer	
	$	%	$	%
Mutual Fund IRA Values On 1/1/26	$120,64 *	100%	$120,649 *	100%
Tax Upon 12/31/92 Withdrawal	$18,097	15% (a)	$60,324	50% (a)
Taxpayers' After-Tax Values	$102,552	85% (b)	$60,325	50% (b)

* Equals the Benchmark Values in Table 3

From the above you will note that—

- *Each* dollar saved and deducted by each taxpayer on 1/1/26 grew, without tax, to $1,206 by 12/31/92.

- Upon the IRA withdrawal, the government not only recaptured its tax that was deferred on 1/1/26 (i.e., $15 and $50, respectively), the government also received the full free-market investment growth on these deferrals, i.e.—

Table 6

Government Tax Collections On 12/31/92

15% Tax Bracket Taxpayer:	$15 x $1,206 = $18,097	See (a) above
50% Tax Bracket Taxpayer:	$50 x $1,206 = $60,324	See (a) above

- Note that the taxpayers effectively contributed $85 and $50 out of their *own* pocket to their tax-deductible IRAs. The remaining part of the $100 contribution (i.e., $15 and $50) represented the government's deferred tax. Thus, upon withdrawal on 12/31/92, the taxpayers received *their portion* of the IRA contribution ($85 & $50), plus the full investment growth thereon, *without further tax*. For example—

Table 7

Taxpayers' After-Tax Values On 12/31/92

15% Tax Bracket Taxpayer:	$85 x $1,206 = $102,552	See (b) above
50% Tax Bracket Taxpayer:	$50 x $1,206 = $60,324	See (b) above

- It is important to recognize that tax-deductible saving is *neutral* taxation, and it is fair to all taxpayers, regardless of their tax bracket. Each taxpayer defers otherwise taxable income. This tax deferral is subsequently taxed upon a withdrawal, at which time it is taxed at progressive, ordinary income tax rates. What is avoided is the senseless, self-defeating second layer of ordinary income tax that's imposed on the taxpayer's investment income and realized gain.

- With tax-deductible IRA-type plans, all taxpayers effectively enjoy a *zero* tax rate on *their own portion* of their contribution to the IRA, e.g., the $85 and $50 illustrated above. This is the same amount that would have been consumed (spent) if it had not been saved via the tax-deductible IRA-type plan. Thus, for this "spending" amount that is saved and invested, tax-deductible IRAs produce a zero tax on realized capital gain and a zero tax on dividend and interest income. This is proper, neutral taxation, and every taxpayer, regardless of tax bracket, is treated fairly.

  Surely, too, and properly so, unlimited, tax-deductible IRA-type plans are more favorable, simpler, and more fiscally sound than reducing the capital gains tax and indexing the asset basis for inflation. While reducing the capital gains tax is also very appealing and very sound, such a partial removal of the income tax bias against such saving is not the best course to follow.

Measuring The Cost Of IRAs

Government tax policy is driven by staff revenue estimates. IRAs are staff-labeled as "tax-expenditures" and staff-described as being "most similar to those direct spending programs which have no spending limits, and which are available as entitlements to those who meet the statutory criteria established for the programs." They liken it to Medicare, Social Security, etc.! *Nothing could be more inaccurate than those staff descriptions!*

IRA-type tax deductions are not "spendings," they're voluntary savings! The government's tax analysis faces 180° in the wrong direction! This leads to Committee decisions and government tax policy that is also faced 180° in the wrong direction!

As illustrated with tax-deductible IRA-type plans, the government gets back every nickel of the tax deduction, plus growth thereon, at free-market rates of total return! The alleged revenue loss the government incurs is the second layer of tax that it should not impose in the first place, because it is progressively destructive to the government's tax receipts and imposes confiscatory taxation on all taxpayers who save! *And "saving" is the life blood of any progressive civilization.*

Even the government's 1995 Budget document demonstrates that its "tax expenditure" revenue estimates for tax policy deliberations are grossly misleading. For example:

Table 8

U.S. Budget Analytical Perspectives—Fiscal Year 1995
(pages 59-61)

1994 Tax Expenditure Loss From IRAs

1994 Tax Expenditure	$5.415 Million
*Discounted Present-Value Of The Above Tax Expenditure	1.735 Million

*This figure had never been disclosed before

The above $5.4 million IRA tax expenditure corresponds to the Joint Committee on Taxation figures that are used by the Ways & Means Committee in their tax policy deliberations. However, the *present-value figure* reflects the more realistic fact that all IRA tax *deductions* are recovered by the government with free-market rates of growth thereon! In effect, therefore, the government admits that its tax expenditure figures used for Committee tax policy deliberations are over three times too high when measured on a more realistic basis ($5.4 ÷ $1.7 = $3.3)! Further, the $1.7 million present-value figure represents the senseless and self-defeating second layer of tax that should never be imposed in the first place.

A few years ago, a highly respected Washington, DC, actuary analyzed the government's methodology in determining tax expenditures relating to tax deferred saving. His conclusion was "...these tax expenditure facts are conceptually flawed, arbitrary, and almost useless for budget purposes...Any tax law based on such arbitrary and capricious figures can only be good by accident." Amen.

In short, universal, unlimited, tax-deductible saving (as found in the bipartisan H.R. 328, the Individual Investment Account Act) totally removes the income tax bias against saving. It is very important to recognize and accept the fact that such tax-deductible saving represents *neutrality* in regards to the basic taxpayer decision of whether to "save" or "consume" income. Thus, the removal of the tax bias against saving via H.R. 328, *does not* mean that such removal favors saving over consumption; it *does not*, it is neutral.

Clearly, when the question is raised as to the cost of enacting tax-deductible saving legislation, the paramount question is quite different—namely, what's the cost of the existing, unrelenting fiscal drag on the economy that arises from the existing tax bias against saving? Common sense and rational tax revenue estimation clearly show that eliminating the income tax bias on saving can only be positive, not negative, legislation.

The Tax Revenue Impact of Unlimited, Tax-Deductible Saving
As Proposed in H.R. 328

The League strongly supports H.R. 328 (and S. 159, its companion bill in the Senate) that provides for universal, unlimited, tax-deductible IRA-type "investment accounts." This legislation also includes the removal of other senseless biases against saving usually found with existing IRAs, such as penalty taxes, forced distributions, etc. See the summary of H.R. 328, attached.

To illustrate the fiscal impact of H.R. 328, the well-known and respected economics advisory firm, Fiscal Associates, in 1993 prepared an economic forecast of the revenue aspects of H.R. 328 on two bases: *static* (government method) and *dynamic* (a far more rational method for measuring the impact of taxes on saving).

Table 9

Estimated Static Revenue Losses And Dynamic Revenue Gains
From Universal, Unlimited, Tax-Deductible IRA-Type Plans

BILLIONS OF DOLLARS

Years	Static Revenue (Loss) (a)	Dynamic Revenue Gains (b)	Net Dynamic Federal Tax Gains & (Losses) (c = a + b)	Net Present-Values Of Gains (Losses) Discounted @ 11.6%* Net Dynamic Tax Revenue (d)	GDP (e)
1995	$ (28)	$ 18	$ (10)	$ (23)	$ 121
2000	(67)	69	2	(31)	916
2010	(146)	178	32	11	2,830
2020	(288)	370	82	57	4,186
2030	(567)	762	195	95	5,076
2040	(1,115)	1,571	456	124	5,661
2060	(4,314)	6,677	2,363	164	6,297

*The above net present-value calculations assume a discount rate of 11.6 percent—the estimated rate of return to society given by a long-term return on mutual funds. The favorable swing (i.e., loss to gain: -b to +a) in estimated revenues is mind-boggling (e.g., $136 billion in year 2000)! A copy of the complete Fiscal Associates report is available to you upon request.

Fiscal Associates' forecasted results also portray a dramatic increase in taxpayers' after-tax income and related standard of living that will flow from the prompt enactment of H.R. 328.

Table 10

How Universal, Unlimited, Tax-Deductible IRAs
Will Increase After-Tax Incomes In the Year 2000

Adjusted Gross Income *	Percent Change In After-Tax Income
Under $5,000	.2%
$5,000 - $10,000	3.4%
10,000 - 20,000	13.6%
20,000 - 30,000	19.3%
30,000 - 40,000	12.4%
40,000 - 50,000	12.3%
50,000 - 100,000	23.3%
100,000 - 200,000	6.3%
200,000 - 500,000	3.3%
500,000 or more	5.8%

* Adjusted gross income as currently defined

Note how middle-income America will enjoy the bountiful fruits of unlimited, tax-deferred saving and free-market enterprise that flows from unlimited, tax-deductible saving via the enactment of H.R. 328.

The above positive fiscal results can not be ignored by Congress, nor the public. While there may be differences among economists as to the efficacy of dynamic vs. static scoring and the underlying assumptions and methods, the "dynamic" results are not only dramatically favorable, *they do reflect common sense and a far more rational method of estimating the program's fiscal results.*

H.R. 328 is bottomed on plain common sense and reflects the economic facts of life that when you reduce the costs of saving, you get more of it. Further, H.R. 328 induced-saving is always measurable and held in trust for productive, free-market investment that will grow to everyone's advantage, including the government's, as it collects its taxes on the enhanced values at ordinary income tax rates when benefits are paid. Compounding this tax collection growth are the added taxes arising from enhanced GDP and the broadbased increase in taxes generated thereby.

It is important to recognize that unlimited, tax-deductible saving *without* penalty taxes, forced distributions, and no income nor estate tax at death, will greatly increase the propensity of most taxpayers to save increasing amounts over that which they would save under the biased-against-saving ordinary income tax. New saving and increased saving have no offsets to eventual government tax receipts, because, by definition, these amounts of saving would have otherwise been spent, thereby forgoing any further enhanced tax receipts by the government via personal, free-market investment growth.

Similarly, to the extent that the "new saving" portion of a taxpayer's tax-deductible contribution matches or exceeds his or her tax bracket (e.g., when 15% or more of the tax-deductible contribution represents *new* saving for a 15% tax bracket taxpayer), that new saving portion will match or exceed the government's borrowing that's needed to replace the temporary loss of revenue from tax deferral. Thus, net national saving is maintained or enhanced.

Conclusion

There is no rational reason to defer an aggressive Congressional push to enact universal, unlimited, tax-deductible saving as proposed by H.R. 328. To the extent that existing budgetary rules, or precedents for tax revenue estimation methods, if any, appear to impede the consideration and enactment of H.R. 328, it is most appropriate to very seriously consider their inapplicability and their inappropriateness to this legislation. Surely, sound, vital legislation that increases personal saving within the U.S., as well as the government's tax revenue receipts derived therefrom, must not be held hostage to rules and precedents that are inappropriate and self-defeating to all concerned, including the government.

The 1994 election reflects a strong voter/taxpayer demand for a bipartisan government to be bold and sensible in removing the dead-weight burden of irrational, self-defeating government from their backs. The anti-saving bias of the ordinary income tax is a classic example of faulty government, and it must be removed. H.R. 328 is a most attractive, sound way to show that this Committee and Congress is thoughtful and resolute in seeking proper solutions to our nation's economic problems.

We appreciate your request that we testify on this most important matter. On behalf of savers and investors, and their vital interests in the fiscal soundness of our government, we thank you for your serious interest. As always, action is what counts.

SUMMARY OF THE INDIVIDUAL INVESTMENT ACCOUNT ACT
H.R. 328

- Unlimited tax deductions for all contributions from any taxpayer.
- Tax-free investment growth until withdrawal.
- All withdrawals are taxed at ordinary income tax rates.
- No penalty tax on any withdrawal.
- No forced distribution at any age.
- With all withdrawals being taxed at ordinary income tax rates, there is no rational need for income tax nor estate tax at death. Beneficiary can maintain the account and assumes the benefactor's tax basis, if any.
- Principal Residence Rollovers:

  Home Purchase: Up to $15,000—indexed for inflation—of otherwise taxable distributions may be rolled over from the account without tax for first purchase of principal residence. However, the tax basis of residence is reduced by like amount.

  Home Sale: Proceeds from sale of a principal residence may be rolled over into the investment account without tax. The tax basis of the account is thereupon adjusted to reflect the tax basis of former residence, plus the existing law's $125,000 exemption on the home's sale after age 55.

  This home sale rollover provision is particularly attractive to "empty nesters" who won't sell their home due to the income tax on the gain that mainly arises from inflation. This provision lets them roll over an unproductive asset (home) for productive investments in the account. Thus, they may be able to live better in retirement. The government will probably make money on this, because otherwise the "empty nester" may opt for a "stepped-up basis" for his home upon death. This rollover provision is a valuable option for many people.
- Tax-deductible premiums for life insurance are an acceptable investment within the account, provided the proceeds are payable into the account for investment therein and eventual taxable distribution.

Mr. THOMAS. Thank you, Mr. Kelly; thank you very much for your testimony.

I thank the panel for its testimony. Does any member of the majority wish to inquire?

Mr. Houghton.

Mr. HOUGHTON. Thank you very much, gentlemen, for being here. Obviously, this is an issue of great concern. I wonder if any of the other witnesses agree with Mr. Kelly.

The reason I ask this question, we were talking about this the other day, and it seems to me, we have got a condition in this country which works against savings. Everything that the credit card companies espouse works against savings, and everything that stores espouse works against savings, and business doesn't save at all. Business either pays out dividends to stockholders or it puts money in investment. Poor people have a very difficult time with saving. So it comes in sort of a very narrow strip of those people who are saving the way we consider saving.

Now, in Japan, the saving rate is between 10 and 15 percent of the GDP. And if we have a GDP of $6.8 trillion—call it $7 trillion—in order to get to 10 percent, that would be $700 billion. I don't see anything which doubles from 4-point-whatever-it-is to 10 that would be needed to borrow from ourselves rather than borrow from the outside to take care of our trade deficit. I don't see anything in these programs other than H.R. 328 that gets us anywhere close to the amount of dollars that we need, which is roughly $350 billion in new savings.

Maybe you would like to comment on that.

Mr. JAFFE. I would agree with you, but I think we need to take the focus off the marginal players, the people on the low and high ends. Whatever we do, it is not going to change their lifestyle or spending or consumption habits.

However, there is a large group in the middle. And one of the problems is that consumption has an immediate payback and you see what you bought and you can use it and touch it and things like that, whereas you sort of can't see that with savings. But if you put in enough carrots up front, you definitely can change the mood and the motivation of the public.

Our clients continually want to know what they should do from an aftertax point of view. And taxes are the tail, not the dog, but it is a big tail. And you need to—an unlimited IRA deduction will change the saving habits of that middle group, absolutely.

Mr. HOUGHTON. I think it probably will, but the question is, does it generate the money which we need as a Nation, that we keep talking about?

Mr. SNYDER. I think we have seen a major reduction in the amount of savings from roughly 5.6 percent of GDP in 1981 to 1985 to 3.4 percent today, a 40-percent reduction in 10 years. And we are saving half as much as Germany is; only 25 percent as much as the Japanese. So there is no question there has been a drastic change.

If one looks at dates, one sees the changes occurring in synchronism with the recession, the job uncertainty, and uncertainty for the future value of the dollar.

It would seem to me that anything that would be an added incentive to personal saving would be worthwhile and would put more money into the savings system. Whether or not this particular bill or any other bill would make a substantial difference, I am not in the position to determine at this time. In general, our organization would be in favor of anything that does promote savings for a long term, particularly for retirement.

Mr. HOUGHTON. Would you like to comment on that, Mr. Kelly?

Mr. KELLY. First of all, in all the discussion here today—I have sat through most of it—we have always talked about how we need to increase the incentives for saving. My position is that we don't need to increase the incentives for saving; we need to decrease and get rid of the disincentives for saving.

When you have an unlimited tax deduction for saving, you return to neutrality on the question of saving versus consumption, and therefore the important thing is to get rid of that disincentive to saving. And when you have the disincentive to saving, you find that even in the higher tax brackets the huge disincentive to saving not only kills the taxpayer at the higher tax brackets—the higher you go the more disincentive there is—but at the same time the government is killing its own tax base. As you take away savings from individuals because of taxes, you are not going to have that money to tax again or again or again.

And what you have with tax-deferred saving is that this capital can grow in the free enterprise sector and then, when you decide to spend it and take the money out, Uncle Sam can stand there with his hand out, at the progressive income tax rates, and take away that 50 percent, or the 15 percent, depending on the individual's tax bracket. There will certainly be far more saving with unlimited tax-deductible IRAs. There is no question about that.

Mr. HOUGHTON. Could I just follow up very, very briefly.

I understand what you are saying, and I don't disagree with any of these things, but the point is we have a savings problem in this country and we are trying to wrap our arms around the basic concept of this thing; and my question is, does this do enough toward regenerating the savings psychology which we have had in this country, which has left us?

You can have success in H.R. 328. You can have success in some of the IRAs, but does it really do the thing that makes you feel that we are back on the track?

Mr. KELLY. Oh, indeed. First of all, you have to understand that with existing IRAs, we talk about the young people who don't save enough—what they don't take into account is that we have penalty taxes under individual tax-deductible IRAs, or even other IRAs, backloaded IRAs as they have them today—not backloaded, but nondeductibles. A young person who puts his money in and pulls it out before 59½, that is another 10 percentage points. That is a 67-percent tax increase. That is stupid.

What our Nation needs is the encouragement to save, go back to tax neutrality, have tax deduction for saving.

You heard the testimony here today by all the financial services industry that would say, we will go out and we will beat the bushes to bring people in to save. There is no question that savings would go up like a rocket if you permit tax-deductible saving without pen-

alty taxes and without forced distributions and those kind of disincentives.

Mr. HOUGHTON. I have overstayed my time. Thank you, Mr. Chairman.

Mr. THOMAS. Does any member of the minority wish to inquire?

Mr. Neal, cosponsor of H.R. 682.

Mr. NEAL. Thank you, Mr. Thomas.

Mr. Snyder, I have filed two versions of IRA legislation. Mr. Thomas and I have filed an expansive IRA, and I have filed a narrower version because in the end my goal is to get something passed.

Let me raise this question to you, and it cuts to the heart of the matter: If we are really trying to promote our savings rate, why do we—and I raise this as a rhetorical question, obviously—why do we argue that we ought to make it easy to get at what we put in the IRA?

Mr. SNYDER. Part of the answer depends on what age you are. For young people to save money on the future when they do not know what will happen in their future is asking quite a bit. In addition, when they are young it is hard to save for retirement because they are saving for a home or trying to make ends meet with a minimal salary and young children. If you place more restrictions on the IRA, what you are doing is making it more difficult for a younger person to make the commitment.

For those of us who are my age or older, the restrictions don't matter much. My kids are all out of college and earning their own livings and doing quite well. It is the middle group that suffers when you tighten the restrictions.

By easing the restrictions a little bit, you add a reason to invest in an IRA. So I personally would be in favor of minimal restrictions, and I would personally be in favor of the provisions we have been talking about here.

My organization is in favor of an expanded, tax-deductible IRA. The need is greater now than ever before, because of the mobility of our profession.

Mr. NEAL. Mr. Kelly, and then Mr. Jaffe, if you want.

Mr. KELLY. If your question is, do we need restrictions on the person so that he will not pull it out, let me just make this observation. I have already commented about penalty taxes, but when you put money into an IRA with a tax deduction, you are going to pay tax at ordinary income tax rates when you pull it out. And that is enough disincentive to pull it out right there.

But if the person wants it, let him take it out. The important thing is to get them to save in the first place, and having people contribute moneys as best they can as they go through life will do wonders for the savings in our Nation. I heard Alan Greenspan testify and say that's what our Nation needs, is just save for a rainy day.

Mr. NEAL. At lower interest rates.

Mr. KELLY. That will lower interest rates. That is right. You heard the same testimony. When you have more savings, you are going to have lower interest rates. When you have more computers, they are going to drop in price; it is no different.

Mr. NEAL. I see you have given some thought to this.

Mr. KELLY. I have been at this for a long time.

Mr. JAFFE. If you assume that the average individual works 40 years and we could get that individual to contribute $2,000 in each of his first 7 years, he will have just as much money for retirement as that individual who doesn't contribute for the first 7 years and contributes $2,000 for the next 33 years.

The sooner you save, the easier it is. And while we would rather you didn't take the money out, having that impediment to take the money out results in it not getting in. So we are in favor of easier ways to letting the money out. And my suggestion is that the public will fall in love with having that big savings account and that money will stay there.

Mr. THOMAS. Thank you very much.

I want to thank the panel.

Mr. Kelly, you are stroking all of my biases with your testimony because people talk about a flat tax and the consumption tax and a whole new way of approaching taxes. I think under our current system if you would free up the distinction between savings, and spending—which is—consumption—and savings, and not have a tax disincentive to save, you would go a long way in changing the current tax system to create an opportunity for investment.

But I have a very particular question to Mr. Jaffe whose profession is advising people about what they ought to do with their finances.

When we changed the rules on the IRA, both in terms of the deductibility but also limiting who can get it, in terms of your panoply of planning approaches, did you have a hole there? Was the IRA an important part of your presentation, or was it not around long enough to create an opportunity to mix with other structures? Did it create a hole or was it just not there?

Mr. JAFFE. It was always one of the first things that we could look at, even today, because there are many people who do still qualify for the tax-deductible IRA. It would be the first suggestion that we would look at to find tax-efficient ways to improve the person's meeting of its objectives.

To say there is a hole, sure, if that is no longer available as a tax-deductible vehicle and there are other vehicles that can do the job better today, then we would go down the pecking order to what makes the most sense for a particular situation.

Mr. THOMAS. But at the time that it was available, the IRA was one of the more attractive first offers in terms of financial planning?

Mr. JAFFE. We have 2,000 clients, and I cannot think of one who has compensation that did not have an IRA.

Mr. KELLY. A comment was made that, yes, we have to get something passed. I think it was Mr. Neal that made that observation.

May I observe to the committee that this committee and the taxwriting committee and the budget committees are those who are charged with the responsibility of getting our tax system right. And if this committee and the taxwriting committee and the budget committee cannot get the scoring right, then our Nation is in deep, deep trouble.

May I urge you to think about that.

Mr. THOMAS. On that note, today's hearing is adjourned. Tomorrow morning at 10 o'clock; the Ways and Means hearing on the Contract With America will continue in this room at 10 a.m. tomorrow. Thank you.

[Whereupon, at 1:52 p.m., the hearing was adjourned, to reconvene at 10 a.m., Wednesday, February 1, 1995.]

TAX PROVISIONS IN THE CONTRACT WITH AMERICA

WEDNESDAY, FEBRUARY 1, 1995

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, D.C.

The committee met, pursuant to call, at 10 a.m., in room 1100, Longworth House Office Building, Hon. Bill Archer (chairman of the committee) presiding.

Chairman ARCHER. The committee will come to order. If our guests and members of the committee will please take seats so we can commence.

Today is the final day of our full committee hearings on our Contract With America. We have, over the last month, heard from innumerable people, a cross section of experts, some from the real world, some from the academic world, and they have given us a lot of input.

I believe we have a much better understanding of the provisions as we proceed to the markup phase. Our panel of witnesses today represents the Bar Association, accounting and pension professions. The committee has always valued the technical comments of these organizations.

We also will hear from witnesses about the home office deduction provision in the Contract. This provision, which overturns an unfortunate interpretation by the Supreme Court, will provide welcome relief to small businesspeople across the country.

We are also going to hear from witnesses about the estate tax exemption increase contained in the Contract, and today's witnesses probably all will agree that our work in the estate tax area has only just begun. The estate tax is arguably the most unfair tax we have on the books, taking as much as 55 percent of the value of family businesses and farms merely because someone has died.

In addition, the estate tax is a direct dollar-for-dollar tax on capital savings which we so desperately need in this country for job creation.

Finally, we will discuss the debt reduction checkoff contained in the Contract. This provision will allow taxpayers to participate directly in reducing the national debt and presents some interesting possibilities.

But before moving to our witnesses, I recognize Mr. Kleczka for the opening statement on the minority side.

Mr. KLECZKA. Fine. Thank you, Mr. Chairman.

Mr. Chairman and members, today I would like to address that part of the Contract which provides for the deficit reduction check-

off box. Under this proposal, taxpayers would have the option of checking a box on their income tax return designating up to 10 percent of the amount of tax they owe to be directed toward deficit reduction. While it sounds like a simple and commonsense proposal, it is far from it.

The checkoff box is, at best, a gimmick and at worst a straitjacket that will cause unforeseen harm to Americans. In order to understand why this idea offers no benefits and risks a great deal of harm, let me first explain how it works.

Under the bill, individuals could check off a box on their income tax return and designate that up to 10 percent of their tax liability would go toward deficit reduction. Treasury would then be required to provide Congress with an estimate of the total amount of funds designated by taxpayers to go toward deficit reduction for the prior year. After the current fiscal year appropriations bills have all been passed, Congress then would have the responsibility of going back and enacting further spending cuts. And if we chose not to or were unable to do so, we would face across-the-board reductions in all programs.

That is where the harm comes in. Spending cuts under this Contract are already going to be severe. A number of proposals already before the committee will cost billions of dollars.

For example, according to Treasury, the capital gains tax preference will cost $183 billion over the next 10 years. Neutral cost recovery will cost $120 billion. The super IRAs will cost $17 billion, and the $500-per-child tax credit will cost an estimated $288 billion. In fact, the total cost of the tax provisions alone exceeds some $725 billion. That is nearly three-quarters of a trillion dollars.

My Republican colleagues have assured me all proposals in the Contract will be paid for with spending cuts. Cutting three-quarters of a trillion dollars in the budget means that about every American stands to lose something. All programs will have to be cut and cut deeply.

Everyone likes to say cut fraud and abuse in the system. Unfortunately, my friends, there is not three-quarters of a trillion dollars of abuse going on. That means people should expect cuts in programs like Medicare, veterans benefits, education and student loans and just about every other program you can think of.

Now, if you add this checkoff proposal, the cost of the Contract grows even larger. In 1994, individual income tax receipts amounted to $542 billion. That means if everyone took advantage of the box and checked off the full 10 percent every year for the next 10 years, we would have to cut an additional $54 billion—or a total of $542 billion—in addition to the $725 billion already called for. That does not even take into consideration the balanced budget amendment, which will lead to even more cuts.

How is Congress going to cut all this spending to the bone and then have to come back and cut even further?

Worse still, there will not be a warning as to the size of these additional cuts. Americans will have to wait until all the numbers are computed by Treasury to learn if the programs they depend on are at risk of being cut once again. In fact, we Democrats have consistently asked for a list of what programs will be cut to pay for the Contract and have yet to get a satisfactory answer.

The checkoff proposal means that even if Republicans did answer us, and the American people also received the answer on what they intend to cut, that list would not be complete. Further cuts would be needed to pay for the amount that the individuals checked off. As a result, the checkoff box will tighten the straitjacket on government even further. It could prevent Congress from assisting victims of natural disasters, could deny Congress the ability to provide for its most vulnerable citizens, the elderly, and it will stop Congress from helping those veterans who have fought for this country.

It is a very serious problem, and it deserves very serious consideration. In America, we believe in one person, one vote. However, the checkoff box gives the wealthy more say than other groups in government. Since the wealthy owe a greater amount of tax, if they check off the box, the amount that must be cut from spending will be greater. In this way, the wealthy can force Congress to cut more. That is unfair and that is wrong. The wealthy do not deserve a greater say in government than the middle class or the poor.

Finally, if my Republican colleagues believe the checkoff box is such a good idea, let us ask the taxpayers to give us more advice as to where to cut. I propose another set of boxes alongside the 10 percent checkoff box, and those set of boxes would have broad Federal spending categories like defense, social programs, welfare, agriculture, education, and veterans programs.

Any taxpayer who checks the 10 percent deficit reduction box will then be asked to give us further guidance as to where we should cut those programs. They could choose one or they could choose more. Know full well there are those in our society who will check the 10 percent checkoff box and also check defense. Well, that will not sit too kindly with some Members of this Congress. And there are those who will come back and check off the 10 percent deficit reduction box and go after welfare, and that will not sit well with others. But I think if we are going to budget by initiative referendum, my friends, let us go all the way. Under this method, Americans can make all the tough decisions that we in Congress are forced to make every day. They can determine the spending allocations that appeal to them.

Obviously, such a proposal would be unworkable and would not make sense, no more sense than the original Contract proposal on the 10 percent deficit box.

I want to work with my Republican colleagues on this Contract. Some of the proposals are genuinely good, and I am happy to be here to discuss them with you. I like the IRA proposals and am interested in the capital gains indexing proposal. However, I cannot support misguided proposals like the checkoff box, and I am disappointed such an idea would be put forward. Hopefully, we will all have the wisdom to delete it and get down to the work on the serious proposals before the committee.

Chairman ARCHER. Without objection, as usual, every member will have the right to insert any statement in the record at this point.

[The following was subsequently received:]

STATEMENT OF REPRESENTATIVE JIM RAMSTAD
WAYS AND MEANS COMMITTEE
HEARING ON CONTRACT WITH AMERICA
February 1, 1995

Mr. Chairman, it is a pleasure to welcome this panels -- particularly since two of the witnesses are from Minnesota: John Forsythe and Tom Diedrich.

Mr. Forsythe is Vice President for Tax and Public Affairs of Ecolab, St. Paul, MN, and is testifying on behalf of Ecolab's Sales Force Employees.

Mr. Diedrich of the Diedrich Group, Minnetonka, MN, is here on behalf of the Bureau of Wholesale Representatives.

I am very pleased we have two witnesses from Minnesota who know how much this tax relief will help the self-employed and other workers who conduct their business at home.

Clarifying the home office deduction would make a major difference to thousands of small businesses in the Third Congressional District and throughout Minnesota and the country. The home office deduction provision is one of several initiatives in the Contract with America that recognizes the important contribution small businesses make in our economy. Small businesses create over 80 percent of the new jobs in America.

The home office deduction provision is on the cutting-edge of job trends as more Americans choose to "tele-commute" by computer or utilize other methods to work at home. We should especially help parents with young children who want to spend more of their working hours at home.

The Contract With America's Job Creation and Wage Enhancement Act includes a provision allowing taxpayers to qualify for the home-office deduction if the home-office is (1) used exclusively for business purposes, (2) used on a regular basis, (3) used to perform tasks that could not easily be performed elsewhere and (4) is essential to the taxpayer's business.

Mr. Chairman, thank you again for assembling such an excellent panel. I look forward to hearing from all of our witnesses today.

Chairman ARCHER. Our first two witnesses will be Congressman Wayne Allard from Colorado and Congressman Bill Barrett from Nebraska.

We are happy to have you here with us this morning, and I am sure you are aware of the standard we try to live by here which is to keep your oral testimony within 5 minutes and submit your entire written statements for the record. Without objection, you will have that right. We are again pleased to have you.

Congressman Allard, you may proceed.

STATEMENT OF HON. WAYNE ALLARD, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF COLORADO

Mr. ALLARD. Thank you, Mr. Chairman and members of the Ways and Means Committee. Thank you for allowing me to testify today before the committee on a topic which is very near and dear to my heart and that is the home office tax deduction.

I would also like to recognize the hard work that another member of your committee has put forward on this issue and that is Congresswoman Johnson from Connecticut. And I look forward to working with her on this very important issue and the rest of the committee.

As you know, the recent *Soliman* Supreme Court decision and subsequent IRS regulations have made it impossible for many business entrepreneurs to use the home office tax deduction. This situation must be remedied.

In the last Congress I introduced legislation which was cosponsored by 79 colleagues. This Congress I have introduced H.R. 40, which in just the first 4 weeks of this session has been cosponsored by 65 of our colleagues. This legislation is designed to restore Congress' original intent, which I believe was to make the home office tax deduction available to a wide array of small businessowners and entrepreneurs.

With April 15 fast approaching, the last thing most Americans want to think about is taxes. In fact, the average American must now work the first 125 days of the year to pay all Federal, State and local taxes.

The bulk of the family tax bill consists of income taxes, payroll taxes and property taxes. However, one factor which adds to the growing tax bill of many self-employed and small businessowners are the new rules governing the home office tax deduction.

Increasingly, it is the little guy who gets squeezed by the tax system. While large corporations can rent space and deduct office and virtually all other expenses, many taxpayers who work out of their homes are no longer able to deduct their office expenses.

Traditionally, the Tax Code has permitted individuals who operate businesses within their homes to deduct a portion of the expenses related to that home. However, over the past 20 years, Congress, the courts, and the IRS have reduced the scope and usefulness of the deduction.

The most serious blow came 2 years ago with the Supreme Court decision and subsequent IRS action virtually eliminating the home office deduction for many.

Under the Supreme Court's new interpretation of principal place of business, a taxpayer who maintains a home office but also per-

forms important business-related work outside the home is not likely to pass IRS scrutiny. This change effectively denies the deduction to taxpayers who work out of their home but also spend time on the road. Those impacted include sales representatives, caterers, teachers, computer repairers, doctors, veterinarians, house painters, consultants, personal trainers and many more. Even though these taxpayers may have no office other than their home, the work they perform will often deny them a deduction.

According to the IRS, 1.6 million taxpayers claimed a home office deduction in 1991. While not all of these taxpayers will be affected by the change, many will. Clearly, any taxpayers who operate a business out of their home must review their tax situation.

There are many reasons why a broad home office tax deduction is important. The deduction is profamily. It helps taxpayers pursue careers that enable them to spend more time with their children. The deduction helps cut down on commuting and saves energy. The deduction recognizes the advances of technology—computer and telecommunication advances mean that more and more individuals will be able to work for themselves and maintain a home office.

The deduction is a boost to women and minorities who are increasingly starting their own businesses. In fact, over 32 percent of all proprietorships are now owned by women entrepreneurs, and Commerce Department data reveals 55 percent of these women businessowners operate their firms from home.

Minorities are making similar advances. There are now well over 1 million minority-owned small businesses, and a good number of these are operated out of the home.

I think it is critical that we pass this legislation, and I ask that the Ways and Means Committee give it very serious consideration. Thank you, Mr. Chairman.

[The prepared statement follows:]

Testimony
Rep. Wayne Allard
Home Office Tax Deduction
Committee on Ways and Means
February 1, 1995

Mr. Chairman, Members of the Ways and Means Committee, thank you for allowing me to testify today before the Committee on a topic which is near and dear to my heart -- the Home Office Tax Deduction.

As you know, the recent Soliman Supreme Court decision and subsequent IRS regulations have made it impossible for many small business entrepreneurs to use the home office tax deduction. This situation must be remedied.

In the last Congress I introduced legislation which was cosponsored by 79 colleagues. This Congress I have introduced H.R. 40, which in just the first four weeks of this session has been cosponsored by 65 of our colleagues. This legislation is designed to restore Congress' original intent, which I believe was to make the Home Office Tax Deduction available to a wide array of small business owners and entrepreneurs.

With April 15, fast approaching the last thing most Americans want to think about is taxes. In fact, the average American must now work the first 125 days of the year to pay all federal, state, and local taxes.

The bulk of the family tax bill consists of income taxes, payroll taxes, and property taxes. However, one factor which adds to the growing tax bill of many self-employed and small business owners are the new rules governing the home office tax deduction.

Increasingly, it is the little guy who gets squeezed by the tax system. While large corporations can rent space and deduct office and virtually all other expenses, many taxpayers who work out of their home are no longer able to deduct their office expenses.

Traditionally, the tax code has permitted individuals who operate businesses within their homes to deduct a portion of the expenses related to that home. However, over the past 20 years Congress, the courts, and the IRS have reduced the scope and usefulness of the deduction.

The most serious blow came two years ago when a Supreme Court decision and subsequent IRS action eliminated the home office deduction for many. Under the Supreme Court's new interpretation of "principal place of business" a taxpayer who maintains a home office, but also performs important business related work outside the home is not likely to pass IRS scrutiny.

This change effectively denies the deduction to taxpayers who work out of their home but also spend time on the road. Those impacted include sales representatives, caterers, teachers, computer repairers, doctors, veterinarians, house painters, consultants, personal trainers and many more. Even though these taxpayers may have no office other than their home, the work they perform will often deny them a deduction.

According to the IRS, 1.6 million taxpayers claimed a home-office tax deduction in 1991. While not all of these taxpayers will be affected by the change, many will. Clearly, any taxpayers who operate a business out of their home must review their tax situation.

There are many reasons why a broad home office tax deduction is important. The deduction is pro-family. It helps taxpayers pursue careers that enable them to spend more time with their children. The deduction helps cut down on commuting and saves energy. The deduction recognizes the advances of technology -- computer and telecommunication advances mean that more and more individuals will be able to work for themselves and maintain a home office.

The deduction is a boost to women and minorities who are increasingly starting their own businesses. In fact, over 32 percent of all proprietorships are now owned by women entrepreneurs, and Commerce Department data reveals that 55 percent of these women business owners operate their firms from home. Minorities are making similar advances. There are now well over one million minority owned small businesses and a good number of these are operated out of the home.

Finally, the home office tax deduction helps our economy. It benefits small businesses and entrepreneurs who develop new ideas, and create jobs. Many of America's most important businesses originated out of a home office.

Small business is increasingly the engine which drives our economy. With large firms downsizing, entrepreneurs must pick up the slack. The importance of this trend is demonstrated by the job shift that occurred during the slow recovery from the most recent recession. During the period of October 1991 to September 1992 large businesses cut 400,000 jobs while small business created 178,000 new jobs. During the boom years of the 1980s, the vast majority of the 20 million new jobs created were in the small business sector.

It is critical that recent assaults on the home office tax deduction be reversed. That is why I have introduced legislation to fully restore the deduction. I am pleased to note that similar language is included in the Contract with America. It is therefore guaranteed a vote in the House in the first 100 days.

This invariably leads to the question, How is your bill different from the language in the Contract With America?

First of all, I think we all achieve the same objective, I think any Congressional action is going to send a clear message to the IRS and the courts that we intend for the deduction to apply more widely.

Having said that, I feel our version contains elements that are missing from some of the others. We make clear that if the home is the sole fixed location of the business, then the deduction can certainly be taken. We also tie the IRS' hand and prevent them from using some of the arbitrary numerical tests that have been used to restrict the deduction in the past.

The goal is to make clear that if one uses a portion of the home exclusively and regularly for a home office, then one can generally take the deduction.

I plan to be very active in working to see that restoration of the home office tax deduction is approved by both the House and Senate, and signed by the President in 1995. Thank you. I will be happy to take questions.

Chairman ARCHER. Thank you, Mr. Allard.

Our next witness is Congressman Bill Barrett. Congressman Barrett, you may proceed.

STATEMENT OF HON. BILL BARRETT, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEBRASKA

Mr. BARRETT. Mr. Chairman and members of the committee, thank you so much for having this hearing in the first place and allowing me to speak in favor of increasing the estate tax exemption from $600,000 to $750,000, and then, of course, indexing it thereafter.

Although I strongly support the provision in H.R. 9, the Job Creation and Wage Enhancement Act, I need to add that I believe the exemption does not go far enough. It will not fully address the problems the Tax Code creates for keeping family farms in the family.

The American Farm Bureau and other agricultural organizations believe the estate and gift tax exemption should be increased to levels of up to $2 million. They argue that more farms have assets exceeding the $600,000 exemption, and the heirs are forced to sell inherited property to pay estate taxes.

Due to inflation, and, of course, the nature of farmers to hold on to their land—an average of 28 years now per farm—owners of farms are more likely to be affected by the estate tax than other people. The average value of farm assets for the 55,000 farmers in Nebraska is now $697,000 per farm.

Some opponents of raising the exemption level believe the so-called wealthy estates have enough liquidity that it is not a problem to pay estate taxes, and, of course, the other expenses attendant to inheritance. Unfortunately, these opponents do not have an understanding of family farm operations nor do they understand how capital-intensive family farms really are and must be—to remain viable.

Farmers may appear wealthy on paper, but, in reality, most of the overwhelming number of farmers have very little cash on hand, with the bulk of their estates or their assets tied to farm real estate and equipment. In Nebraska, farm real estate accounts for more than 70 percent of the total assets for an average farmer.

The heirs of these estates are usually the sons or the married daughters that are actively involved with the farming operation but have very few assets themselves. The heirs may be assisting with the actual farming, but the properties are solely owned by the decedent. Due to the exemption allowed under current law, the family heirs are too often forced to sell a portion of the farm real estate to pay taxes, which, in turn, threatens the viability of the restructured farm operation. The disposed property is not just an asset but it is an important income-producing asset.

Another concern, Mr. Chairman, as it relates to the estate tax question, is the average age of our Nation's farmers. Compared to the average head of households in the United States today, which is 48 years of age, roughly half of the 2 million farmers in this country today are age 55 or older. More than 17 percent of our farmers are now 70 years of age or older. This creates a situation where there will be an extensive turnover of farming operations in

the next few years as we lose these older farmers. If Congress does not raise the estate tax exemption, we will lose farmers, and we will be losing the foundation of family farming upon which American agriculture has thrived.

Opponents may also argue family farms may utilize a provision of the Tax Code for special use valuation of farm real estate. Earlier, when I referred to H.R. 9 not going far enough, I was making reference to this issue, specifically section 2032A, the provisions on the special use provision.

This special use valuation applies so long as the inheriting family members continue to farm the property. If an inheriting family member chooses to cash lease their interest to the family member to actually farm the property, section 2032A does not apply. A daughter who, as a doctor, may return to the community and cash rents to her brother does not qualify.

I believe disqualifying property from special use valuation solely on the basis of a cash leasing arrangement among family members is contrary to the congressional intent which is behind section 2032A. The bill I introduced, H.R. 501, clarifies that a cash leasing arrangement among inheriting family members will not disqualify the property for special use valuation. It goes a step further and includes surviving siblings and other qualifying heirs.

Mr. Chairman, the provisions of H.R. 9 will go a long way to help keep the family farm in the family, and later in this session I hope that we can discuss further changes to the estate taxes to help keep the family farms in the family.

Thank you, Mr. Chairman.

[The prepared statement follows:]

Testimony of the Honorable Bill Barrett (NE-3
House Ways and Means Committee
February 1, 1995

Thank you, Mr. Chairman, for having this hearing and allowing me the opportunity to speak in support of increasing the estate tax exemption form $600,000 to $750,000 by 1998, and to index it for inflation thereafter.

Although I strongly support this provision in HR 9, the Job Creation and Wage Enhancement Act, I must add that I believe the exemption does not go far enough, and won't fully address problems the tax code creates for keeping family farms in the family.

As you know, the American Farm Bureau and other agricultural organizations believe the estate and gift tax exemption should be increased to levels up to $2 million.

They argue, correctly, that more and more farms have assets exceeding the $600,000 exemption, and the heirs are forced to sell land, equipment and/or buildings to pay estate taxes.

Due to inflation, and the nature of farmers to hold on to their land--an average of 28 years per farm--owners of farms are more likely to be affected by the estate tax than the general population.

The average value of farm assets for the 55,000 Nebraska farmers is $697,000 per farm.

Some opponents of rasing the exemption level, or heaven forbid, those who would even lower the $600,000 level, believe these so-called wealthy estates have enough liquidity that it is not a problem to pay estate taxes and other expenses.

Unfortunately, these opponents do not have a general understanding of family farm operations, nor do they understand how capital intensive family farms must be to remain viable.

Farmers may appear wealthy on paper. However, in reality the overwhelming number of farmers have very little cash-on-hand, with the bulk of their assets tied to farm real estate and equipment.

In Nebraska, farm real estate accounts for more than 70 percent of the total assets for an average farmer.

The heirs of these estates are usually the sons or married daughters that are actively involved with the farming operation but have few assets themselves.

While the heirs may be assisting with the actual farming, the machinery, land and buildings are solely owned by the decedent.

Due to the exemption allowed under current law, the family heirs are too often forced to sell a portion of the farm real estate to pay taxes which in turn threatens the viability of the restructured farm operation.

As you know, the disposed property is not just an asset, but it is an important income producing asset.

Another concern, as it relates to the estate tax question, is the average age of our nations' farmers

Compared to the average head of households in the US, which are 48 years of age, roughly half of the 2 million farmers are age 55 or older. More than 17 percent of our farmers are 70 years of age or older.

This creates a situation where there will be an extensive turnover in farming operations in the next few years as we lose these older farmers.

If Congress does not act to raise the estate tax exemption, we'll not only be losing farmers, we'll be losing the foundation of family farming upon which American agriculture has thrived.

Another point opponents may argue is that family farms may utilize a provision of the tax code for special use valuation of farm real estate, and therefore need no further relief from estate taxes.

When I refer to HR 9 not going far enough to give family farms tax relief, I was making reference to this issue, specifically Section 2032A.

I have introduced legislation, HR 501, to amend the Internal Revenue Code (IRC) Section 2032A, the special use provision.

In 1976, Congress sought to help families keep their farms by allowing a farm to be valued in its use as a farm, rather than at its market value.

This "special use" valuation applies so long as the inheriting

family members continue to farm the property.

But suppose one of the inheriting heirs does not choose a life on the farm. Perhaps, for example, it is a young doctor who has returned to practice in her rural hometown, but she won't be farming. She'll leave that up to her brother.

If this inheriting family member chooses to cash lease her interest to the family member to actually farm the property, Section 2032A does not apply.

I believe to disqualify property from special use valuation solely on the basis of a cash leasing arrangement among family members is contrary to the congressional intent behind Section 2032A.

My bill, HR 501, clarifies that a cash leasing arrangement among inheriting family members will not disqualify the property for special use valuation.

Mr. Chairman, I understand that the Committee is strictly focusing today on provisions in HR 9 that raise the estate tax exemption, and may not be ready, or willing, to also include extraneous measures, such as HR 501.

While I can certainly respect the Committee's position, I hope that at some future point we can discuss further changes to estate taxes toward the goal of keeping family farms in the family.

Believe me, the relief provided by HR 9 for family farms will be beneficial and will go a long way toward keeping alive the family farm. But I encourage the Committee to finish the job by considering and passing provisions from HR 501.

I appreciate being given this opportunity and stand ready to answer any questions you may have.

♦ ♦ ♦ ♦

Chairman ARCHER. Gentlemen, thank you for your very cogent input to the committee. Do any members wish to inquire?

OK, I have Mr. Bunning, Ms. Dunn and Mr. Kleczka. Anyone else? Mr. Herger. All right.

Mr. Bunning.

Mr. BUNNING. Well, rather than inquire, I want to thank both Mr. Barrett and Mr. Allard for their testimony and agree with Mr. Barrett on our ability to expand that deduction past the $750,000 limit. Because of personal experience with it, and with experiences in my district with that restriction being at $600,000, we need to expand the deduction now; particularly in the farm community, which 14 of my counties that I represent are so involved with family farms, and with the inflated value of those family farms as far as tax liability is concerned.

The home office deduction—I am a cosponsor with Wayne Allard on that bill, and have been in the last Congress, and could not agree with him more that that ought to be looked at and included, and I just hope that we can get it done.

Thank you both for your testimony.

Mr. ALLARD. Thanks for your comments.

Mr. BARRETT. Thank you.

Chairman ARCHER. Mr. Kleczka.

Mr. KLECZKA. Thank you, Mr. Chairman.

I have a question for Representative Allard. Under your proposal for the home office deduction, my question is what is built into the legislation to prevent abuse of restoration of this deduction and also what are the limits on the actual deduction?

As I look at your testimony, you indicate one category of professionals would be teachers, another would be doctors. I can see a teacher bringing home some homework or tests to grade, things of that nature. Would that qualify for a home office deduction? Or in the doctor situation, does that home office have to be used for examining patients, seeing patients or just he claims he does work there?

I am saying if that be the case, I have an office in my home also where I take back constituent correspondence, call constituents, work on legislation, and I am wondering if I would also qualify?

Mr. ALLARD. No, sir, you would not qualify because that is not your sole fixed location of doing business. The purpose of the——

Mr. KLECZKA. Well, the teacher's sole fixed is not his or her home either.

Mr. ALLARD. The purpose of the legislation is to try to reduce the regulatory burden on the home office person, the person who is trying to work out of his home. Frequently, that is where businesses start. That is where people get started in business. If we are going to open that up, we need to do that.

So I want you to look very closely—it is the sole fixed business location language that we add, and you have to use your home exclusively and regularly as a home office.

Let me give you one example of somebody who—or a couple of people in your community, I am sure, that you can find who work out of their homes. Probably an electrician or——

Mr. KLECZKA. Give me a teacher example, where a teacher would qualify.

Mr. ALLARD. I don't see a teacher qualifying unless they are running a day care center—you are thinking about the regular professional teacher?

Mr. KLECZKA. Right. Goes home from school, from the classroom.

Mr. ALLARD. In terms of a day care teacher or a teacher providing for the handicapped and doing that teaching out of their home, then, obviously, if they have a room set up and they are teaching to handicapped children or young people, then it is part of their business as a contract teacher and they would qualify.

Mr. KLECZKA. The activities would have to happen in the home itself.

Are there any limits on the actual deduction that could be claimed?

Mr. ALLARD. There is no maximum deduction on there, except that I think just because of the homes that you are dealing with, I do not think that is going to be particularly a problem.

Basically, what we are talking about, the figure I give you, we are talking about people who are starting out in business in their home. If they are a large business, then the incentive is there for them to move out and to rent space and to incur the cost of operating, basically, a business out of their home. Because it is much more convenient, you have so many employees, and most people do not want to do business——

Mr. KLECZKA. OK, I understand that, but my further question on the actual deduction. If I have five rooms to my home, and I devote one for the home office, I can deduct from my taxes one-fifth of all the expenses of the home, from mortgage to heat to light and everything else?

Mr. ALLARD. Not necessarily. If that room is the least expensive room, as far as operating—maybe you built five rooms on. Maybe the other four are extremely expensive rooms, and that one you are running your home office is a less expensive room. It has to meet the qualification that it is used as the regular place of business, as a sole and fixed location, and that is where you are running your business out of.

Mr. KLECZKA. Who makes the determination as to how much I can deduct?

Mr. ALLARD. Well, obviously——

Mr. KLECZKA. Let's say it is the most expensive room in the house.

Mr. ALLARD. As any businessman will know, if you are a prudent businessman you need to itemize all your costs and get a portion down as a percentage of your total cost of doing business. So you allocate that particular amount of cost related to that room and then that becomes the cost of doing business as far as that room is concerned.

Mr. KLECZKA. So in a five-room example, I can deduct one-fifth of the cost of everything associated with the home, including the cutting of the grass.

Mr. ALLARD. No, in my view, that depends on the cost of that room. You could take a deduction—if it is the least expensive of the rooms, then you would take a proportionate share of the total cost for that room. You do not necessarily take 20 percent.

Mr. KLECZKA. I can see some real abuse coming here, and I do not think we have enough IRS auditors to go and measure homes and find the value of homes. Thank you.

Chairman ARCHER. Mr. Herger.

Mr. HERGER. Thank you very much, Mr. Chairman.

I want to commend our two witnesses, our colleagues, for your long-time work on behalf of American agriculture and the family farmer.

I particularly want to commend you, Mr. Barrett, and your testimony, in bringing out the fact of our family farms and the difficulty in being able to keep our family farms farming, being able to pass on from one generation to the other those who have created the best-fed nation in the history of the world that we have, with a smaller amount of farmers every year.

And particularly you speak about some legislation you have that has to do with the Revenue Code section 2032A, the special use provision. I might just add to that, that number has not been changed since 1983. Certainly, it is time for a change. I commend you and support your legislation. Congressman Thomas and I have legislation in this same area. Again, I thank you for your work.

Mr. BARRETT. Thank you, Mr. Herger.

Chairman ARCHER. Ms. Dunn.

Ms. DUNN. Thank you, Mr. Chairman, and thank you very much, gentlemen, for testifying. I think you have hit some sensitive nerves here, and I certainly support you both in what you are trying to do.

Mr. Barrett, I wanted to add to your excellent description of how the estate tax currently affects farmers by telling you that in my district we have a number of small timberowners of timber farms, and the effect on that group is that their family, upon death, cut the trees and sell the property. So, eventually, because of this terribly onerous burden of regulation, we are losing small timber farms in the State of Washington, and it is a great tragedy because that affects the ability of the public to come onto private property where the owners have allowed them to use the facilities for recreational use and a number of other uses.

So I agree with you the law must be changed, and your proposal is a most interesting one. We have heard others, but I think yours gets closer to reality when it comes to the amount of exemption that we should allow.

Mr. BARRETT. There are some real-life stories out there—thank you, Ms. Dunn—about the adverse effects, social, economic, political effects, on the populace. I think this is an area which needs to be addressed. Thank you.

Chairman ARCHER. Mr. Camp.

Mr. CAMP. Thank you, Mr. Chairman. I want to thank my colleagues, Mr. Allard and Mr. Barrett, for testifying today.

The estate tax exemption and the home office deduction are critical issues to me and to the people of the Fourth District of Michigan, and I want you both to know I appreciate your efforts in this regard and in making these items more workable for the taxpayers of this country. Thank you.

Mr. ALLARD. Thank you.

Mr. BARRETT. Thank you.

Chairman ARCHER. Mr. Christensen.

Mr. CHRISTENSEN. I also want to thank the witnesses. And, Congressman Barrett, as my entire family lives and farms in your district, I can't tell you how much this kind of relief is needed.

The old saying that a farmer lives poor and dies rich could not be further from the truth. Not only today do they live poor but they die poor because of this type of low exemption. We need to correct it. I support it, and thank you for your testimony today.

Mr. BARRETT. Thank you.

Chairman ARCHER. Gentlemen, thank you very, very much.

Mr. BARRETT. Thank you, Mr. Chairman.

Mr. ALLARD. Thank you, Mr. Chairman.

Chairman ARCHER. Our next panel: Mr. Porter, Ms. Walker, Mr. Terry, Deborah Walker, and David Walker. Please take your seats at the witness table.

Before introduction of our first witness, I would like to recognize my colleague, Nancy Johnson of Connecticut.

Mrs. JOHNSON. Thank you, Mr. Chairman.

It is a special pleasure to welcome Michael Porter to this hearing. He is the C. Rowland Christensen Professor of Business Administration at Harvard University and has conducted extensive research on the competitive strategies of companies and on the competitiveness of states and nations.

He serves as cochairman of the Subcouncil on Capital Allocation of the Competitiveness Policy Council, charged with developing concrete recommendations for improving the savings rate and efficiency of corporate investment in America. He has also led major research on efforts to deal with the problems of underinvestment and economic development in America's inner cities.

I welcome you here today and the rest of the panelists.

Mr. PORTER. Thank you.

Chairman ARCHER. Mr. Porter, again, the standard under which we operate is we ask you to keep your oral testimony to under 5 minutes, and you may submit a complete written statement for the record in its entirety without objection. That also applies to the rest of the witnesses.

Mr. Porter, you may proceed.

STATEMENT OF MICHAEL E. PORTER, C. ROWLAND CHRISTENSEN PROFESSOR, HARVARD UNIVERSITY, CAMBRIDGE, MASS.

Mr. PORTER. Thank you, Mr. Chairman.

From someone who has spent many years studying the problems of investment in the United States, I cannot tell you how important and timely these hearings are. The central problem facing the American economy—and there is no doubt about it—is inadequate savings and especially inadequate investment by the private sector. We are simply not investing enough to support economic growth and a rising standard of living. This is true in the economy as a whole, and it is particularly true in our distressed inner-city areas, where investment is leaving rather than coming.

The only way we are going to be able to sustain a rising standard of living in this country is to step up the rate of investment, especially in equity capital. It is equity capital that supports entry into

new products and new services, that supports the R&D that is required to create new jobs rather than just boost the productivity of existing businesses, which often reduces employment.

Yet the rate of investment by American industry is declining at a precipitous rate. In fact, as of 1993 or 1994, the net investment, after depreciation, of American industry is now only 2 percent of GDP rather than 3.5 to 4 percent in the seventies and sixties. It is no wonder that even the somewhat slow economic rate of growth that we have now forces us into capacity constraints because our net rate of investment in the economy is so low.

Why do we have low investment in our corporate sector? Well, there are three basic causes that you have the means to deal with in this committee.

The first is, of course, inadequate savings, not just savings by government in the form of dissavings but low private savings that have fallen from 6 percent of GDP as recently as the early eighties, to 3 percent of GDP in 1994.

I share with you the view that we must reinstitute some kind of an individual retirement account incentive for savings. I believe, however, that our retirement account proposal should be related to income; that is, you should have to save more, depending on your income, to get the benefit. The details are in my testimony.

The second fundamental cause of underinvestment in our economy in the corporate sector is overinvestment in real estate. The United States spends an enormous fraction of its overall pool of investment capital in real estate. Indeed, as you all probably know, in a single year, the total tax break for investment in residential real estate in the United States is $82 billion per year to incent investment in this particular form which, although it does create jobs and it does improve our quality of life, does not have the same leverage in improving the long-term growth of the economy as investment in the corporate sector.

I believe it is time to scale back some of the subsidies for real estate investment, particularly for affluent Americans. The details are in my testimony.

The third problem, limiting corporate investment, is not just a savings problem, but it is a deeper problem having to do with the way we regulate the financial markets in this country and the way we create tax incentives that work against investment.

We have this low rate of investment in U.S. industry in new plant, equipment and R&D, yet we have companies buying back tens of billions of dollars of their stock instead of investing.

Last year's stock buybacks totaled about $70 billion. That did not create new assets—that was not net investment by corporations. That was them buying back their own stock.

We have a continued high rate of M&A activity in this country. Instead of new investment in new plant and equipment, companies last year spent $230 billion making acquisitions that changed control of assets but did not create new net assets.

Now, why is this happening? Well, first of all, it is happening because of outmoded and excessive regulation of our financial markets that dates back to the twenties and thirties when our financial markets were different, when the owners of equity shares in Amer-

ica were small individuals. We simply must reform our financial market regulation.

I am chairing a group that will issue a report on this in the spring.

But of particular interest to this committee is the disincentive that our tax system places on investment, particularly investment in equity capital. Our system is biased against equity investment—severely biased against equity investment. It double taxes dividends on equity. It double taxes retained earnings on equity capital. By not indexing capital gains, it biases against long-term equity investment toward short-term holdings.

The 1986 Tax Reform Act was supposed to equalize the treatments of various forms of income. Instead, it increased the bias against equity investment which we so desperately need.

I share with this committee the sense that we must introduce a long-term capital gains incentive. However, as detailed in my testimony, I believe it should be limited to equity investment. I think this is where the greatest leverage for economic growth comes, and I also believe it should be prospective. I think we should not give windfalls for past investments. We should make the incentive prospective on new investments with the clock starting today.

I share with you the view that we must index capital gains for inflation, and I would also move toward starting to provide an exclusion for dividend income from equity. The details are in my statement.

We have a particularly acute problem of lack of investment in the Nation's inner cities. Our past approaches to dealing with distressed communities have failed. I detail those in some of my writings on this subject, which I will provide to the committee.

[The writings are being retained in the committee files.]

Mr. PORTER. We need a new paradigm for dealing with the Nation's inner cities, and I think that paradigm must be one that moves away from massive subsidies and uneconomic behavior and toward private sector investment in profitmaking businesses. That is the only way to have a sustained, profitable, and ongoing inner-city economy.

We must build on the competitive advantages of investment in inner-city areas. Advantages like physical proximity to the downtown business districts. Advantages like a large unmet demand in the local community.

In order to create and step up the incentives for such investments, I believe we should take those general tax policy recommendations I made 1 minute ago, but we should move more aggressively to provide incentives for investments in inner-city areas. In particular, I would propose a 100-percent exclusion of long-term capital gains from equity investment in distressed inner-city communities.

The criteria must be the location of the business and the kind of employment in that business. We should not be giving tax incentives to businesses that do not employ local residents.

I would also recommend we provide a 100-percent exclusion of dividends from equity investment in distressed inner-city communities. Many inner-city businesses do not qualify for going public, or the traditional kinds of exit options that venture capitalists use.

I think we need to provide a way to get dividends returned back to those investors to incent these investments. Again, the details of all of this are in my testimony.

I would like to thank you for the opportunity to talk so briefly about these subjects, and I would welcome your questions.

[The prepared statement and attachments follow:]

TESTIMONY OF MICHAEL E. PORTER
HARVARD BUSINESS SCHOOL

My name is Michael E. Porter. I am the C. Roland Christensen Professor of Business Administration at the Harvard Business School where I conduct research on the competitive strategies of companies and on the competitiveness of states and nations. I serve as co-chairman of the Subcouncil on Capital Allocation of the Competitiveness Policy Council, charged with developing concrete recommendations for improving the rate and efficiency of corporate investment in the American economy. I have also led a major research effort on the special problems of investment and economic development in America's inner cities.

The hearings of this Committee could not be more timely and important. The central problem facing the American economy, and the greatest limit on improving the nation's prosperity, is inadequate savings and investment. While there are many causes, the single most important cause of America's inadequate private savings and investment is the nation's tax policies. The Committee has the opportunity to institute reforms which would not only benefit the economy as a whole, but would also significantly speed up investment in our distressed inner city areas.

I will begin by examining the reasons why wages have stagnated in the United States in the recent decade and link wage growth to private sector investment. The rate of U.S. corporate investment has stagnated and declined in the last decade. There are three main causes: inadequate savings, overinvestment in real estate, and policies limiting corporate investment. In each area, tax policy plays a prominent role, and I suggest directions for reform.

Inadequate corporate investment in the nation's inner cities is a particularly pressing item on the national agenda. I describe a new framework for economic development in our nation's distressed communities, based on private sector initiative and the principle of profit. The overall recommendations for tax reform should be taken one step further for distressed areas.

Investment and the Standard of Living

A rising standard of living in the United States depends on the ability to improve productivity in value terms, where value refers to the dollar value of output per worker. Improving productivity in volume terms, or the number of units of standard products produced per worker, benefits company efficiency but will not by itself support rising wages. At the same time, efficiency improvements in making standard products are more easily matched by international competitors or offset with lower wages. America's ability to compete depends critically on improving the value of products and services to command higher prices, not just lowering cost.

But improving the value productivity of existing products and services is not enough. Economic and job growth rely heavily on creating *new* products and entering *new* markets. This leads to new jobs and offsets the reduction in employment that often accompanies productivity growth in established products and services.

To increase the value of existing products, create new products, and enter new markets, firms must invest in *intangible assets* such as research and development, training, and start-up costs of entering new products and markets including costs of establishing brand names and distribution channels. Intangible investments must be financed with *equity capital*, because they provide no collateral and entail higher risk.

Productivity growth in the American economy has been slow in recent decades, resulting in declining real wage income. In the early 1980s, reported productivity growth began to rise significantly in manufacturing, leading many observers to celebrate the return to competitiveness of American industry. The celebration was dampened, however, because real wages continue to languish.

The answer to this apparent puzzle, as shown in **Figures 1 and 2**, lies in the distinction between value and volume productivity. Volume productivity, which is what is reported by the

Bureau of Labor Statistics, has indeed grown more rapidly in non-financial corporations as a whole, and in manufacturing, in the previous decade than before. Historically, as **Figures 1 and 2** illustrate, value and volume productivity tracked each other closely in the U.S. economy. Beginning in 1981, however, value productivity, which is what determines wages, has grown much more slowly. This is true for non-financial corporations and even more true for the manufacturing sector. The reason is that American manufacturing companies have not been able to sustain or improve prices. To say it differently, American manufacturing industry has done a good job in the 1980s and early 1990s of producing standard products more efficiently, but is failing to create higher value product varieties and entirely new products to the degree necessary to support rising wages.

Corporate Investment in the United States

The only way to improve the nation's value productivity and hence prosperity is through sustained investment by the private sector. It should not be surprising, then, that these disturbing trends in corporate productivity reflect a disturbing pattern of declining net investment (investment after depreciation) since the early 1980s. Yet as **Figure 3** shows, net non-residential fixed investment as a percentage of GDP has declined precipitously since 1981. Net non-residential fixed investment in recent years has been less than 2% of GDP. It should not be surprising, then, that economic growth rates in the 3% range raise fears about shortages of capacity. **Figure 4** shows the dramatically greater rate of corporate investment in Japan, the leading competitor to U.S. firms in international markets. These disturbing trends in overall corporate fixed investment apply equally to investment in machinery and equipment.

The United States is also lagging in R&D. At a time when R&D investment is increasingly critical given the knowledge intensity of competition, the United States has been investing at a significantly lower rate than Japan, as shown in **Figure 5**. The U.S. rate of corporate R&D investment as a percentage of GDP has been flat or slightly declining, while in Japan it has increased.

Without a higher rate of investment in new machinery, new capacity, new technology, and new products, the United States cannot enjoy sustained job growth or growth in wages and the standard of living.

Causes of Inadequate Corporate Investment

The causes of inadequate corporate investment in the United States can be divided into three broad categories.

1. Inadequate savings. Members of the Committee have heard a great deal about the problem of government dissavings. Equally serious is the problem of gross private savings, which have declined from about 6% of GDP as late as the early 1980s to about 3% of GDP in 1994 (see **Figure 6**). The Committee has heard extensive testimony about private savings, and the role of tax policy in discouraging it.

Recommendations for Tax Policy. I concur with those who propose the reinstitution of the individual retirement account (IRA) to provide an incentive for savings, until such time as the United States can move to a more consumption-based tax system. Any new IRA, however, should be designed to reflect the fact that feasible saving levels depend on income. Therefore, the minimum contribution to an IRA to begin qualifying for tax deferral *should rise with income*. A person making less than $40,000 a year, for example, should only receive tax deferral for IRA contributions in excess of, for example, $1,000. A person earning an income of $100,000 would have to contribute, for example, $5,000 in taxable contributions before additional contributions were tax deferred. A cap would limit the total amount that could be deferred each year. This would serve to focus the incentive on boosting savings instead of subsidizing savings that would take place irrespective of the incentive.

2. Overinvestment in real estate. While the United States begins with a woefully low level of savings, the problem is compounded by the fact that a huge fraction of the pool of

savings is invested in real estate rather than in industry. As shown in **Figure 7**, net fixed investment in residential real estate accounts for *more than 50%* of the nation's entire private net investment budget. Investments in real estate create some jobs and improve the quality of life, but corporate investment has higher ongoing leverage for economic growth and wages.

The size of real estate investments in the United States is no accident, but the result of a huge array of incentives. Many of these are embedded in the tax system. For example, Federal tax expenditures (tax breaks) directly related to residential real estate in FY 1993 were $81.6 billion per year (note that the table listing tax expenditures was curiously omitted from the FY 1994 and FY 1995 U.S. budgets and must be restored). To put this number in some perspective, the tax expenditures due to expensing of corporate research and development in FY 1993 was less than $2 billion.

Recommendations for Tax Policy. It is time to move towards scaling back the massive subsidies for real estate investment in the United States, especially for more affluent Americans. One place to begin is to cap at $350,000 the combined principal amount of mortgage and home equity loans qualifying for interest expense deductibility, while indexing the cap to inflation. The cap could be phased in over time. Similarly, the tax-free rollover of capital gains in the sale of owner-occupied housing could be capped at a fixed level.

3. Policies limiting corporate investment. Low rates of corporate investment do not just reflect low savings and heavily subsidized competition for savings from real estate. Most corporate investment is funded by internally generated funds, not new savings. Corporate investment in the United States is not constrained by low profitability. Indeed, as shown in **Figure 8**, U.S. industry is among the most profitable of any in the world, and far more profitable than industry in Japan and Germany. This high current profitability implies a higher hurdle rate (required return) on investment than elsewhere and a shorter time horizon.

Consistent with this, American companies have spent tens of billions of dollars buying back their own stock rather than investing. As shown in **Figure 9**, U.S. stock repurchases in 1994 rose to $68.2 billion. Companies buying back stock (more than 990 in 1994) were not merely companies in declining industries but included firms such as Amgen, AMP Inc., Eaton Corp., Columbia/HCA Healthcare Corp., Hewlett-Packard, IBM, Lotus Development, and Merck who compete in rapidly growing industries and enjoy numerous investment opportunities.

In addition to stock repurchases, American industry continues its massive investment in acquisitions. As shown in **Figure 10**, the dollar volume of M&A activity has risen dramatically since 1980, reaching $227 billion in 1994. While acquisitions can be a part of a strategy to create new products and new businesses, much of the investment in acquisitions involves merely a change of ownership of established products and plants. Therefore, acquisition investments make only a modest net contribution to growth in the economy.

The low rate of corporate investment, as well as inefficiencies in the investments that are taking place, result from financial market regulation and tax policy.[1]

Financial Market Regulation. While the U.S. capital markets are efficient in the sense of low transactions costs and rapid processing of public information, the structure of equity ownership and corporate governance reduces the rate, efficiency, and time horizon of investment for established companies. (The U.S. system for funding startups provides major advantages vis-à-vis other nations. The problem arises when companies become profitable and well established.)

The U.S. markets are characterized by an extreme degree of separation between the ultimate *owners* of equity capital, the *investment managers* who choose which companies to invest it in, and the *professional managers* who actually run companies. This separation has

[1] A detailed treatment of the U.S. capital allocation system and its consequences can be found in *Capital Choices: Changing the Way America Invests in Industry*, Council on Competitiveness and Harvard Business School, Washington, DC, 1992. The Subcouncil on Capital Allocation of the Competitiveness Policy Council will be issuing a report detailing specific recommendations to boost the rate and efficiency of investment in the spring of 1995.

widened and shifted dramatically in character with the growth of pension funds and mutual funds over the last several decades. The separation between owners, investment managers, and professional managers is exacerbated by regulation which limits the ability of owners and investment managers to become directly involved in corporate governance.

This separation means that owners, investment managers, and professional managers have widely differing amounts of information about long-run corporate prospects, but all share good information about current profitability. Separation also implies that equity owners must measure the performance of investment managers, and investment managers must do the same for professional managers (who own little stock). Such performance measurement, in the face of limited information about long-term fundamentals, inevitably shortens investment time horizons. Owners measure investment managers based on quarterly and yearly portfolio appreciation. Investment managers, in turn, are under enormous pressure to select companies based on their potential for near-term stock price appreciation, which is most heavily influenced by surprises in current earnings. The net result is pressure on companies to raise current profitability. Companies buy back their stock to prop up share prices that are sensitive to earnings-per-share growth, and are rewarded through price appreciation for taking large write-offs which will make it easier to show growth in next period earnings. Profitability is high, and funds invested by companies are deployed efficiently. Yet companies are not investing enough to sustain product prices, fuel growth, and maintain competitive position in the long run. The massive fall in the value of the dollar, as in the 1970s, has served to mask the international competitive consequences of this set of choices.

These measurement and information problems are exacerbated by the fragmentation of equity ownership, which is partly the result of government regulation. Securities regulation was designed in an era when unsophisticated individuals owned most stock, and has not been modified to reflect the fundamentally different circumstances today. The result is that investment managers own small stakes in many companies, and lack the incentive or ability to develop information about long-term prospects and to take an active role in corporate governance. Yet unlike individual investors, investment managers are motivated to engage in rapid trading based on perceived near-term stock price movements. The average holding period of a share of stock has fallen from about seven years in 1960 to about two years today. This heightens the sensitivity of professional managers to near-term earnings, deters investments with long-term payouts, and encourages acquisitions which produce instant growth in sales and profits. Note that the other nations with capital market structures similar to the United States—the United Kingdom, Canada, and other former British Empire nations—have also been chronic underinvestors in recent decades.

Redressing these problems will require relaxing outdated securities and pension fund regulations, encouraging greater long-term ownership by employees and managers, limiting unnecessary securities litigation, and other steps to be contained in the Report of the Subcouncil on Capital Allocation.

Tax Policy. Tax policy constitutes the other drag on corporate investment. The U.S. tax system, as is well known, is biased against investment except in real estate. What is less well known is that our tax system is biased heavily against equity investment, especially long term equity investment. The U.S. system imposes double taxation of dividends from equity investments while it taxes interest on debt only once. Through taxes on capital gains, it also imposes double taxation of retained earnings (earnings that are reinvested in the business). Capital gains are not indexed for inflation, which creates a bias against investments with a longer term payout and a bias against holding. The net effect of these policies is to dramatically increase the return required on equity investments in companies to produce an acceptable after-tax return to investors. The 1986 tax reform, while seeking to equalize the tax treatment of different forms of income, actually made the bias against long-term equity investment far worse.

These tax policies and the U.S. financial market regulation combine to generate rapid trading, high investment hurdle rates, large equity buybacks, heavy investment in acquisitions, and low investment in fixed assets and R&D by established companies.

Recommendations for Tax Policy. Ideally, the United States would move towards a consumption-based tax system. In the interim, however, the following changes take on critical priority to increase the rate of long-term corporate investment, especially in equity:

- Provide a 50% exclusion for long term capital gains from equity investments in corporations. In order to both reduce the double taxation of retained earnings and lengthen time horizons, the minimum holding period should be at least three years. Alternately, the percentage exclusion should rise with longer holding (e.g., 10% exclusion if held one year, 20% exclusion if held two years; up to a 50% exclusion if held 5 years). The exclusion would not apply to investment in residential real estate, collectibles, bonds, or other forms of assets. To limit the cost of this policy and to avoid windfalls, the exclusion should be prospective, with the holding clock starting with the date of enactment.

- Index capital gains for inflation, using a revised CPI reflecting actual inflation, to further reduce the bias against long-term investment.

- Provide a 50% exclusion for dividends on equity investments in operating companies, to reduce the double taxation of dividends.

Corporate Investment in Inner Cities

These recommendations will increase the overall rate and time horizon of corporate investment in the U.S. economy. However, nowhere is corporate investment more needed than in the nation's distressed inner city areas. Unless we find new approaches, the inner cities will continue to be a drain on the shrinking public coffers. Revitalizing inner cities requires the creation of healthy local economies and jobs, not just meeting social needs. Without the parallel development of jobs, efforts to address social problems cannot be successful, especially in a time of fiscal scarcity.

Past approaches to economic development in inner cities have failed. Real estate development projects, based on the false premise that real estate development would attract industry, have proven disappointing. Huge subsidies to entice firms to locate in inner city areas have not led to sustainable companies and have further drained public funds. My paper *The Competitive Advantage of the Inner City* describes the problems with these and other past approaches, which share a common flaw—they defy economic reality.

Economic reality is this: sustainable economic development in inner cities, or anywhere else, can only result from profitable, private sector investments which do not need ongoing direct subsidies. Profitable investment, in turn, must rest on the competitive advantages of an inner city location compared to elsewhere in the regional economy. The inner city can only produce profitable firms if it can find an economically viable niche based on trade and exchange in the region.

My research suggests four types of potential competitive advantages of an inner city location. These must become the cornerstone of an inner city economic development strategy:

- *physical location*: proximity to downtown business districts, transportation and tourist infrastructure, hospital complexes, and other attractions.

- *local demand*: the ability to serve a large, underserved market in the inner city with distinctive needs.

- *integration with competitive clusters in the regional economy*: the employment and commercial opportunities (buying and selling) arising from the ability to link with centers of excellence in the region.

- *availability of certain types of human resources:* access to a large labor pool of loyal employees suitable for a range of industries and occupations.

The businesses which currently survive and even prosper in inner city areas are those that benefit from these advantages, despite facing numerous obstacles such as security, infrastructure, and regulation. With a concerted strategy, their potential is far greater.

The central goal of government policy toward inner city economic development must be to *enhance the economic value of the inner city as a profitable business location.* In the spirit of federalism, state and municipal governments must identify the competitive advantages and disadvantages of each particular city, and customize a strategy to their particular circumstances. The disadvantages of inner cities today as a place to do business must be eliminated, via programs in training, security, infrastructure, deregulation and the like that reflect an economic strategy rather than structured as social programs. Subsidies will be necessary, but must be directed to improving sites and upgrading business infrastructure rather than propping up firms without true profitability.

The only way to achieve sustainable economic development in inner cities is to mobilize the capital and expertise of the private sector. **Figure 11** summarizes the differences between this approach to economic development in inner cities and the old models that have failed.

Recommendations for Tax Policy. Tax policy has an important role to play in aligning incentives with the goal of sustainable economic development in troubled cities. In particular, tax incentives *based on the premise of profit* can play a vital role in speeding up private investment in inner city areas as part of a broader strategy to improve the inner city as a business location. The same tax biases against equity investment that exist in the economy at large must be eliminated in inner cities, but we need to move more aggressively given the social and economic distress of these communities.

Tax incentives should be based on company or subsidiary location in distressed areas and employment of local residents, *not* the race and gender of business owners. Race- and gender-based programs are subject to manipulation and may fail to benefit inner city residents. Distressed inner city areas can be defined as census tracts where 50% of the households live below 80% of the median income of the surrounding metropolitan area and unemployment is 25% greater than the state average.

Specific tax policy changes should include the following:

- Provide 100% exclusion of long-term capital gains from equity investment in companies or subsidiaries located in distressed inner city areas, provided these firms provide a minimum level of employment of local residents.

  - require a minimum 3-year holding period or exclusion increasing with holding period
  - require a minimum percentage of workforce from the local community (for example, 25%)
  - a business would be defined as a single-unit company or a profit center based in the inner city

- Provide 100% exclusion of corporate dividends from inner city-based companies or subsidiaries with a minimum level of local employment. Many of the businesses that can prosper in inner cities will not be amenable to public offerings and other traditional exit strategies. Fully tax exempt dividends will create a powerful way to provide ongoing return to investors without the need for sale or recapitalization.

  - set rules to ensure that dividends are paid from profits after reasonable compensation and subject to normal transfer pricing rules, to avoid abuses.

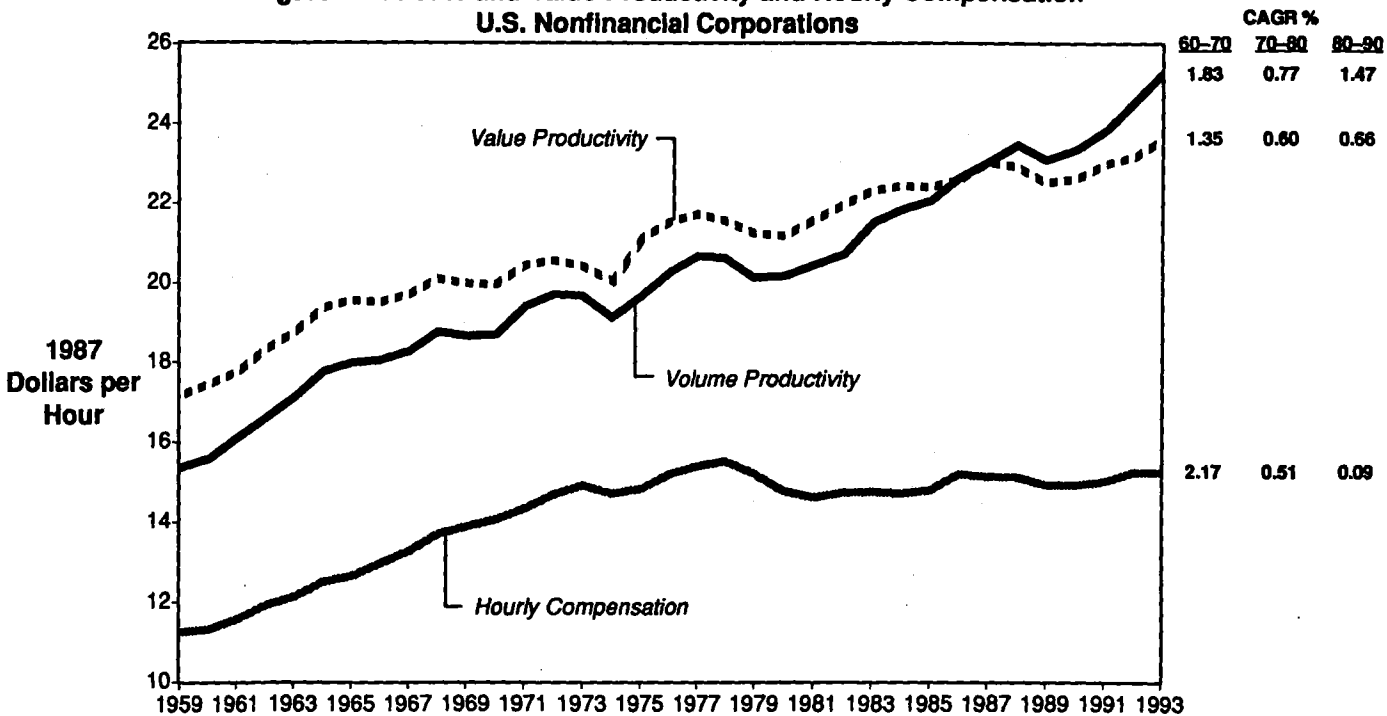
Implementation and oversight of these benefits will be based on the same general principles that govern the tax code generally.

- Use of this incentive will be on a self-certifying basis, subject to audit in the regular IRS cycle. Once qualifying census tracts are defined, businesses would be required to certify that a minimum of 25% of their employees were local residents.

- On audit, businesses would have to prove that dividends paid were from profits, and the recipient of the dividend would have to have received written notification from the company that they were eligible for the exclusion. For publicly traded companies meeting these requirements, the financial institution executing the trade would have to notify the purchaser of eligibility.

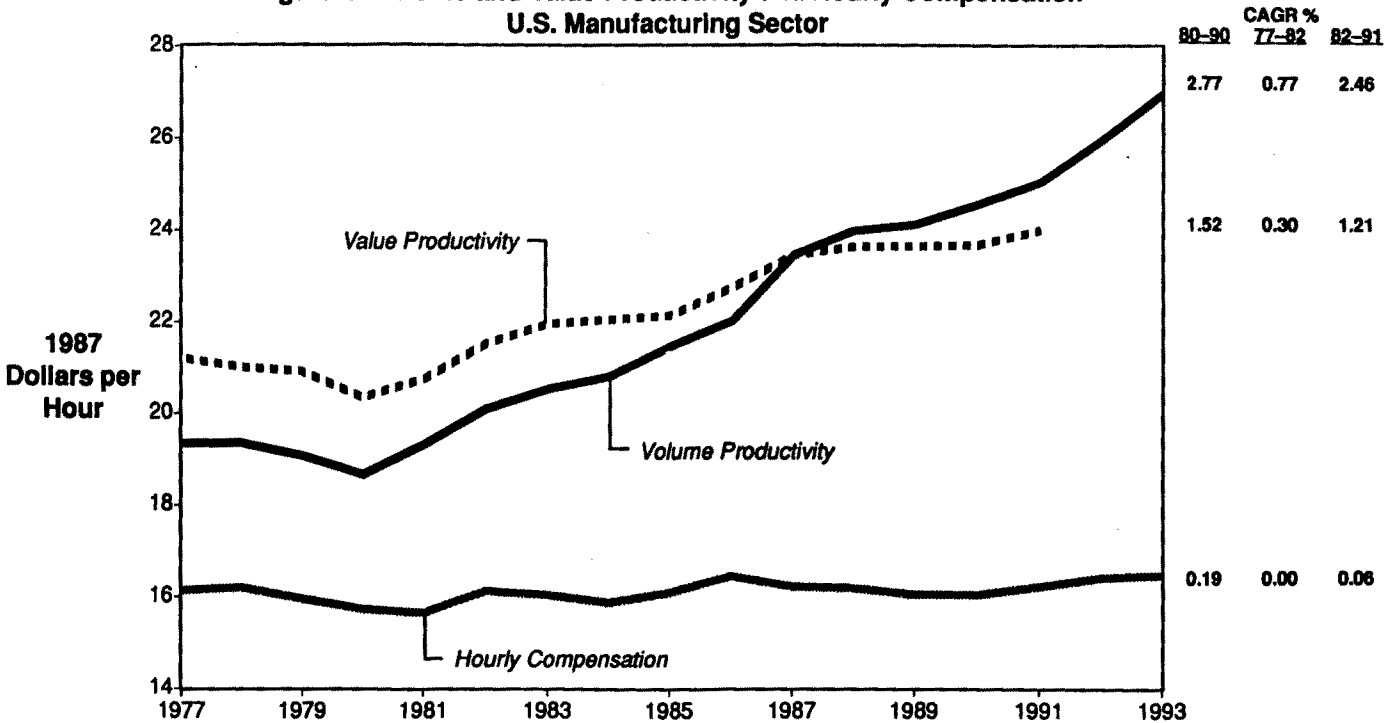
The Committee's commitment to encourage investment through tax reform provides a historic opportunity to develop an urban policy that seeks to restore the economic vitality of our cities by grounding development policy in sound economic theory. From the experience gained from real estate tax policies, we know it can work. Each of these policy changes sends a very clear message that Congress believes in the competitive advantage of the inner city and is willing to invest in creating a sustainable economic base.

Figure 1: Volume and Value Productivity and Hourly Compensation
U.S. Nonfinancial Corporations



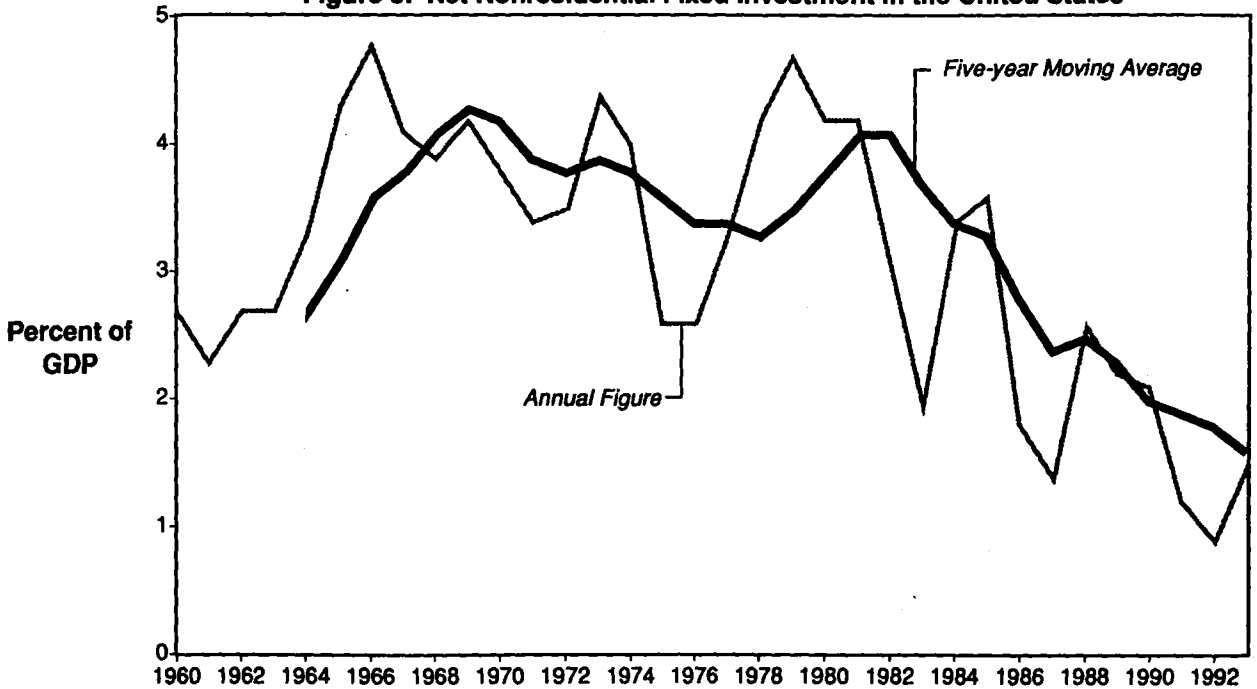
Source: Bureau of Labor Statistics, Author's Calculations

Figure 2: Volume and Value Productivity and Hourly Compensation
U.S. Manufacturing Sector



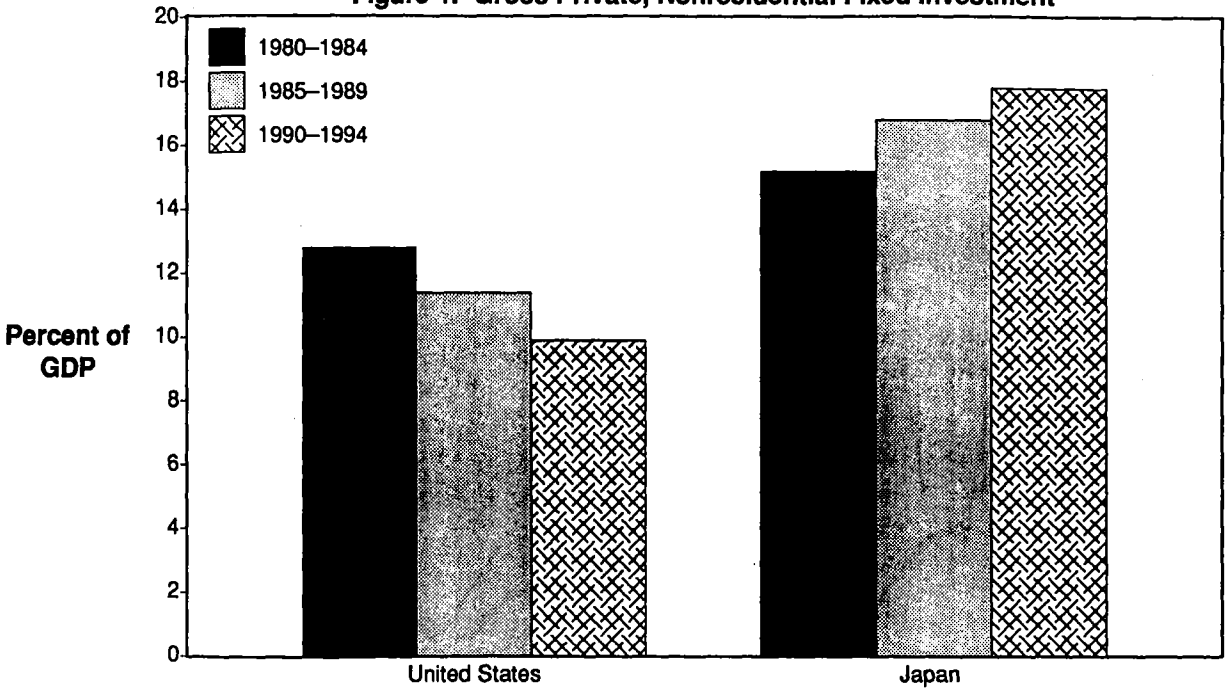
Source: Bureau of Labor Statistics, Author's Calculations

Figure 3: Net Nonresidential Fixed Investment in the United States



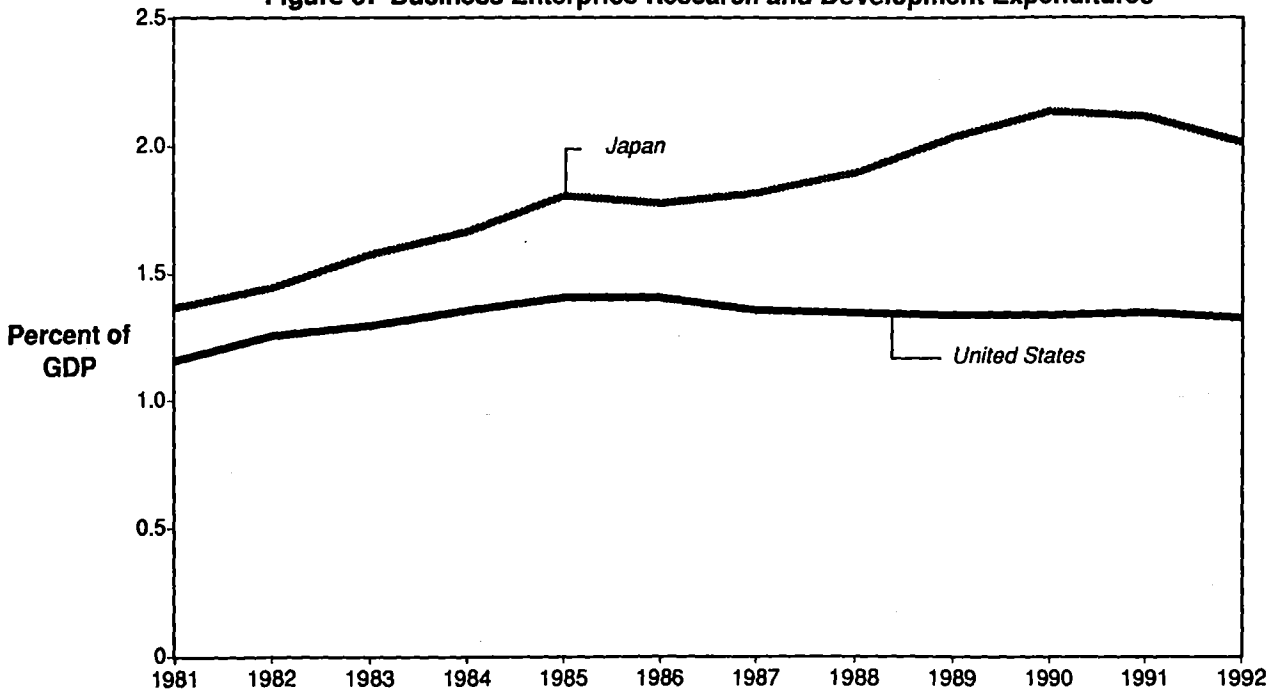
Source: *National Income and Product Accounts, Survey of Current Business*

Figure 4: Gross Private, Nonresidential Fixed Investment



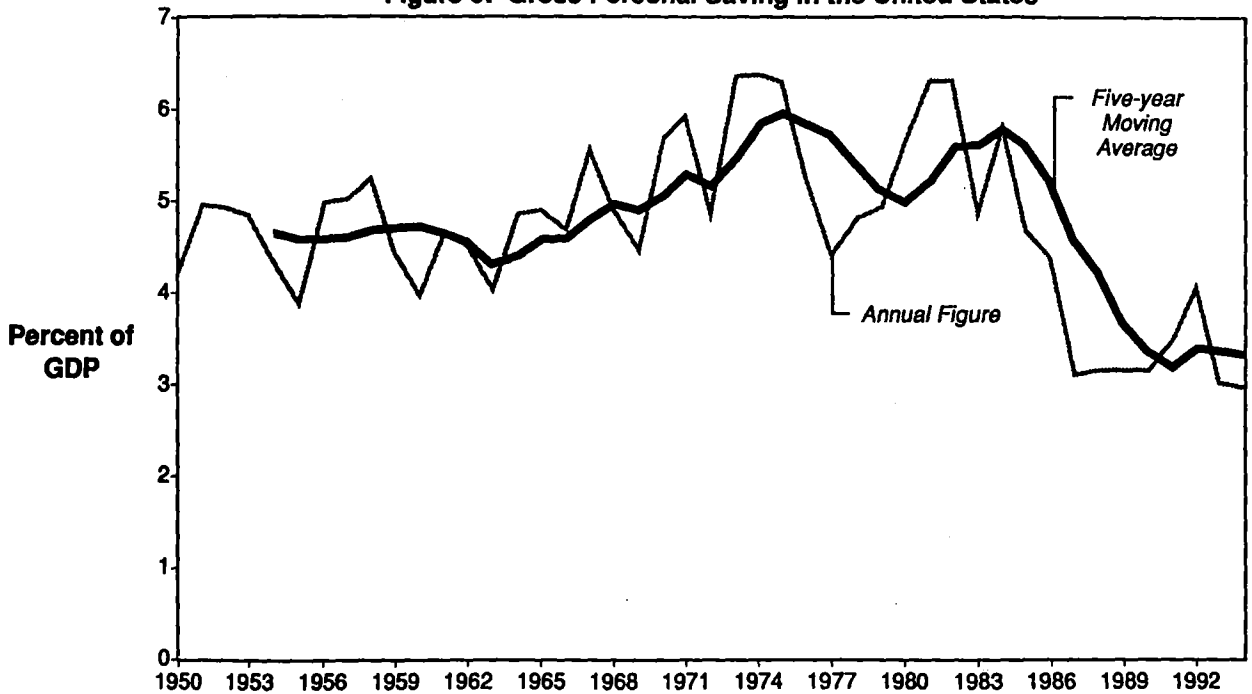
Note: 1994 based on first two or three quarters
Source: OECD Quarterly National Accounts

Figure 5: Business Enterprise Research and Development Expenditures



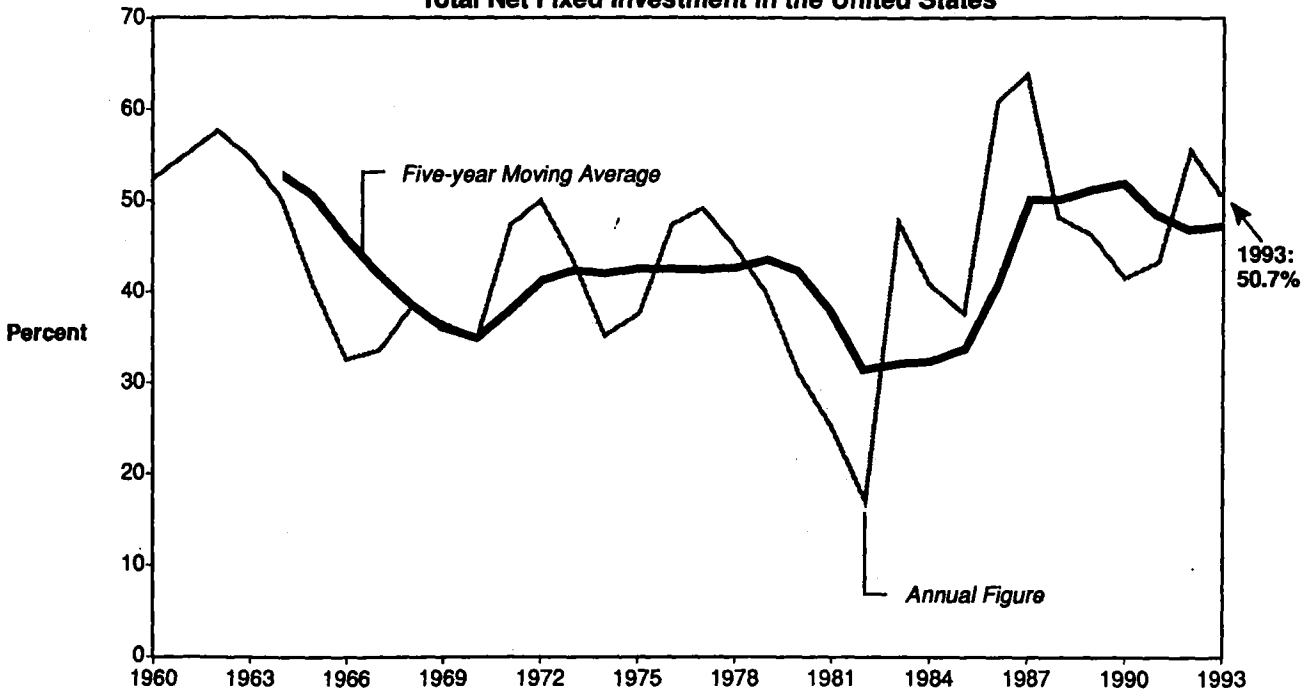
Note: Exclusive of government support. Figures are estimated or adjusted, as necessary, by OECD Secretariat. U.S. data excludes all or most capital expenditures. Japanese figures based on overestimated data.
Source: OECD / EAS (STIU Database), May 1994

Figure 6: Gross Personal Saving in the United States



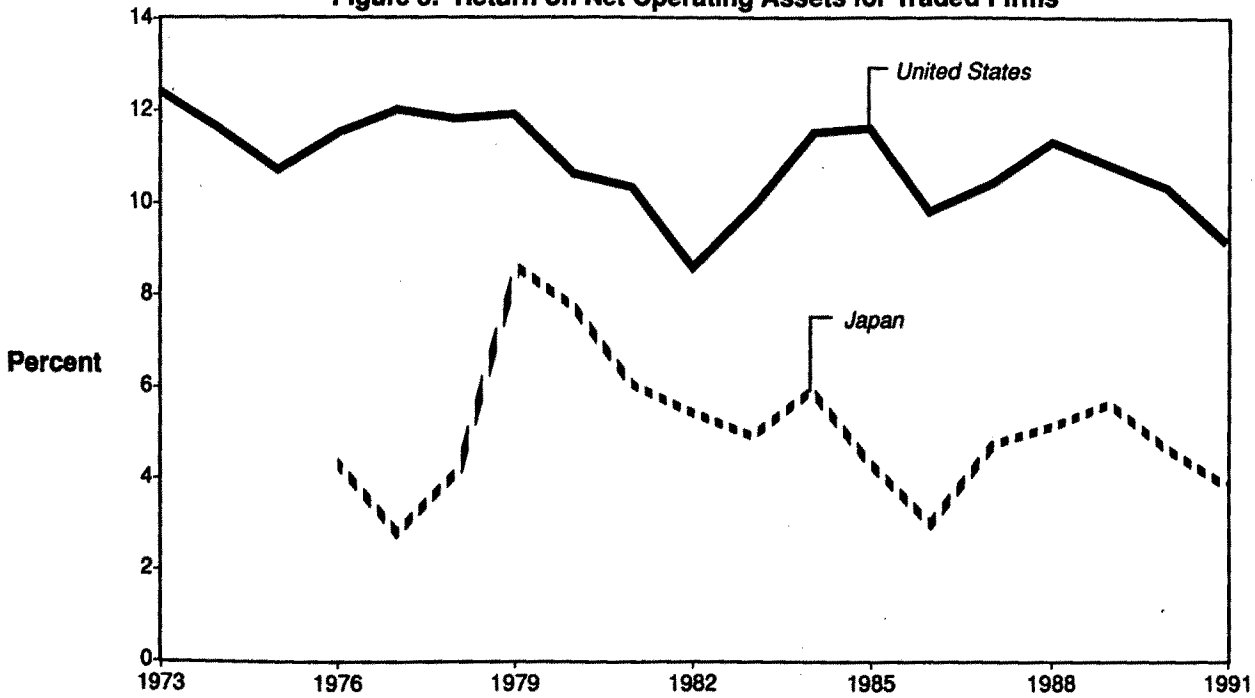
Note: 1994 data based on first three quarters
Source: *Survey of Current Business*, U.S. Department of Commerce

Figure 7: Net Residential Fixed Investment as a Portion of Total Net Fixed Investment in the United States



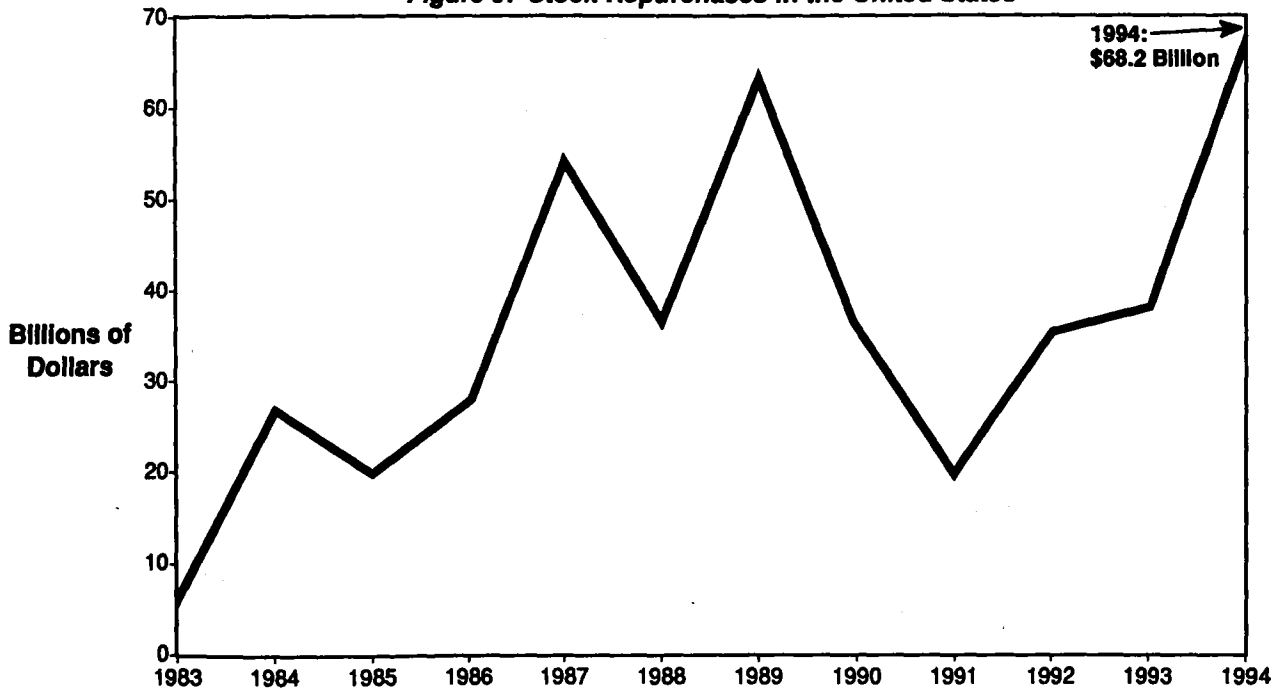
Source: *National Income and Product Accounts, Survey of Current Business*

Figure 8: Return on Net Operating Assets for Traded Firms



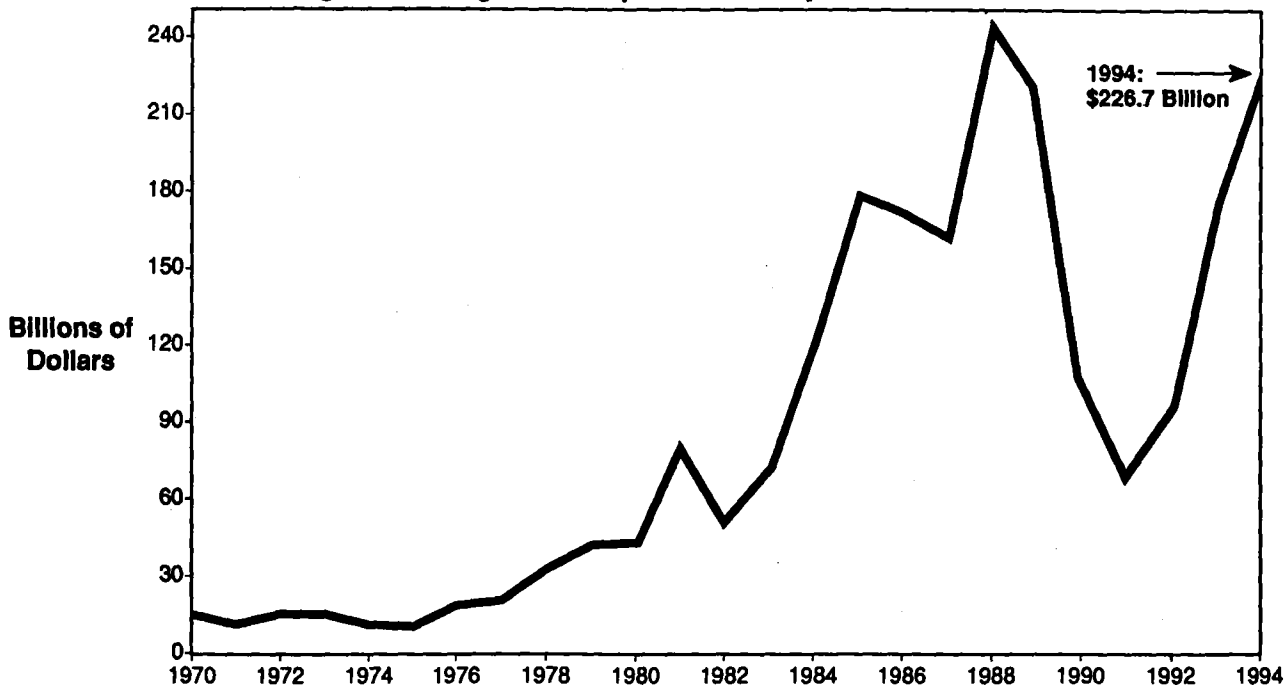
Source: Hatsopoulos and Poterba, "America's Investment Shortfall: Probable Causes and Possible Fixes"

Figure 9: Stock Repurchases in the United States



Source: Securities Data Company

Figure 10: Merger and Acquisition Activity: Total Dollar Value Offered



Note: Includes all transactions involving at least one U.S. firm
Source: Merrill Lynch Mergerstat Review

Figure 11 New Model of Inner City Economic Development

New Model	Old Model
• Economic	• Social
• Private sector	• Government, social service organizations
• Genuinely profitable businesses	• Businesses based on subsidies or mandates
• Inner city as an integral part of the regional economy	• Inner city as an isolated economy
• "Export"-oriented businesses	• Companies serving only the local community
• Engage skilled and experienced minorities in wealth creation	• Social service motivation
• Engage mainstream, private sector institutions	• Create new institutions
• Address inner city disadvantages directly	• Subsidies to counterbalance disadvantages
• Government focused on improving the environment for business	• Government directly involved in providing services or funding

Chairman ARCHER. Thank you, Mr. Porter.

Our next witness is Deborah Walker, representing the American Institute of CPAs.

Welcome. You may proceed.

STATEMENT OF DEBORAH WALKER, CHAIR, TAX DIVISION, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, WASHINGTON, D.C.

Ms. DEBORAH WALKER. Thank you, Mr. Chairman and members of this distinguished committee.

I am Deborah Walker, chair of the AICPA tax division, the national, professional organization for certified public accountants. We have more than 320,000 members who advise clients on international, Federal, State and local tax matters and prepare income and other tax returns for millions of Americans.

Our technical policy comments are based on our evaluation of a proposal's complexity, administrability, likelihood of compliance and fairness. As much as we favor simplifying the Tax Code, we realize that simplification cannot always be the overriding criteria.

In some cases, from our base of experience with taxpayers and how laws affect their behavior, we are able, I believe, to comment on the economic or social aspects of the proposal.

The AICPA stands for the proposition that America deserves a more understandable and a simpler tax system that facilitates voluntary compliance. We believe that the present law is unnecessarily complex and, in many cases, difficult to administer and that such complexity fosters noncompliance and lack of trust with the tax system.

The AICPA supports the reinstatement of tax relief for net long-term capital gains. Taxpayers do take tax consequences into account in making their business decisions, and reducing the tax on capital gains will unlock for more productive uses a significant amount of capital that otherwise may stay held in its present form until death. A lower capital gains rate will increase Americans' willingness to save and invest.

However, the AICPA opposes the rules for indexing assets for purposes of determining gain or loss because they are much too complex, they treat different assets differently, and they provide great opportunities for abuse. You need to understand we are not against indexing. Rather, we are against these provisions for indexing.

We do not believe the advantages of this limited indexation provision sufficiently outweighs the creation of added complexity and enhanced opportunities for tax arbitrage. The use of debt will create the greatest opportunity for abuse. The combination of the 50-percent capital gains deduction and indexing of asset basis can result in a negative tax rate. By failing to require indexation of debt and allowing a deduction for interest payments, the negative rate is increased.

Consequently, if this is enacted, tax advisers will doubtlessly urge their clients to borrow as much as possible to acquire capital assets. By allowing a full deduction for interest, which includes an inflation component against investment income, and indexing the basis of assets for determining gain, the tax system gives two de-

ductions for the same inflation. This means that the more debt that is assumed the greater a taxpayer's rate of return. With this provision enacted, tax planners and investment advisers will have the next great tax shelter for their clients.

A simpler way to eliminate income taxes on inflation and avoid this abuse and possible tax shelter creation would be to increase the deduction allowable for long-term capital gains based on the holding periods of the assets. For example, if assets are held from 1 to 3 years, you could have a capital gains deduction of 50 percent. If assets are held for 3 to 5 years, the capital gains deduction would be greater. If assets are held for longer than 5 years, the capital gains deduction would be still greater.

The neutral cost recovery system in the proposed legislation likewise creates unacceptable complexity for the benefits sought. The difficulty of analyzing whether to elect the system or remain on the present system, as well as the tremendous compliance and administrative burdens, strongly suggests an alternative approach.

The AICPA recommends dealing with the inflationary aspects of business property through a substantially broadened expensing provision under code section 179.

We strongly support the efforts to simplify revenue laws and reduce the overall burdens caused by excess government regulation. However, we urge that the Internal Revenue Service and the Treasury Department be excepted from the requirements that would impair the timely issuance of tax regulations.

Because of the complex nature of the code, taxpayers are unable to comply with the law without guidance provided by regulations in many cases. The Tax Code is subject to different interpretations by the IRS and taxpayers, and the absence of regulations increases the likelihood and volume of tax litigation, increasing tax compliance costs.

Many taxpayers we work with prefer the certainty of regulations to the uncertainty of arguing with the Internal Revenue Service over varying interpretations. It is for these reasons that tax regulations are important.

While the AICPA supports the social objectives of the family tax credit and elimination of the marriage penalty, we cannot support these provisions because they basically add another layer of complexity for individuals complying with the tax system. Tax relief for these objectives could be accomplished more simply by a change in the standard deduction or a change in the exemption. In the case of a marriage penalty, the two-earner deduction may be more appropriate.

Finally, the AICPA supports the establishment of the American dream savings account because it expands retirement savings options. It has the advantage of taxing individuals when they can afford it most, during their working years, and not creating an additional tax burden when they can afford it least. Also, taxpayers are likely to place amounts in retirement funds if they know that such funds are available without undo tax burden during times of financial needs.

While we support the American dream savings account provisions, we cannot support the conversion of existing retirement sav-

ings assets to these accounts because this does not significantly increase savings.

And, finally, there are a number of technical tax provisions which we have detailed in our written comments on all of these provisions which I would like included in the record. I don't have time to cover them this morning.

Thank you for your attention.

[The prepared statement follows:]

TESTIMONY OF DEBORAH WALKER
AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Mr. Chairman, and members of this distinguished committee:

I am Deborah Walker, chair of the Tax Division of the American Institute of Certified Public Accountants (AICPA). The AICPA is the national, professional organization of certified public accountants comprised of more than 320,000 members who advise clients on federal, state and international tax matters as well as prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-size businesses, as well as America's major businesses, including multi-national corporations. Many serve businesses as employees. It is from this base of experience that we offer our comments on the tax proposals contained in the *Contract with America*.

In many parts of the following testimony, we do not comment on the economic or social policy aspects of the proposals but rather restrict ourselves to comments on technical tax considerations and whether the proposal is likely to achieve its objective. In other cases, from our base of experience with taxpayers and how tax laws affect their behavior, our comments may also be based on our view of sound economic or social policy.

Our technical policy comments are based on our evaluation of a proposal's complexity, administrability, likelihood of compliance, and fairness to the taxpayers that are intended to be covered by the provision. As much as we favor simplifying the tax code, we recognize that simplicity cannot always be the overriding criterion.

In our experience, complexity discourage compliance. It can also create unfairness because it can result in otherwise identically situated taxpayers being treated differently solely because of differences in their tax adviser's knowledge.

The AICPA stands for the proposition that America deserves a more understandable and a simpler tax system that encourages and facilitates voluntary compliance. We believe that the present law is unnecessarily complex and in many cases difficult to administer, and that such complexity fosters noncompliance and lack of trust in the tax system. Accordingly, even when we disagree with the methodology for achieving some of the proposed changes to tax law, we have tried to suggest simpler alternatives for accomplishing the objectives. We encourage the Committee, as they progress in their deliberations, to seek information from the Internal Revenue Service regarding the administrability of specific proposals. In addition, the AICPA offers to work with the Committee in any way to ensure that the proposed legislation is workable and will achieve the desired goals.

H.R. 9 - JOB CREATION AND WAGE ENHANCEMENT ACT

Introduction

H.R. 9 significantly revises the tax treatment of capital assets and business property. In our view, the combination of a 50 percent capital gains deduction and indexation of cost basis results in an interplay of new rules that would be incomprehensible to most taxpayers. The Neutral Cost Recovery System (NCRS) likewise creates unacceptable complexity for the benefits sought.

We believe there is a simpler approach that would accomplish most of what is being proposed. We support the capital gain deduction, but suggest it be broadened based on holding period. By allowing a base deduction percentage (say, 50 percent) for assets held from one to three years, a larger percentage deduction for those held three to six years, and a yet larger percentage deduction for assets held over six years, the anti-inflationary aspects of indexing can be approximated. Similarly, as an alternative to NCRS, we recommend a broadening of the present Code section 179 rules, allowing taxpayers greater leeway in deducting currently the cost of depreciable business property.

Sec. 1001. 50 Percent Capital Gains Deduction.

The AICPA supports the reinstatement of tax relief for net long-term capital gains. Taxpayers do take tax consequences into account in making their everyday business and investment decisions. Our members see this every day in working with clients. Many taxpayers decide not to devote their capital to what they believe would be the most productive uses because to do so would first require paying income taxes on the gain and inflation inherent in their current investments. We, therefore, believe that reducing taxes on capital gains will "unlock," for more productive uses, a significant

amount of capital that would otherwise be held in its present form until the owner's death. A lower capital gains tax rate will increase Americans' (including middle-income taxpayers) willingness to save and invest.

As an organization that has consistently spoken out for simpler approaches to taxation, we are mindful of the concern that reinstating a 50 percent capital gain deduction will restore complexity to the Internal Revenue Code. We do not believe it will. In this regard, it is instructive to note that, in 1986, when net capital gains were subjected to the same tax rates as ordinary income, the complex statutory provisions dealing with such gains were left in the Code "to facilitate reinstatement of a long-term capital gains rate differential if there is a future tax rate increase" (1986 Tax Reform Act Bluebook, p. 179). Even though it eliminated the capital gain deduction, Congress recognized the likelihood that some differing treatment of capital gains would subsequently be reinstated.

Indeed, the real complexity comes from any differentiation in treatment of ordinary income versus capital gain, and the necessary body of law regarding characterization of income as capital or ordinary. Present law taxes capital gains at a maximum rate of 28 percent, rather than the highest ordinary rate or 39.6 percent. Thus, the complexity that results from differing treatment exists under current law and reinstating a 50 percent deduction does not measurably add to complexity.

We have one comment on the effective date of this provision. Since all gains recognized after 1994 would get the benefit of the new deduction, current and future proceeds from pre-1995 installment sales will receive an unbargained-for benefit. However, when capital gain and ordinary income rates were set at the same level, in the 1986 Tax Reform Act, post-1986 gains from earlier year installment sales were subject to an unbargained-for added tax cost (since they lost their 50 percent deduction for amounts received after 1986). The proposed effective date provides "rough justice," and would certainly be simpler than having to maintain two regimes (this proposal and prior law) until all installment sale proceeds from pre-1995 transactions had been recovered.

Sec. 1002. Indexing of Certain Assets for Purposes of Determining Gain or Loss.

The AICPA opposes this provision because it is much too complex, it treats different types of assets differently and it provides opportunities for abuse. AICPA Statement of Tax Policy 9, *Implementing Indexation of the Tax Laws* (1981), recommended that Internal Revenue Code provisions be indexed (generally including asset bases) to minimize the impact of inflation on the tax system. The proposed legislation comports in theory with our prior recommendation, but is significantly more complex and selective in its application. Further, we do not believe it deals adequately with the issue of debt.

The proposal requires taxpayers to use the gross domestic product (GDP) deflator. This number is currently published only quarterly and released after or close to the date estimated tax payments are due for some quarters. The use of quarterly GDP deflators would add another level of complexity and uncertainty for taxpayers required to compute estimated taxes for any quarter. Taxpayers need an annual index, available before the beginning of the year.

Also, for many items (such as a personal residence with subsequent improvements, stocks other than mutual funds with a dividend reinvestment plan), indexing would be difficult because many tax records are currently maintained on an annual basis. Even if records were maintained on a quarterly basis, the sale of such property would require numerous indexation calculations to determine the proper taxable gain or loss.

Furthermore, the fact that property such as options would not be indexed could result in substantial differences in their tax treatment vis-a-vis that of underlying stock, while no substantial difference in economics exists--particularly with respect to long-term options. In an S corporation, the provision specifying that S corporation stock would not be indexed while the assets it holds would be indexed, could result in significant potential differences between outside basis and inside basis in the corporation.

We do not believe the advantages of this limited indexation sufficiently outweigh the creation of added complexity and enhanced opportunities to engage in tax engineering and tax arbitrage transactions. The use of debt will create the greatest opportunity for abuse. Even as proposed, for assets with relatively short holding periods (1-2 years), the combination of the 50 percent capital gain

deduction and the indexing of asset basis can - combined with deducting interest on debt assumed to pay for the asset - result in a negative tax rate. In addition, however, by failing to require indexation of the debt or the interest payments, the negative rate is increased. Consequently, tax advisors will doubtless urge clients to borrow as much as possible to acquire those assets. The current return on the capital can be sheltered by the interest deduction on the debt, the sale of the asset will produce a significantly smaller capital gain due to indexing the cost of the asset, and the debt will be repaid at the asset's sale in the same nominal dollar amount as originally incurred - but with dollars that are worth substantially less than they were when the debt was acquired. By allowing a full deduction for interest which includes an inflation component against investment income, and by indexing the basis of assets for determining gain, the tax system gives two deductions for the same inflation factor. This means that the more debt that is assumed, the greater a taxpayer's rate of return on the investment can be.

Assume, for example, that a taxpayer buys stock for $1,000 with a note charging 8 percent interest. Assume further that inflation is 5 percent during the year and the property appreciates 10 percent before sale. With a 50 percent capital gain deduction, the 10 percent before-tax gain is really an 8 percent after-tax gain (assuming a 40 percent ordinary income tax rate). With indexation, the after-tax gain increases to 9 percent. If the interest expense deduction is included in the rate of return, that rate increases to 12.2 percent. The taxpayer has realized a tax benefit for deducting the inflation element of interest expense and adjusted taxable gain for the inflation element of the appreciation, as well as taxing the gain at a more favorable rate.

We are mindful of the language of proposed Code section 1022(h) that a transfer of cash (among other things) from one person to another with a principal purpose of securing an indexation adjustment will allow the Secretary to disallow that adjustment. If subsection (h) is intended to "solve" the debt arbitrage problem, we would caution you that the tracing problems inherent in such a solution will likely be a nightmare. As practitioners, we have had to work with the tracing rules required as a result of some of the changes to the interest deduction rules in the 1986 Tax Reform Act, and we can tell you they provide no easy - and no certain - answers. You might wish to obtain Internal Revenue Service input, as to the ease of working with tracing requirements from their perspective.

A much simpler way to eliminate income taxes on inflation would be to increase the deduction allowable for long-term capital gains based on holding period. For example, a smaller deduction could be provided for net capital gains recognized on assets held more than one year, but less than three years (the proposed 50 percent), with a larger deduction for those held from three to five years, and the largest deduction provided for those held longer than five years. The percentages could be set at any amount Congress deems appropriate. Such a system, with one overall approach for net capital gains, would be much simpler for taxpayers to use.

Sec. 1003. Capital Loss Deduction Allowed with Respect to Sale or Exchange of Principal Residence.

The AICPA supports the policy of allowing capital loss treatment on sale of a principal residence, but believes it should be available for use only against gains on sales of other principal residences. Traditionally, in this country, sales of personal assets at a loss have provided no tax benefit at all, and we understand the case for continuing this treatment. Still, for a very large number of Americans, a home is viewed both as a personal asset and as the biggest investment many taxpayers will ever make. The fact that home ownership has traditionally been encouraged in our tax laws (Code sections 121, 163, 1034) gives added credence to a desire (particularly given the economics of real estate over the past decade) to ameliorate actual or potential economic losses of today's homeowners.

We believe, however, that the proposal goes too far, and needs to be somewhat restricted. It would leave in place the special treatment allowing total deferral of a gain on sale of a principal residence where sales proceeds from the old home are reinvested (within the statutory time) in a new residence, and would also leave in place the absolute exclusion of $125,000 gain for older taxpayers selling their principal residences. A capital loss on the sale of a principal residence would be subject to the regular capital loss rules - no more that $3,000 deducted against ordinary income in a year, and that $3,000 representing $6,000 of the capital loss. These losses will, to the extent possible, be used to shelter other capital gains having nothing to do with home ownership and up to $3,000 of ordinary income.

Thus, for example, we would expect to see many taxpayers utilizing these losses to obtain a "free" step-up in basis for other capital assets they hold, by selling stocks at a gain (a reduced gain, too, thanks to the indexation of basis) and buying them back at current higher prices for no economic cost except the brokerage commissions.

Accordingly, we would recommend that such capital losses be treated consistently with gain on a principal residence and be available only to offset future (or past) gains on sales of principal residences. Where taxpayers have had to reduce the basis of a residence to obtain a tax-free rollover under Code section 1034, a loss on sale of a principal residence could be added to the basis of the next residence acquired.

Sec. 2001. Depreciation Adjustment for Certain Property Placed in Service after December 31, 1994.

The AICPA opposes the Neutral Cost Recovery System (NCRS) because of its complexity and recommends dealing with the inflationary aspects of business property through substantially broadened expensing under Code section 179. The difficulty of analyzing whether to elect NCRS under proposed Code section 168(k) or to remain on the present system (including indexation of basis, should that remain in the new law), as well as the tremendous compliance and administrative complexity of this provision, strongly suggests an alternative approach.

AICPA Tax Policy Statement No. 7, *Analysis of Capital Cost Recovery Proposals* (1980), notes that "in periods of inflation, the simplest and most effective hedge against investment erosion caused by inflation is immediate write-off of capital investment, so that the tax benefits of invested funds are available immediately for further investment. A second hedge is indexation, so that cost recovery is geared to inflation adjusted cost rather than historical cost." Proposed Code section 168(k), providing both indexing and an opportunity cost allowance (the 3.5 percent factor for assets with recovery periods of up to 10 years), would substantially neutralize the tax factor in capital budget decisions.

Tax neutralization, however, comes at the cost of adding great complexity to the Code and to the capital budgeting decision process. At a minimum, every eligible purchase of assets eligible for 200 percent declining balance depreciation will require a decision, even if by default, whether to use the indexing system or to elect out of it. Such a decision would involve analysis reflecting the requirement to use 150 percent, rather than 200 percent, declining balance depreciation, the additional deduction created by the 3.5 percent factor and an assumption as to inflation. The present value effect of these deductions will vary, of course, depending on a given taxpayer's assumed rate of return and future tax rates. This promise of future income tax benefits may be further discounted by taxpayers who remember the rapid reduction in 1986 of the tax benefits conferred on depreciable assets by the 1981 tax act, especially if the cost indexing provisions of section 1002 remain in the new law. The election not to have the new provision apply can be made on a property by property basis necessitating individual calculations for each acquisition.

Confusion is compounded when the asset is sold or otherwise disposed of. The original cost of the asset is reduced under Code section 1016 only by the unadjusted depreciation deductions allowable, but not below zero. For those assets not depreciated under proposed Code section 168(k), proposed Code section 1022(c) provides that the adjusted basis at the time of disposition is indexed for inflation in calculating gain. Comparing the consequences at some hypothetical future disposition will be part of the analysis to be made when deciding whether to use proposed Code section 168(k) or to elect out of it.

From a simplification standpoint, these provisions should not be enacted. The new depreciation system in section 2001 would significantly change computerization needs, as well as tax accounting for tangible property. It appears intended to allow the same benefit as full expensing, but with a much more complicated implementation presumably due to revenue constraints.

A much simpler alternative approach would be to raise the Code section 179 expense amount (currently $17,500, and proposed to go to $25,000) up to say, $50,000 without any phase-out. Another option is to consider an open-ended (or mass asset) account system for depreciation, where there is one account for each recovery period for personal property.

Secs. 7001-7009. Regulatory Impact Analysis.

We strongly support efforts to simplify the revenue laws and to reduce the overall burdens caused by excessive government regulation. However, we urge that the Internal Revenue Service and Treasury Department be excepted from the requirements imposed by this title. We believe the reach of Title VII would impair the timely issuance of tax regulations, which are imperative to the administration of the internal revenue laws.

Under Title VII, Regulatory Impact Analyses, significant additional analyses would be required for any regulatory action that would affect more than 100 persons. Thus, these proposals would, de facto, affect all tax regulations in a manner which we believe would be tantamount to a moratorium on their issuance. This would seriously exacerbate compliance problems which arise from the complexity of our tax statutes. The Internal Revenue Code is not self-governing legislation; it is highly complex in concept and articulation, and in all too many places it specifically leaves to the Treasury Department the responsibility of implementing conceptual rules through regulation.

As Internal Revenue Commissioner Margaret Richardson recently stated: "A significant part of [this country's] noncompliance problem can be attributed to the complexity of the tax code itself, and frequent changes in the tax law." We could not agree more. Because of the complex nature of many areas of the Code, taxpayers are unable to comply with the law without the guidance provided by regulations. Further, those same regulations also set forth binding rules on examining revenue agents and other IRS personnel, giving taxpayers the basis for challenging positions taken by the IRS on examination and in the courts. Because the tax code is subject to different interpretations by the IRS and taxpayers, the absence of regulations will seriously increase the likelihood and volume of tax litigation, increasing significantly the cost of compliance.

Regulations do not always burden citizens. They can be pro-taxpayer or can simplify what the statute has initially made complex. We certainly do not always agree with the positions taken in tax regulations, but we recognize that without them the complexity of the law would leave both the taxpaying public and government agencies unable to apply and administer many provisions with certainty. Many taxpayers prefer the certainty of regulations to the uncertainty of arguing with the Internal Revenue Service over varying interpretations of certain provisions.

Congress is seriously considering making major changes to the Internal Revenue Code this year. Some of them are of unbelievable complexity (look, for example, at the statutory language indexing the tax cost of capital assets, or the provisions intended to alleviate the marriage penalty). The need for regulations, on an expedited basis, would never be greater than the day after these (and many other) tax provisions in the *Contract with America* were enacted.

It probably sounds strange to hear that the private sector would generally welcome regulatory action by the Internal Revenue Service and the Treasury Department. Consider, however, that organizations like the American Bar Association Tax Section, New York State Bar Association, the Tax Executives Institute, and the AICPA - all of whom would seem to have reason to cheer a slowdown in the regulatory process - have asked this Congress to allow the present tax regulation process to continue. We hope you will take all these requests most seriously.

Sec. 12001. Increase in Unified Estate and Gift Tax Credits.

The AICPA supports this provision and recommends that Congress increase the unified credit to bring it in line with the intentions as set forth in 1981--to establish an exemption equivalent that would allow middle class Americans to freely pass property to their children. Furthermore, after the unified credit has been increased to nullify the effect of seven years of inflation, the AICPA supports provisions which index the unified credit to prevent the middle-class from being subject to additional estate tax due only to inflation.

The 1981 *Economic Recovery Tax Act* increased the unified credit, over a six-year period, to its present exemption equivalent amount of $600,000. In 1987, this amount was fully phased in but seven years of inflation have eroded this figure. The unified credit will now only protect $475,000 of property as measured in 1987 dollars. Surprisingly, this erosion has occurred in a period of relatively low inflation. This type of erosion particularly hurt the middle class and many family

business owners. As a result, there are many middle-income individuals who find themselves subject to an estate tax that was meant to apply to the wealthy. If the unified credit were adjusted for inflation since 1987, the exemption equivalent would be at least $750,000.

Sec. 12002. Increase in Expense Treatment for Small Business.

The AICPA supports the proposed legislation, but would like to see the adjustment expanded. Attention needs to be paid to the phaseout rules currently in the code. Under today's law, businesses investing over $217,500 cannot take advantage of expensing at all. While that number would go to $225,000 if this section is enacted, the cost of sophisticated equipment is frequently far in excess of $225,000, thereby making this small business incentive for capital expenditure irrelevant for many taxpayers. H.R. 9 would not index this amount, and it would be a very small business indeed that could benefit from the proposal. The AICPA believes this deduction should be allowed in full regardless of the capital expenditures made.

Sec. 12003. Clarification of Definition of Principal Place of Business.

The AICPA supports this proposal, which would modify the U.S. Supreme Court *Soliman* decision, in deference to today's working environment and lifestyles. The proposal clarifies the definition of principal place of business. It allows for the home office to be used for essential administrative or management activities conducted on a regular and systematic basis, where no other office space is provided for such activities.

The technological advances of the past twenty years have alleviated the need for hiring many support personnel and for coming in personal contact with colleagues on a day-to-day basis. As a result, many taxpayers have found it advantageous to work from their homes. Home offices are utilized by sole proprietors, and owners of small businesses operating in partnership and corporate form. In addition, many businesses have found it necessary to promote flexible and alternative work schedules for their employees, balancing work and family issues. As a result many of these employees have set aside a separate area of their homes to accommodate their business needs.

H.R. 8 - SENIOR CITIZENS' EQUITY ACT

Sec. 201. Repeal of Increase in Tax on Social Security Benefits.

The AICPA supports the rollback of tax on Social Security benefits but recommends the outright repeal of Code section 86 (a)(2). This proposal, which would phase-out the repeal of Code section 86(a)(2), creates unnecessary complexity for individuals.

Sec. 301. Treatment of Long-Term Care Insurance or Plans and Sec. 302. Exclusion for Benefits Provided Under Long-Term Care Insurance; Exclusion for Employer-Provided Coverage.

The AICPA supports these provisions, but recommends that certain issues be addressed Consideration should be given to expanding the provisions to provide benefits and coverage to self-insured employer plans. If an employer self-insures long term care benefits, the tax treatment for employees should not differ.

As a matter of statutory construction, the $200 daily exclusion from income under proposed Code section 818A(e) will be completely missed by most taxpayers and practitioners. At a minimum, a reference to this provision needs to be included in section 137, the cross-reference found in the portion of the Code where income exclusions are enumerated.

While it is clear that the continuation coverage rules do not apply and we do not recommend that this be changed, we do believe that these policies should be completely portable irrespective of employment statutes. In addition, much of this statute refers to individuals but does not consider group or family policies. The statute should consider both individual and family/group policies a likely outgrowth of this legislation as the market for long-term care insurance expands.

Sec. 302. Exclusion for Benefits Provided Under Long-Term Care Insurance for Employer-Provided Coverage.

The AICPA supports this provision which treats premiums for and proceeds from long-term care insurance like other health insurance premiums and proceeds, thus providing parity between long-term care insurance proceeds and other insurance contracts payable on account of sickness or injury. While we understand the need to limit premiums excluded from income based on tax benefits, this will require valuation of the total benefit and possibly an adjustment for the exclusion. It would be more efficient for the tax exclusion for premiums to be based on the premium cost and not the benefits paid.

Sec. 303. Qualified Long-Term Services Treated as Medical Care.

The AICPA supports the adoption of this provision. However, it should provide that the change is not intended to affect the deductibility of items currently allowed under Code section 213(d)(1)(A).

Because the insurance premium deductible by an individual is combined with all other qualifying medical expenses, it is subject to the 7.5 percent of adjusted gross income limitation. Thus, no individual premium limitation based on age is necessary.

Sec. 305. Exclusion from Gross Income for Amounts Withdrawn from Individual Retirement Plans or 401(k) Plans for Long-Term Care Insurance.

The AICPA supports this provision but suggests the need for the clarification of the reporting and withholding requirements by the plan administrator or IRA custodian to take into account the nontaxable nature of these distributions. Furthermore, the AICPA recommends that this exclusion be expanded to all salary deferral retirement plans, such as Code section 403(b) plans.

Sec. 306. Tax Treatment of Accelerated Death Benefits Under Life Insurance Contracts.

We support this proposal and suggest some restrictions on the distribution of the proceeds and consistent treatment of viatical arrangements (contracts for the sale of life insurance policies to third parties where a terminally or chronically ill person has no accelerated death benefit clauses in the life insurance policy).

Accelerated death benefits have become more prevalent in recent years as a source of needed funds for support or medical expenses which may enhance the quality of life for the terminally ill. The tax-free payout of accelerated death benefits to those who are terminally or chronically ill expands the use of life insurance from survivor protection to an expanded type of protection of the insured's estate.

To achieve the stated goals of the provision, the tax-free distribution of proceeds should be limited to the insured or to the insured's guardian.

Sec. 307. Effective Date.

The AICPA supports the effective date of these provisions but recommends that section 306 be retroactive to eliminate existing controversies on the tax treatment of certain accelerated death benefits.

H.R. 6 - AMERICAN DREAM RESTORATION ACT

Sec. 2. Family Tax Credit.

The AICPA opposes this provision because it adds an unnecessary layer of complexity for individuals. Tax relief for this group could be accomplished more simply by expanding the standard deduction and/or the personal exemption. Should, however, Congress determine that a family tax credit is the only acceptable alternative, it should be creditable against the alternative minimum tax (AMT). From both a simplification and policy standpoint, it would appear that taxpayers should qualify for this credit if they have a child who otherwise qualifies as a dependent for federal income tax purposes, as opposed to qualifying for the EITC. Also, while EITC definitions are the reference point for the family tax credit, the EITC is allowed until the child is 25 while the family tax credit is eliminated at age 18. This is an additional reason for avoiding reference to the EITC and relying on the standard deduction or personal exemption.

Section 35(d)(3) states that Code sections 32(d) and (e) shall apply in calculating the family tax credit. The reference to section 32(d) means that married individuals will not be able to claim the credit if they do not file a joint tax return. There are many valid reasons for married individuals not filing joint tax returns. We believe that the filing of a joint tax return should not be a condition for the ability to claim the family tax credit.

Sec. 3. Credit to Reduce the Marriage Penalty.

While we fully support a legislative effort to mitigate or eliminate the marriage penalty, the AICPA opposes this provision both on complexity grounds and because the $2 billion annual benefit bears very little relationship to the magnitude of the marriage penalty in our current tax system. The provision's limitation on the credit to the taxpayers' "actual" marriage penalty will necessitate highly complex parallel tax calculations for millions of taxpayers, since the actual penalty can only be determined after allocating income, losses, deductions, exemptions, and credits between the spouses. Basically, the provision would force all married couples to prepare as many as five federal tax returns, each with a regular and an alternative minimum tax calculation. As an example of how complex this could be, consider the interplay between the proposed American Dream Savings Account and this provision. If one spouse works and the other does not, they are entitled (but only on a joint return) to a $4,000 deduction for an ADSA contribution. On a separate return basis, the nonworking spouse deduction would, presumably, be disallowed to one taxpayer, and any dividend or interest income on that part of the account would be taxed to the other - and all for the limited purpose of determining if there will be any marriage penalty relief.

Also, we call your attention to what appears to be a legislative drafting error resulting in the potential for interpreting proposed new Code section 23(c) to mean (in conjunction with new Code section 23(a)) that each affected taxpayer can claim a credit for the lesser of the joint/single differential or $2 billion, not that the revenue loss from all affected taxpayers should be limited to $2 billion. While this error is easily corrected, difficulties inherent in applying the proposal include how and when the $2 billion amount would be calculated and allocated to taxpayers entitled to it. How could this be determined in enough time to be useful to taxpayers and practitioners in projecting tax liability, monitoring cash flow, and providing planning advice? The added uncertainty would also complicate the timely payment of estimated taxes.

Because of the inherent complexity of the parallel calculations (of which the above ADSA discussion is but one illustration) and the fact that the benefit is based on the income of taxpayers claiming the benefit, we think this provision is unworkable. Alternative approaches should be developed and thoroughly reviewed prior to adoption, with particular emphasis on avoiding undue complexity. One alternative would be the "two-earner deduction," which was in effect between 1982 and 1986.

Also, the "marriage penalty" could be calculated as being equal to the difference between the tax calculated on the joint tax return as prepared and the amount of tax that would have resulted if the taxpayers' married filing jointly (that is combined) taxable incomes were divided in half, with tax calculated using the single tax rate tables. Another alternative is to just increase the tax bracket amounts for married returns or adjust the married filing jointly tax rate, given the predominance of two-earner families at various income levels.

Some other complicated issues that need to be considered in this provision are:

- The various adjusted gross income limitation provisions (such as medical expense, charitable contributions, casualty losses, phase-outs, etc.)
- The Code section 469(c)(7) exception to Code section 469's application to real estate where one spouse qualifies the couple for this provision's benefits.
- The alternative minimum tax, minimum tax credit and net operating loss carryover calculations.
- The definition of the term "legally married." Code sections 6013 and 7701(a)(38) discuss spouses, and husband and wife, but not the term "legally married."

Taxpayers living in community property states are faced with added problems under this provision. Community property and income would have to be divided between the spouses. Any pre-nuptial and post-nuptial agreements would have to be considered for this calculation as well. Alternatively, the federal tax rules could specifically ignore state community property rules and individual agreements.

Sec. 4. Establishment of American Dream Savings Accounts.

The AICPA supports this proposal because it expands retirement savings options in a simple manner. It has the advantage of taxing individuals when they can afford it most (during their working years) and not creating an additional tax burden, as existing retirement vehicles do, when the taxpayer can afford it least (during retirement). Also, taxpayers are more likely to place amounts in retirement funds if they know that such funds are available, without undue tax burden, during times of financial needs. The ADSA addresses financial concerns by making the accounts available, without penalty, for certain qualified distributions. While we support ADSA, we cannot support the conversion of existing retirement savings assets to these accounts.

Also, while considering enactment of these new retirement vehicles, certain issues need to be resolved. Will the taxpayer will be required to allocate withdrawals made from one account among all existing IRA accounts and among qualifying and non-qualifying distributions? To avoid complexity, we believe that distribution from these accounts should be treated independent of other IRA accounts, having no impact on the tax treatment of other IRAs.

A major trap for the unwary is presented in proposed Code section 408A(e). In order to get tax-free status for certain distributions, at least $1,000 must remain in the account. This $1,000 minimum seems inappropriate; a taxpayer who needs money from an account to satisfy the acknowledged purpose should not have to incur the tax. If the goal is to maintain minimum account levels, the requirement should be part of the definition of the account and not a distribution requirement.

The new definitions of qualified special purpose distributions for home purchases, medical and higher education expenses are complex. It seems appropriate to utilize existing Code sections that are already supported by regulations, IRS rulings and other precedents. Qualified distributions should include substantially equal periodic payments. Proposed Code section 408A(d)(2) does not include substantially equal periodic payments in the definition of qualified distributions. Such payments should be included in the definition of qualified distributions for those situations where an individuals retire from the work force before age 59-1/2.

If rollover contributions are allowed, rollover contributions from qualified retirement plans and Code section 403(b) annuities should be allowed. Proposed Code section 408A(c)(5) limits rollover contributions to rollovers from IRAs or other ADSAs. Qualified retirement plans and Code section 403(b) annuities can be rolled over to IRAs. Therefore, taxpayers should be allowed to make a rollover contribution to an ADSA directly instead of being required to rollover qualified retirement plan or Code section 403(b) annuity distributions first to IRAs.

H.R. 11 - FAMILY REINFORCEMENT ACT

Sec. 201. Refundable Credit for Custodial Care of Certain Elderly Dependents in Taxpayer's Home.

While we fully endorse tax legislation to lessen the burden of caring for elderly dependents at home, the AICPA opposes this provision because it adds unneeded complexity to the Internal Revenue Code. The analogous goal could be accomplished by increasing the exemption for these dependents without the complexity of an additional tax credit.

In addition, if these provisions are enacted, the statutory language should be consistent with the language contained in section 301 of the American Dream Restoration Act. Both sections contain definitions of similar terms which, at present, are inconsistent.

Chairman ARCHER. Thank you, Ms. Walker.

Our next witness is Thomas Terry, chairman of the section of taxation for the American Bar Association.

Welcome to the committee. You may proceed.

STATEMENT OF THOMAS D. TERRY, CHAIR, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION, WASHINGTON, D.C.

Mr. TERRY. Thank you, Mr. Chairman.

My name is Thomas Terry, I am the chairman of the American Bar Association's section of taxation.

The tax section is composed of approximately 25,000 tax lawyers located throughout the United States. It is the largest, broadest based professional organization of tax lawyers in this country. Our members live in small communities and large cities—Main Street and Wall Street. We advise our clients on personal tax problems. We work with thousands of small businesses, some that have been around for many, many years and form the economic backbone of their communities and others who are the new, emerging industry leaders of tomorrow. We also represent this country's major multinational corporations, both as in-house counsel and as outside advisers.

This diverse membership base makes its possible for us to offer the committee and its staff a variety of experiences in interpreting and in complying with the tax law. Over the years, the section has sought to make this experience available to the committee on a completely nonpartisan basis, and we are here again to offer our assistance on that basis.

We have prepared detailed technical comments on most of the tax provisions in the Contract With America, and they are included in our written statement. We have intentionally avoided taking positions on economic or social policies. Rather, our comments are intended to assist this committee in crafting rational, understandable and administrable tax legislation.

The section has long worked toward an understandable system that fosters relatively easy compliance. In that vein, we respectfully request the committee and its staff to consider three important matters as they proceed:

First, as the markup decisions are made, we urge the committee to ask whether there are ways to achieve a particular policy result in a simpler, more straightforward manner.

Mr. Chairman, we compliment you for introducing specific bills and, therefore, making the proposed statutory language available to us at this time for public comment. As you know, that has not always been done, and it has been most helpful.

Tax lawyers make their living interpreting the tax law and are often portrayed as having an economic interest in increasing complexity. The truth is that we strongly support every possible effort to simplify both existing law and the new proposals which are under consideration by this Congress.

Second, we ask that you consider the administrability of the proposed legislation.

As the committee's legislative package evolves, we encourage you to actively seek help directly from the Internal Revenue Service. For example, during the legislative process the committee might re-

quest the Service to provide a mockup of the relative portion of the tax return affected by a specific proposal. You might ask them to provide you a description of the recordkeeping that taxpayers will be required to maintain and the volume and interpretive materials, regulations and rulings, that the Service expects to publish in order that people will be able to understand and comply with the new law.

With this information in hand, it may then be possible for the committee to revise the proposals during your deliberations in order to increase the administrability of the proposals.

Third, assuming it is not inconsistent with your specific policy objectives, we believe you should try to minimize the extent to which a tax proposal creates an uneven economic playingfield.

As tax lawyers deal primarily in the details of the tax law, we do not presume to substitute our economic judgment for that of the committee. However, our experience in providing tax advice to people and businesses over a period of many years suggests that the tax system is better off, and the American people's perception of the fairness of the system, which is very important, is much stronger if tax legislation generally provides individuals or businesses with similar economic incomes pay the same amount of tax.

We are not elected officials, and we realize the policy choices are yours, not ours.

One additional point. We urge the committee to enact the technical correction provisions which were included in the bill that passed the House in the last Congress. The provisions are truly purely technical, they are bipartisan, they are badly needed, and they ought to be enacted promptly.

We appreciate your consideration, Mr. Chairman. Thank you very much.

[The prepared statement follows:]

TESTIMONY OF THOMAS D. TERRY
ON BEHALF OF THE AMERICAN BAR ASSOCIATION
COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES
February 1, 1995

ADDITIONAL COMMENTS SUBMITTED FOR PRINTING

The following comments represent an abbreviated version of the technical and administrative analysis prepared for distribution to the Committee. These comments were assembled from submissions prepared by members of the committees of relevant jurisdiction and expertise within the Section of Taxation of the American Bar Association. The longer version prepared for distribution to the Committee included additional comments on the following subjects: family tax credit; capital loss on principal residences; home office deduction; moratorium on regulations; private causes of action; increase in unified estate and gift tax credit; the Senior Citizens' Act; and the Family Reinforcement Act.

I. THE AMERICAN DREAM ACT

A. Reduction of Marriage Penalty

The proposal leaves the design of the credit to the Secretary of the Treasury and provides only minimal guidance as to the policies that should inform that design. We believe that it is incumbent upon Congress to provide specific guidance regarding the form that the credit should take because the proposal implicates various policies.[1]

A significant policy consideration relates to the distributional effects of the credit, which may be greatly affected by the way the credit is implemented. For example, a flat credit up to the amount of a couple's marriage penalty presumably would have a different distributional effect than a credit computed as a percentage of the penalty. We believe that, as elected representatives of the people, Congress is the appropriate body to make such fundamental determinations as the desired distributional effect of a legislative provision.

In determining the proper form of the credit, the Committee may wish to consider additional policy issues such as the following.

1. Limitation of the Credit to the Marriage Penalty Associated with Earned Income

In 1978, the American Bar Association adopted a resolution recommending that Congress amend the Code to provide a credit to offset the additional tax that married individuals pay on their earned income.[2] The reasons for limiting the proposal to earned income included: (i) increased administrability, (ii) reduced taxpayer burden, and (iii) concerns that married couples would shift ownership of income-producing property between themselves so as to maximize the availability of a credit on other forms of income.[3] In addition, one of the chief arguments for providing relief from the marriage penalty is that the penalty discourages the second spouse from entering the work force because a higher marginal rate would apply to the resulting income.

Prior law included relief from the marriage penalty that was targeted to earned income. Specifically, from 1982 through 1986, the Code included a "two-earner deduction" that was intended to reduce the marriage penalty on two-earner married couples. Married couples filing joint returns could deduct from gross income an amount equal to the lesser of $3,000 or 10 percent of the earned income of the spouse with the lower earned income for the year. This provision was repealed by the Tax Reform Act of 1986. The legislative history explains that the 1986 Act's changes in the standard deduction and the tax rate schedules minimized the marriage penalty notwithstanding the repeal of the two-earner deduction.[4]

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[1] Various competing policies come into play in connection with the marriage penalty. For example, the tax system tends to view a married couple as a unit and to tax each couple's combined income without regard to the portion of the income earned by each spouse. This view results in horizontal equity between a one-earner married couple and a two-earner married couple with the same total income. This view, however, results in a lack of horizontal equity between a two-earner married couple and two unmarried individuals with the same income.

[2] Tax Section Recommendation No. 1978-6, 104 ABA Repts. 768 (1979).

[3] Similar concerns led to the enactment of the so-called "Kiddie Tax" by the Tax Reform Act of 1986. *See* IRC § 1(g).

[4] *See* General Explanation of the Tax Reform Act of 1986, prepared by the Staff of the Joint Committee on Taxation, at 19 (1987).

2. The Method for Determining the Amount of the Credit -- Precision vs. Simplicity

If the credit were to be determined precisely, it would be based on a comparison of (i) a married couple's tax liability as shown on their joint return and (ii) the combined tax liability on their separate incomes if they were not married. Unfortunately, determining the individuals' separate tax liabilities as if they were unmarried is complicated in two important ways. First, various judgments must be made regarding the calculation of that hypothetical liability. For example, how should itemized deductions be allocated between the two spouses? Should one spouse be able to claim the standard deduction if the other spouse itemizes? How should exemptions for dependents be allocated? How should various phase-out provisions be applied? Should either spouse be able to claim the child-care credit? These and a number of other issues must be resolved if the amount of the penalty that any given married couple bears is to be determined precisely.[5]

Second, if such a refined system were developed, married couples would have to make the required computations simply to determine whether they were *entitled* to the credit. According to recent estimates by the Service, taxpayers filed approximately 44 million joint returns for 1993.[6] Thus, a very substantial number of taxpayers would be required to make these calculations even though many would find they were not actually entitled to a credit.

A factor to consider in determining the acceptable level of taxpayer burden is the impact of the provision on a taxpayer's total tax liability. As a result of the $2 billion revenue constraint, it is likely that the amount of the credit would be fairly small for a large number of taxpayers. For example, if the proposal resulted in marriage penalty relief for one-half of the 44 million couples who filed joint returns for 1993, the average relief provided would be roughly $91.

Consistent with our general view, we urge the Committee to sacrifice precision for simplicity and administrability. One approach that the Committee might consider is reinstating a provision similar to the two-earner deduction but in the form of a credit. The credit could be set at a certain percentage of the earned income of the spouse who has the lower amount of earned income for the year.[7] The credit also could be capped to limit the revenue loss and achieve any distributional effects that the Committee may believe to be appropriate.

B. American Dream Savings Accounts

1. Major Comments

a. Rollover of Qualified Plan or IRA Funds to an ADS Account. A rollover may be made from an IRA account (other than an ADS account) to an ADS Account prior to January 1, 1998. This provision, coupled with the rollover provisions of existing law, would permit any individual to -- (i) in accordance with plan provisions, withdraw amounts from a qualified pension, profit-sharing, or stock bonus plan, including a section 401(k) plan,[8] or from an existing IRA account; (ii) roll over such amounts either directly to an ADS Account in the case of an IRA account, or to a conduit IRA in the case of withdrawals from a qualified plan; and (3) where a conduit IRA has been used, roll over the amounts from that account to an ADS Account. These rollovers could begin after December 31, 1995, the effective date of the American Dream Act, but could be made only until December 31, 1997.

The American Dream Act provides that upon a rollover into an ADS Account, any amount includible in the individual's gross income as a result of such rollover would be included ratably over the four year period beginning with the taxable year in which the distribution from the pre-existing IRA account is made. Thus, gross income for these years would include employer contributions to a qualified plan (deferred wages), untaxed investment income of the qualified plan, deductible contributions previously made to an IRA, and untaxed investment income of deductible and nondeductible IRA accounts. This treatment is similar to the lump sum distribution treatment that was enacted in the Tax Reform Act of 1986.

These rollover provisions would effectively permit certain employees who have current IRAs or who are covered by a qualified plan to circumvent the required distribution rules for qualified plans in

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[5] Even after resolving all of these issues, any precision would be illusory since taxpayers often would order their affairs differently if they in fact were not married.

[6] *See* Internal Revenue Service, Statistics of Information Bulletin, Fall 1994, at p. 20.

[7] The child-care credit involves a comparable structure. *See* IRC § 21.

[8] *See* IRC § 401(k)(1)(B)(i).

section 401(a)(9)[9] at the cost of paying tax spread over four years on the taxable amounts withdrawn and rolled over. The qualified retirement plan and IRA required distribution rules serve to prevent unintended benefit from qualified plan treatment, which allows contributions to the plan, representing deferred compensation, and income from investment of the employee's interest in the plan, to be accumulated tax-free until distribution from the plan to the employee.

The existence of the front-end tax and the exemption of distributions from current tax means that there is substantially less need for minimum distribution rules, at least during the life of the contributor, in the case of ADS Accounts than in the case of deductible IRAs. On balance, it may not be worth the added complexity to impose lifetime minimum distribution rules on ADS Accounts.

b. After-Death Distributions. Existing law generally provides that benefits payable from a qualified plan or an IRA that begin after the death of the participant must be completed within 5 years after the date of death, unless the after-death distributions meet certain requirements. Because the ADS Account rules do not require distributions after death, an ADS Account could be passed on at death to one or many beneficiaries, to be withdrawn only when and if ever needed, with no tax when the amounts are withdrawn. This exclusion of the amount in the ADS Account from income taxation over successive generations seems hard to defend. Therefore, the Committee may want to consider adopting a minimum distribution rule for ADS Accounts that applies only to after-death distributions.

c. Continued Existence of Nondeductible IRA Provisions. The continued existence of the nondeductible IRA provisions of prior law after enactment of the ADS Account provisions would cause major confusion, as well as major administrative problems for banks and other financial intermediaries maintaining these accounts. We presume it also would cause extreme administrative difficulties for the Internal Revenue Service.

If the ADS Account provisions are adopted, there would be three different types of IRA accounts: deductible IRA accounts, nondeductible IRA accounts, and ADS accounts. The designation "ADS Account" would not avoid this confusion. Many individuals would be bewildered by the range of choices available and would not readily understand the relative benefits and detriments of one type of account as compared to another. It is likely that individuals would (i) make contributions to the wrong type of account, (ii) claim deductions for contributions that do not qualify, (iii) experience difficulty in tracking tax basis for the accounts, and (iv) treat distributions as nontaxable even though deductions were taken.

There is no need to maintain the nondeductible IRA provisions if the ADS Account provisions are adopted. The ADS Account treatment is far more favorable except that the contributions must remain in the account for at least five years unless one of the special exceptions applies. The five year requirement, with the exceptions, is likely to be a very small price to pay for the tax benefits provided by an ADS Account. In order to reduce complexity, ease administrability, and decrease opportunities for tax avoidance, the existing provisions for nondeductible IRA contributions should be repealed for years after the date of enactment of the ADS Account provisions.

In addition, consideration might be given to requiring existing IRA accounts containing solely nondeductible contributions to be treated as ADS Accounts, with the tax upon a deemed withdrawal of the accumulated income in the IRA being payable perhaps over a four-year period after an appropriate transition period, such as one year after date of enactment.

On the other hand, if individuals are to have the opportunity before January 1, 1998, to transfer existing qualified plan or IRA account balances to an ADS Account, paying tax on such distributions over a four-year period, the existing provisions for nondeductible IRAs must be retained until that time unless direct rollovers from qualified plans are to be permitted (*see, infra*).

2. Technical Comments

a. Establishing an ADS Account. An ADS Account would be required to be designated as such by the taxpayer when established. Because of the danger of confusion with other types of IRAs, and to prevent tax avoidance, it should be provided that an ADS Account must be established with that designation in a manner consistent with regulations. This would allow the Service to set up a more definitive and complete set of requirements.

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[9] These rules normally require the employee to defer withdrawing amounts until age 59½ and to begin withdrawing the employee's interest in the plan or IRA beginning no later than age 70½. The amounts must be withdrawn beginning by age 70½ in no lesser amounts than will be required to pay out the employee's entire interest in the plan over the life of the employee, or the employee and a designated beneficiary (or the life expectancy of the employee, or the employee and such beneficiary).

b. Time for Contribution. The American Dream Act provides that ADS Accounts are to be treated in the same manner as "individual retirement plans." *See* IRC § 7701(a)(37). It is unclear whether this reference incorporates the existing law rule permitting IRA contributions for any year to be made up to the due date of the taxpayer's return for that year (April 15 of the following year). Although the technical rationale for the April 15 due date contribution rule (this being the time when the deduction is taken) is lacking in the case of an ADS Account, that same rule also is provided under existing law for nondeductible IRA contributions. Failure to afford this treatment of ADS Accounts will cause confusion that could lead to mistakes and disallowed ADS treatment under the five-year rule.

c. Rollover Contributions -- Direct Rollovers from Qualified Plans. Rollovers would be permitted from an ADS Account to another ADS Account, or, as previously described, until December 31, 1997, from any other "individual retirement plan." If the latter type of rollover is to be permitted until December 31, 1997, the provision should simply allow direct transfers or "direct rollovers" from a qualified plan until that date. Requiring the use of a conduit IRA adds complexity and administrative difficulty, both for the taxpayer and the Service.

d. Five-Year Holding Requirement. This requirement would result in contributions to an ADS Account that the taxpayer may have made to supplement his or her retirement savings being subjected to the 10 percent excise tax on premature distributions upon withdrawals after age 59½ but within five years after the contribution date. There is widespread understanding, not easily changed, that retirement savings may be withdrawn without penalty after age 59½. This confusion may be unavoidable, given the apparent objective to limit backloaded IRA benefits in all cases to circumstances in which the contributions remain in the ADS Account for five years or more, unless withdrawn as a Qualified Special Purpose Distribution. However, it would lead to strong complaints, probable abuse, and unjustified criticism of the Service. At the very least, consideration should be given to exempting from the penalty excise tax periodic annuity-type distributions as in the case of regular IRAs. *See* IRC § 72(t)(2)(A)(iv). Such amounts continue to represent a gradually decreasing amount of savings over the life of the annuitant. An exception should be considered for distributions upon death or disability. *See* IRC §§ 72(t)(2)(A)(ii), (iii). The funds may be needed for estate administration purposes, and estates should not be held open for prolonged periods except for the strongest reasons. The five-year holding requirement does not include an ordering rule. Compare section 408A(d)(2)(C) as proposed by Senator Roth in the Savings and Investment Incentive Act of 1995 (S. 12). An ordering rule should be added to the American Dream Act. It should be made clear whether the five-year period begins from the date the contribution was made or the end of the year in which the contribution was made. The tracking of ADS Account contributions, rollovers, allocable earnings, and distributions in order to ascertain compliance with the five-year holding rule would impose major administrative burdens on the responsible party. At the very least, it is critical that clear-cut rules for associating distributions with particular contributions and the investment income allocable thereto be provided. Under section 408(o)(4), individuals who make nondeductible IRA contributions to, or receive any distribution from, an IRA are required to report detailed information to the Service concerning such contributions, as well as historical information on nondeductible contributions and distributions excluded from income. In contrast, institutional payors of such distributions are not responsible for allocating and reporting taxable and nontaxable proceeds. The administrative burden caused by the necessary tracing for five-year holding purposes is likely to result in noncompliance if this burden is placed on taxpayers. On the other hand, the tracking requirement also would be difficult, if not impossible, for payors. Taxpayers could create ADS Accounts at multiple institutions without the knowledge of the institutions and could readily transfer ADS Accounts between institutions (trustee-to-trustee and rollover). Congress should give serious consideration to these administrative burdens, from the standpoint of the taxpayer, the institutions holding the funds, and the Service. A clear-cut allocation of responsibilities should be provided.

e. Special Purpose Distribution Rules in General. A distribution would not constitute a Qualified Special Purpose Distribution if it caused the aggregate ADS Account balances of the taxpayer to fall below $1,000. It is not clear whether the entire distribution which causes this result would be treated as failing to qualify as a special purpose distribution, or whether only the portion below the $1,000 floor would be so treated. In general, it is unclear why the $1,000 limitation is necessary, given the limited purposes for which such distributions may be made. The provision adds complexity and increases administrability problems. We think the Committee should consider deleting this limitation.

f. Qualified First-Time Homebuyer Distributions. A qualified first-time homebuyer distribution could be received for reconstruction of a residence, as well as for acquisition or construction, but a first-time homebuyer is defined as a person who had no present ownership in a principal residence during the three-year period ending on "the date of acquisition of the principal residence to which this paragraph applies." Presumably, it is intended to permit reconstruction of a first-time homebuyer's existing residence. Drafting clarification is required. The Date of Acquisition rule provides a binding contract test for acquisition of a principal residence, but such Date is the date on which construction or reconstruction is commenced for these latter cases. We suggest that the binding contract rule be used also for construction or reconstruction

since the dates on which construction or reconstruction begins can be controversial. The special rollover rule for a delay or cancellation of the purchase or construction of a residence also should be extended to the reconstruction of a residence.

g. Qualified Higher Education Expenses. Consideration should be given to expanding the definition of these expenses to include descendants of a son, daughter, stepson, or stepdaughter. We note that S. 12 also includes ancestors of the taxpayer and his or her spouse. We note also that room and board expenses are included in higher education expenses for section 401(k) purposes. Treas. Reg. § 1.401(k)-1(d)(2)(iv)(A)(3). We note an apparent drafting error in that the American Dream Act includes no sections 408A(e)(3) and (4).

h. Qualified Medical Expenses. Long-term care expenses other than insurance premiums do not constitute qualified medical expenses. Long-term care expenses of a disabled taxpayer or enumerated relative may not be covered by insurance and may not qualify as medical care as defined in section 213(d). Costs of caring for a parent in the taxpayer's home that are not covered by section 213(d)(1)(A) are common. A parent of the taxpayer receiving social security benefits, or a child with some income, sufficient in either such case to disqualify that person as a dependent, nonetheless may depend heavily upon the taxpayer for assistance in paying medical costs. The Committee should review these limitations to make certain that they reflect its intentions as to the coverage of the proposal and to clarify the interaction of these provisions with the long-term care exclusion provided by the Senior Citizens' Act.

II. THE JOB CREATION ACT

A. Capital Gains Exclusion and Indexation

1. Introduction

Title 1 of the Job Creation Act would modify the tax treatment of capital gains in three ways. First, proposed section 1201 would allow taxpayers to deduct 50 percent of their "net capital gain" in computing AGI.[10] Second, proposed section 1022 would allow taxpayers to increase their basis in "indexed assets" to reflect inflation. Finally, proposed section 165(c)(4) would allow individual taxpayers to deduct losses arising from the sale or exchange of a principal residence.

In 1975, the American Bar Association recommended that Congress enact a system of indexation of tax basis to eliminate the taxation of nominal gains attributable to inflation.[11] The ABA Tax Section has neither adopted a formal position on the need for, or advisability of, preferential treatment for capital gains income nor does it take any such position before this Committee. The Tax Section's membership reflects the same range and diversity of views on these ultimate policy issues that is found in the nation as a whole. However, as tax professionals who interact daily with taxpayers who must attempt to comply with the tax laws, we have a strong interest in participating in the enactment process to assure that the Congress enacts provisions that are understandable by taxpayers and administrable by the Internal Revenue Service. We generally believe that those objectives are best achieved by reducing ambiguity and increasing simplicity whenever possible.

2. Capital Gains Deduction -- Section 1001 of the Job Creation Act

The Job Creation Act would add proposed section 1201, which would permit both individual and corporate taxpayers to deduct 50 percent of their "net capital gain" in computing AGI.[12] This deduction would replace the current limitation on the maximum tax rate on net capital gain for individuals contained in section 1(h) of the Code and the alternative rate for corporations contained in section 1201. The Job Creation Act also would repeal section 1202, which was enacted in 1993 and generally allows an individual taxpayer to exclude from gross income 50 percent of any gain from the sale or exchange of "qualified small business stock" held for more than five years.

A fifty percent deduction would be a powerful incentive to convert ordinary income into capital gains. Our experience suggests that taxpayers would engage in tax planning to take advantage of this differential.

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[10] A capital gains exclusion would also reduce state income taxation in states that follow the Federal definition of AGI.

[11] *See* ABA Legislative Recommendation 75-4. The recommendation did not and could not anticipate the specific structure of section 1002 of the Job Creation Act.

[12] The Job Creation Act also makes a series of conforming changes to other provisions of the Code; an additional conforming change is needed for section 453A.

The combined repeal of section 1(h) and section 1202 may have an unintended effect on individuals who have invested in "qualified small business stock." Section 1(h) limits the maximum tax rate on net capital gain to 28 percent. Thus, as a result of the 50 percent exclusion for qualified small business stock, taxpayers are subject to an effective maximum tax rate of 14 percent (50 percent of 28 percent) on any gain from such assets or 21 percent if the individual is an AMT taxpayer. By repealing section 1(h), the maximum tax rate on any gain from such assets would increase to 19.8 percent (50 percent of 39.6 percent) for taxpayers who are not AMT taxpayers. In addition, because under the Job Creation Act the 50 percent deduction would only apply to "net capital gain" (*i.e.*, the excess of net long-term capital gains over short-term capital losses), an investor in qualified small business stock would lose all benefits from such investment to the extent the investor had short-term capital losses. We recognize that there is a tension between the goal of simplification we have endorsed and the remedy of providing transition relief to taxpayers who would benefit from existing section 1202. However the Committee chooses to resolve those competing considerations, the availability of transitional relief and the issue of the effective date of the repeal of the current provisions should be explicitly addressed.

3. Indexation -- Section 1002 of the Job Creation Act

The Job Creation Act would add proposed section 1022, which would permit a taxpayer to increase basis in certain "indexed assets" to reflect the impact of inflation during the taxpayer's holding period. The "indexed basis" of the asset would be used for computing gain or loss on the sale or other disposition[13] of the asset.[14] On the other hand, the provision would not apply for purposes of determining depreciation, depletion, or amortization of the asset or for any other purpose.[15]

The Job Creation Act indexes capital assets but does not index debt. While we recognize that the decision not to index debt is a policy judgment, and that indexation of debt raises a number of difficult issues (particularly with respect to financial intermediaries), we wish to alert the Committee to the fact that the failure to index debt will create tax arbitrage opportunities. As experienced practitioners, we expect that taxpayers will enter into tax-motivated transactions designed to exploit such opportunities.

a. Periodic Indexation. Proposed section 1022(e) would provide that the basis of an asset is adjusted quarterly for inflation. Adjustment of basis on a strict quarterly basis may cause taxpayers to delay the sale or other disposition of indexed assets until the beginning of a new quarter in order to obtain the maximum increase in basis (thus minimizing any gain that they may recognize). To avoid such behavior on the part of taxpayers, the Committee should consider permitting taxpayers to adjust the basis of indexed assets by interpolation. Thus, for example, the basis of an indexed asset sold on the 30th day of a quarter could be adjusted by 30/90ths of the inflation occurring during the preceding quarter.

On the other hand, the Committee could greatly simplify the indexing provision by permitting only annual adjustments in basis for inflation. For sales occurring in the middle of the year, taxpayers might be allowed to adjust the basis of any assets sold by interpolation based on the previous year's inflation. For example, for a sale occurring on the 50th day of a year, the basis of an asset could be adjusted by 50/360ths of the inflation occurring during the preceding year. This would eliminate recordkeeping on a quarterly basis and would avoid confusion due to issuance of preliminary and revised inflation figures.

b. Definition of Indexed Asset. An "indexed asset" is defined as (i) stock in a corporation and (ii) tangible property (or any interest therein) that is a capital asset or that is property used in a trade or business as defined in section 1231(b). Explicitly excluded from the definition of an "indexed asset" are (i) a creditor's interest in property, (ii) options, (iii) net lease property, (iv) non-participating preferred

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[13] A distribution on common stock that is not a dividend would be treated as a disposition for these purposes. Does this mean that indexed basis would be available to absorb return of capital distributions? The legislative history should explicitly address this issue. In addition, it would be desirable to clarify how indexation should affect the calculation of earnings and profits for purposes of determining what constitutes a return of capital.

[14] Although new section 1022 would apply for purposes of determining losses as well as gains from the disposition of indexed assets, to the extent that new section 1022 would create or increase a net ordinary loss to which section 1231(a)(2) would apply, or an ordinary loss to which any other provision would apply, the loss would be treated as long-term capital loss. The Job Creation Act does not make clear how this limitation would be computed. We simply note alternative possibilities: (i) compute gain for each asset using indexed basis and then net total gains and losses or (ii) net gains and losses on an unindexed basis for this purpose.

[15] Some clarification of the interaction of indexation with depreciation and similar basis adjustments is required. For example, if a machine is purchased for $100 and depreciated on a straight line basis over 10 years, to what amount of basis (for purposes of determining gain or loss on disposition) will indexation apply? Alternatives include (i) indexation of the original basis without depreciation or similar adjustments and then subtracting the adjustments from the indexed basis on disposition, (ii) applying the indexation adjustment only to the adjusted basis at the time of disposition, or (iii) some intermediate approach that attempts to account for the taxpayer's varying investment in the property over time.

stock that is fixed and preferred as to dividends,[16] (v) stock in a foreign corporation, and (vi) stock in an S corporation. The effect of this definition is to exclude intangible assets such as patents, copyrights, licenses, and similar assets from indexation as well as partnership interests and other interests in unincorporated pass-through entities.[17]

To the extent that lines are drawn between assets subject to indexation and assets not covered, new controversies will arise. While the policy rationales for the explicit exclusions to indexation (such as debt) in the Job Creation Act may be controversial, the explicit exclusions are understandable and generally appear to be capable of reasonably clear delineation. The rationale for departing from the long established definition of a capital asset in defining an "indexed asset" in section 1022(a) is less clear, and the Committee should carefully consider whether the decision to allow indexation of the stock of a corporation holding primarily intangible assets while denying the adjustment to the assets themselves will create unnecessary ambiguity and controversy.[18]

c. Pass-Through Entities.

(1) In General. In general, indexation under proposed section 1022 would not apply to interests in pass-through entities such as partnerships and common trust funds.[19] S corporations are explicitly excluded, apparently to maintain parity between partnerships and S corporations for this purpose. The rationale for denying the indexation adjustment to these interests while providing the indexation adjustment for other entities such as regulated investment companies ("RICs") -- also known generally as mutual funds -- and real estate investment trusts ("REITs") should be more clearly articulated.

Under proposed section 1022, partnerships, S corporations, and common trust funds would pass through any basis adjustment to their equity holders. However, no mechanism for these pass throughs is specified. The Committee should articulate, in at least a general way, how it envisions that such adjustments would be made. For example, if a partnership sells an indexed asset at a gain, a portion of which is protected from taxation by the indexation provision, then distributes the proceeds of the sale to its partners, what will be the mechanics of the pass through? To illustrate, suppose that A and B each contribute $100 to Partnership X which uses the $200 to buy corporate stock. Two years later, X sells the stock for $300 at a time when its indexed basis is $250, then distributes the $300 in proceeds to A and B. A and B will each have gain of $25, which will increase their bases in their partnership interests to $125 each. But each partner will receive $150 on the distribution and unless each receives a $25 adjustment to partnership interest basis for the indexation adjustment, taxation of the distribution will negate the indexation benefit. If a basis adjustment for the partnership interest is made, when is it to be made: at the time of sale of the underlying asset or when a distribution is made? If a partnership has a section 754 election in place, how will indexation apply to the adjustment to the basis in the partnership's assets? How would indexation affect the inside and outside basis reductions required under section 108(c)? Would indexation create a greater difference under section 732 between liquidating and non-liquidating distributions by a partnership? Similar questions arise for other pass-through entities.

In its current form, the provision implicitly requires the Treasury Department to write regulations specifying how indexation is to apply with respect to these types of pass-through entities. If it is intended to delegate such authority to the Treasury Department, the delegation should be explicit. In addition, the Committee should consider whether indexation for pass-through entities can be made effective until basic regulations for pass throughs are published. The better solution would be to include at least basic rules for the intended pass through in the final Job Creation Act.

(2) RICs and REITs. A specific rule is provided under proposed section 1022 for interests in RICs and REITs. Interests in RICs and REITs are eligible for indexation based on the ratio of the value of indexed assets held by the entity to its total assets, with a 10 percent de minimis rule applicable

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[16] The impact of this exclusion on convertible preferred stock should be clarified.

[17] It is not clear how the provision is intended to affect intangible oil and gas expenditures that the taxpayer has elected to capitalize. It would seem that such expenditures should qualify based on their relationship to the underlying mineral interest, which is eligible.

[18] For example, would incorporation of a company having primarily intangible assets run afoul of new section 1022(h) as a transfer to increase the indexation adjustment? If section 1022(h) is retained in the final Job Creation Act, substantial effort will be required to clarify its intended scope. Examples of cases in which the Committee believes the provision should and should not apply would be particularly helpful.

[19] Interests in pass-through entities (other than S corporations, which are explicitly excluded) would not be included in the definition of indexed assets since they are neither stock in a corporation nor tangible property.

at both the high and low ends (*i.e.*, all interests qualify if the entity holds 90 percent qualifying assets and no interests qualify if it holds less than 10 percent qualifying assets). Mutual fund shares can be bought and sold with relative ease, and account balances are often shifted between funds within a family of mutual funds. For this reason, the Committee should consider mechanisms to provide shareholders in such entities with the information they need to report accurately gains on sales of their shares.

d. Other Issues.

(1) Failure to Qualify During Holding Period. The Job Creation Act would provide that indexation would not apply during periods when an asset does not qualify as an "indexed asset." No guidance is offered, however, with respect to relatively short periods of disqualification. As an alternative, section 1022 could provide that an asset qualifies for indexation if it meets the requirements of an indexed asset for a specified portion of the taxpayer's holding period (for example, 80 percent). This would avoid complex adjustments for minor periods of ineligibility. While it appears that it is not intended that periods of ineligibility will "restart" the indexation period, this should be made explicit.

(2) Short Sales. Proposed section 1022 also would provide that the amount realized on a short sale of an indexed asset would be indexed for inflation. Thus, a taxpayer who sells short an indexed asset and more than one year later buys that asset back would have to index the amount realized (*i.e.*, the amount realized on the original sale) for inflation. This provision may alter taxpayer behavior because it creates an incentive to close out any gain position in a short sale before the end of a year in order to avoid having this provision increase gain.

The Job Creation Act also would provide that a taxpayer will not be entitled to index an asset during any period in which it has sold short an asset that is substantially identical to another asset it holds. There is no explanation as to how a taxpayer would calculate the reduction in the "applicable inflation ratio" for periods when such a short sale is outstanding. Arguably, since the applicable inflation ratio is a function of full years during which the taxpayer held the asset (or during which a short sale was outstanding), this provision should only apply to short sales which, in the aggregate, last no more than one year (or, when netted against the taxpayer's holding period, reduce that holding period to a smaller number of whole years). Moreover, this provision may be inappropriate if indexation already applies to the amount realized in a short sale.

(3) Dispositions Between Related Persons. Basis indexation would not apply to dispositions of property between persons who are "related" under section 267(b) or who are treated as a single employer under section 414(b) or (c), except to the extent that the transferee of the property takes a substituted basis in the property. The policy rationale for this provision is not clear. In any event, it is not clear why indexation should be permanently lost (as opposed to deferred) on a related party sale. For example, if Parent sells corporate stock that Parent has held for two years to Child at the market price, Parent will pay tax on any gain without benefit of indexation. In addition, Child's eligibility for indexation will apparently begin on Child's purchase date. Thus, two years of indexation available to unrelated taxpayers will be permanently lost to the family. This loss might be ameliorated by providing Child (and other related purchasers) with the ability to tack Parent's holding period for purposes of indexation. Absent some such amelioration, there will be substantial pressure on the anti-avoidance rule with probable significant increases in controversies as taxpayers seek mechanisms to preserve indexation benefits in transfers involving related parties.

As drafted, the related party rule would encompass distributions of appreciated property under section 311(b) to a stockholder who owns more than 50 percent of the distributing corporation's stock. Given the overall objectives of the proposal, this result appears to be unintended.

(4) Separate Asset Rule. The Job Creation Act provides that substantial improvements to property, substantial contributions to capital of corporations, and other portions of assets "as appropriate to carry out the purposes of this section" will be treated as separate assets and hence will have different indexation periods from the underlying asset to which they relate. While the rationale for this rule is clear, its application is not. In particular, the Committee should define "substantial" for this purpose in objective terms (such as a percentage of value or basis of the underlying asset). In addition, the "other portion" rule should apply only to the extent provided in regulations. Absent such clarification, these provisions are likely to give rise to substantial disputes.

(5) Interaction with Section 1258. The Job Creation Act should address the intended interaction between the proposed indexation provisions and section 1258 (regarding recharacterization of gain from conversion transactions). Section 1258 recharacterizes as ordinary income any gain recognized by the taxpayer equal to the amount of interest the taxpayer would have earned on its net investment at 120 percent of the applicable Federal rate. Applying section 1258 in conjunction with basis indexation under proposed section 1022 would eliminate ordinary income recognition on the inflation component of the gain.

B. Neutral Cost Recovery

1. Complexity Issues

The systemic change occasioned by NCRS would be the third to the depreciation regime since 1980, the predecessors being ACRS (1981) and MACRS (1986).[20] NCRS could result in complexity that could cause difficulty for taxpayers in three respects: (i) calculating the increases in depreciation deductions; (ii) making property-by-property calculations, if required, instead of bottom line group calculations; and (iii) calculating basis adjustments, if required, for recapture or for other reasons.

a. Ease of Calculation. To be readily usable by smaller business taxpayers, the NCRS formula should be susceptible to being expressed in straightforward tables that could be included with return instructions. Computing the inflation adjustment on a quarterly basis, however, would make these tables fairly cumbersome. The Committee may want to consider whether is it possible to use annual or semiannual inflation adjustments rather than quarterly adjustments.

b. Bottom-line Calculation. Because the inflation and return on investment depreciation would have no effect on the basis of property (section 168(k)(7)) or on depreciation recapture, we see no need for a property-by-property calculation. We suggest that the Committee consider expressly providing that taxpayers may calculate the inflation and return on investment amounts on the total depreciation for 3-, 5-, 7, and 10-year property placed in service for a given year and may calculate the inflation amount on other property in such groupings as are appropriate given the decisions made with respect to the quarterly versus annual or semiannual inflation adjustments discussed above.

c. Basis Considerations. Proposed section 168(k)(7) would provide that the basis of assets and the basis of any pass-through entities are not adjusted to account for the additional inflation or return on investment depreciation. Advantages of the no-recapture rule are avoiding calculation of the additional depreciation on a property-by-property basis and consistency with the exclusion of the assets from basis indexation under proposed section 1022. Institution of any basis adjustment or recapture system would greatly increase the complexity of the provision.

2. Other Issues

Our longer submission prepared for distribution to the Committee addressed the following additional Neutral Cost Recovery issues: pass-through entities; integration with basis indexation; normalization; coordination with interest deductions; and anti-churning rules.

C. Regulatory Reform

There is no question that the federal regulatory process needs to be constantly monitored and corrected when it results in the imposition of undue regulatory burdens. We have urged, and continue to urge, the Service and Treasury to adopt regulations that minimize administrative burdens. However, the proposal of a blanket application of an additional set of requirements on the tax regulatory process is misguided, and would produce greater rather than lesser taxpayer burden. The special needs of taxpayers and tax administration have been recognized in past regulatory reform initiatives and should continue to be recognized as the current proposals are examined. In the past, tax regulations have been exempted specifically from many of the requirements to which they would now be subject.

In current practice, tax regulations in both proposed and final form are accompanied by a preamble in which a number of the criteria listed in Title VII of the Job Creation Act (section 7004(c)) are addressed. In other cases the proposed criteria are not relevant. For example, most tax regulations are interpretative, not legislative, regulations. This means that they are issued to provide interstitial guidance with respect to the interpretation of frequently complex and comprehensive sets of laws enacted by the Congress. Before enacting Internal Revenue Code amendments, Congress has the opportunity to consider costs and benefits and to take into account the number of taxpayers affected. In the case of interpretative regulations, the Service and Treasury must follow the expressed intent of Congress in order to issue a valid regulation; they cannot second guess Congressional policies that are fixed by the language of the underlying Code section.

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[20] Given the background of frequent change to the depreciation rules, many taxpayers may not be comfortable with the use of NCRS, which would require use of a less advantageous (150 percent versus 200 percent declining balance) depreciation method in exchange for the deferred benefit of additional inflation and return on investment depreciation. A taxpayer would be disadvantaged in the early years of the property's life and benefitted by the additional depreciation in the later years of the property's life. Given the history of frequent change to the depreciation rules, taxpayers may fear that the deferred benefit will never be realized.

Apart from the fact that current practice satisfies the relevant regulatory impact policies, the imposition of more procedures onto the already burdened process of tax administration would be counter-productive. Subjecting tax regulation, for which there is a large backlog already, to even more procedural hurdles risks bringing the entire process to a halt.

For example, we believe that if provisions such as the indexing of asset basis and proposed individual retirement account rules are enacted, prompt regulatory guidance will be essential to their implementation. Adding new procedural obstacles to tax regulations would inevitably delay by many months the publication of universally applicable guidance, to the detriment of important new Congressional tax policies.

We share the desire of Congress for clear, concise, simple, and unburdensome regulations. Such regulations are possible and highly desirable in many areas, particularly those touching a large number of moderate income taxpayers. However, in certain areas the goal will be unattainable, both because of the complexity of the Code and the complexity of transactions occurring in the marketplace. If proposed section 7006 (concerning complex language) is enacted, it is reasonable to predict that one of two things will happen. Either the section will be ignored on the basis of a general claim that its requirements have been satisfied "to the extent practicable," or the Service and Treasury will diligently attempt to carry out the literal mandate and that effort will delay further the issuance of needed guidance; neither outcome is particularly desirable.

The application of Title VI to tax regulations could be particularly damaging. Under section 6001, the current law provision that makes the required regulatory analysis nonreviewable by the courts would be repealed. Apparently, anyone who felt aggrieved by a tax regulation could complain to the courts that there was some flaw in the regulatory analysis and that the regulation, therefore, should not apply. The opportunity for mischief here would be too great to tolerate in the tax system. The procedure in section 6003 that would require the final regulations to be approved by the Small Business Administration is also potentially disruptive. Code section 7805(f), enacted in 1990, already provides for Small Business Administration involvement in the writing of tax regulations without requiring an additional level of agency approval. Requiring separate approval of one more agency, as a practical matter, would create significant delay and confusion for taxpayers in need of guidance.

The foregoing comments relate specifically to interpretative rulemaking of the sort involved in the great majority of tax regulations. The Congress, however, sometimes delegates legislative rulemaking authority to the Treasury. The tax-writing Committees may wish, in appropriate cases involving such delegation, to specify regulatory procedures, tailored to the tax law context, that address concerns such as regulatory impact and opportunity for notice and comment. However, we urge the Congress not to place additional procedural obstacles in the way of tax regulations as a general matter.

Title V of the Job Creation Act concerns "information collection requests," which are defined in 44 U.S.C. § 3502(11) and enlarges some of the current requirements of those rules. Those rules do not now burden taxpayers or tax administration to any significant extent. Accordingly, Title V is not addressed.

Title VIII of the Job Creation Act is called the "Citizens Regulatory Bill of Rights," and appears to be targeted to regulations other than tax regulations. The recent legislation and proposed legislation known as "Taxpayer Bill of Rights" legislation, on the other hand, is targeted to tax regulations, among other things, and has been the subject of extensive analysis and testimony by the Tax Section. If the "Citizens Regulatory Bill of Rights" also is intended to apply to tax regulations, a wide range of changes would be necessary to accommodate the tax administration system. We contemplate making additional comments regarding Title VIII, but at this time we note one specific concern. Section 8101 of the Job Creation Act provides that each person that is the "target" of a Federal investigation or enforcement action has several specified rights upon the initiation of "an inspection, investigation, or other enforcement proceeding." These rights include the right to remain silent, be warned that statements may be used against them, and have an attorney or accountant present. It appears that, absent modification, this provision could apply in the case of an ordinary audit by the Service, which likely would create unnecessary anxiety for audited taxpayers and might result in a lack of taxpayer cooperation that would hinder the Service's audit process.

Chairman ARCHER. Thank you, Mr. Terry.

Our next witness, David Walker with the Association of Private Pension and Welfare Plans. Welcome to the committee. You may proceed.

STATEMENT OF DAVID M. WALKER, MEMBER, BOARD OF DIRECTORS, ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS, WASHINGTON, D.C.

Mr. DAVID WALKER. Thank you, Mr. Chairman. Thank you for the opportunity of being here and appearing before yourself and the other distinguished members of the committee.

My name is Dave Walker. I am a partner with Arthur Andersen. I am a member of the board of directors of the Association of Private Pension and Welfare Plans—also known as APPWP. I also serve as one of two public trustees for the Social Security and Medicare system and formerly as an Assistant Secretary of Labor for ERISA and head of the Pension Benefit Guaranty Corporation.

I am here today to represent the APPWP on the important topic of savings and investment in general and pension savings in particular. As you know, APPWP is the largest and most diverse trade association dedicated to employee benefit plan matters.

I have submitted a statement for the record, Mr. Chairman, and would now like to proceed to summarize the most important elements.

First, I would like to compliment the committee on holding these hearings and focusing attention on this important topic. While much attention has been focused on the twin Federal budget and trade deficits, not enough attention has been focused on an equally, if not more important, deficit, and that is our savings deficit. Our savings deficit is real and requires immediate attention and decisive action.

This savings deficit has an adverse effect on our ability to sustain long-term economic growth, create jobs, maintain our competitive posture and to improve the overall standard of living of Americans. It also has a detrimental effect on the economic security of Americans in their retirement years.

As a retirement policy expert with significant firsthand public and private sector experience, I can assure you and this committee that this Nation is facing a severe retirement crisis which needs to be addressed. Several key indicators of this looming retirement crisis include the following:

First, the projected financial imbalance in the Social Security and Medicare programs, of which Medicare is particularly acute; second, the declining pension savings and participation rates; third, low personal savings rates; fourth, our aging society, longer lifespans, our increasing dependency ratios, escalating health care costs, declining private sector retiree health coverage rates—just to name a few—in addition to the Federal budget deficits.

Pension plans play a critically important role in helping to ensure the economic security of Americans in their retirement years. The factors that I mentioned will serve to increase the need for both pension plan savings as well as individual savings. However, our current tax and regulatory policies serve to discourage rather than encourage pension savings.

Numerous studies have been commissioned or conducted by APPWP, EBRI and others pointing out the importance of pension savings and the need for related tax and regulatory reform. Several are referred to in my statement.

Employee benefits professionals have been aware of this need and have been engaged in a longstanding battle to increase the visibility and priority of pension savings issues. Recently, chief executive officers of some of the major corporations of America have recognized the increasing importance of this issue and have joined the battle.

In fact, I am proud to say that Larry Weinbach, who is chairman of our global firm, is heading a related task force with the committee on economic development, which is comprised solely of CEOs, and plans to publish a comprehensive, candid and constructive paper in May of this year which will deal with this issue and make a number of specific tax and regulatory reform proposals.

All of these studies, both the ones referred to in my paper and others, demonstrate the need to raise the priority of pension savings and related legislative and regulatory reform matters. In particular, they point out the need to, among other things, raise the maximum contribution of benefit limits applicable to qualified plans, return the full funding limit for qualified plans to its pre-OBRA 1987 levels, simplify pension regulations, especially the nondiscrimination rules, facilitate retirement planning and investment education initiatives by employers and correct the currently flawed tax expenditure calculation methods and assumptions accorded to qualified pension plans.

In summary, pension savings are critically important to the economic security of America and Americans in their retirement years. Congress needs to raise the priority of pension legislative issues and take steps to increase pension savings and address the looming retirement crisis. While additional individual savings vehicles and incentives may be warranted, they should not come in lieu of much-needed pension, tax and regulatory reforms.

I thank you, Mr. Chairman and members of the committee, and would be more than happy to answer any questions you might have.

[The prepared statement follows:]

TESTIMONY OF DAVID M. WALKER
ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS

My name is Dave Walker. I am a Partner at Arthur Andersen LLP and a member of the Board of Directors of the Association of Private Pension and Welfare Plans on whose behalf I am testifying today. I also serve as one of two Public Trustees for the Social Security and Medicare Trust Funds. Previously, I served as Assistant Secretary of Labor for the Pension and Welfare Benefits Administration for the Department of Labor, and as Acting Director of the Pension Benefit Guaranty Corporation (PBGC).

The APPWP is a national trade association for companies and individuals concerned about federal legislation affecting all aspects of the employee benefits system. The APPWP's members represent the entire spectrum of the private pension and employee benefits community: Fortune 500 companies, banks, insurance companies, law, accounting, consulting, investment and actuarial firms. APPWP members either sponsor directly or administer employee benefit plans covering more than 100 million Americans.

I am pleased to have the opportunity to discuss the importance of savings in America, the subject of these hearings. This is a vitally important topic because of savings' direct effect and far-reaching implications concerning the economic security of our Nation and Americans in their retirement years.

Much of the focus of these hearings to date has been on personal savings. Indeed, personal savings is a critical component in ensuring adequate retirement income as well as sources of capital for economic growth. However, the U.S. personal savings rate has generally collapsed since 1980. This collapse in personal savings has increased the pressure on other elements of savings, both Social Security and the employer sponsored pension system. Unfortunately both the Social Security (OASI) and Medicare (HI) programs are encountering their own fiscal problems. The baby-boom generation will greatly increase the retired population in proportion to the working population early in the next century. This will dramatically increase the burden on these important social retirement programs. In addition, the Medicare program is facing escalating costs and is unsustainable in its present form. According to the 1994 Trustees' Annual Report, unless current funding is increased and/or benefit promises are reduced, projections indicate that Medicare will run out of funds in the year 2001 and Social Security will run out of funds in the year 2036. This means that a dark cloud looms over the retirement horizon. However, the one clear bright light in an otherwise dark and dismal savings trend for our country and its retirees has been savings through the private pension system.

It is critical as we review the national policy towards personal savings that we bear in mind that no single element of savings can bear the burden of providing adequate income for this country's retirees as well as the capital necessary for maintaining growth in our economy and improving the standard of living for all Americans. We recognize and applaud your efforts to encourage personal savings. However, we urge you not to forget the vital role that the private pension system plays in overall national savings. In this regard, it is critical that we adopt and maintain legislative and regulatory policies which foster the growth and strength of this system.

It is the importance of this country's pension system to national savings that I would like to focus on in the remainder of my testimony, today. In particular, I would like to discuss the role that pension plans play in the economy. In addition, I would like to share some insight into the current tax expenditure calculations which include those tax expenditures attributed to the employer sponsored pension system. Finally, I would like to offer some recommendations for improving the environment for private pension plans and ultimately to increase our overall savings rate.

Role of Employer Sponsored Pension System in the Economy

The role of the private pension system in providing meaningful retirement income to a sizable portion of the American workforce is well documented and understood. What is less appreciated by those outside the benefits community is the critical role pensions play in the overall American economy. The place to start is with the sheer size of the employer sponsored pension system. In 1950, the system contained approximately 17 billion and accounted for 2% of national wealth; today it has been estimated to contain about $4.0 trillion and constitutes 25% of national wealth. Of this sum slightly less than three quarters are held by private employer plans with the remaining one quarter being held by public sector employers. By 1992, private employer

pension plans alone held nearly one quarter of the nation's equities and approximately 9% of the economy's fixed income holdings.

Much of the growth in pension assets in the early years of the period since 1950 was stimulated by enlightened legislative policies. In 1974, ERISA required employers to set aside specific assets to help assure that promised pensions would be paid. Equally important, ERISA forbade employers sponsoring defined benefit plans from holding more than a modest amount of employer securities, in effect requiring that employers invest the substantial majority of pension assets elsewhere. At the same time, individuals who were responsible for the management and administration of plans and the investment of plan assets became subject to a number of stringent fiduciary standards.

However, since 1980 much of the growth in private pension assets is attributable to a strong investment performance. While the rest of the economy was being deregulated during the 1980's, the budget reconciliation process has resulted in unreasonably curtailing the tax incentives and funding policies related to pension plans. While the ultimate outcome of this activity has been the reduction in pension security for retirement promises made to active employees, there has also been a profound effect on the level of national savings (and hence capital formation) that could be achieved through the pension system.

Furthermore, benefit payments from pension plans have increased at a faster rate than contributions; reflecting the increased burden being placed on this system to provide retirement benefits as personal savings have declined. Unfortunately, defined benefit plan contributions suffered sharp decreases beginning in the latter half of the 1980's. Contributions to defined benefit plans declined from $48 billion in 1982 to $ 25 billion in 1989. Although contributions to defined contribution plans continued to rise during the 1980s, reflecting the increased number of this type of retirement plan, the increase in the rate of contributions did not keep up with the increased rate of payments from these plans. (EBRI, Pension Funding & Taxation, Implications for Tomorrow, Edited by Dallas L. Salisbury and Nora Super Jones, 1994, page 24).

While some of the decrease in the rate of contributions is attributable to increased earnings on financial assets, much of the blame can be laid on tax policies implemented beginning in the 1980's which severely curtailed the growth in new retirement plans and the funding of existing plans. In addition, the dramatic increase in the cost of maintaining a retirement plan has been a barrier to the growth and continued maintenance of these plans.

Specifically, the following represent a sample of several tax changes which have had a detrimental effect from a capital formation and retirement security perspective:

1. Reduction of maximum pensions. Commencing in 1982 and in legislation in succeeding years, Congress rolled back the maximum benefit and contribution limits applicable to tax qualified pension and profit sharing plans. In addition, freezes on the maximum dollar amounts which could be paid from tax qualified plans were imposed on defined benefit plans and defined contribution plans. A freeze on the maximum limit is still in effect on defined contribution plans.

The trend has continued into this decade. Just last year the amount of compensation which can be taken into account when calculating benefits was reduced. Furthermore, in the recently enacted General Agreement on Tariffs and Trade new rounding rules on the cost of living adjustments effectively reduce growth in contributions to retirement plans.

While ostensibly an "attack" on unreasonable benefits for highly compensated individuals, the unfortunate aspect of these rollbacks is that it has a negative ripple effect on non-highly compensated workers and adversely impacts a company's ability to set aside funds for all current workers necessary for retirement. For example, employers may not make contributions on behalf of middle income workers whose projected pensions would exceed current limitations.

2. Reduction in Full-Funding Limitations. In 1987, Congress reduced the maximum amount that could be contributed to pensions from one which permitted employers to set aside funds to pay for projected benefit obligations to one which imposed an arbitrary limitation equal to 150

percent of current liabilities. As a result, depending on plan demographics and other factors, (e.g. interest rates), it is possible for a plan to be at the full funding limit and yet still pay risk related premiums to the PBGC.

3. Additional Tax Rules. Over the decade of the 1980's, Congress and the Treasury Department added an additional 80 pages to the Internal Revenue Code and over 600 pages of regulations. The pension area has become so complicated that the sheer complexity and administrative expense associated with maintaining a pension plan has become a significant barrier to those who wish to start and/or maintain a pension plan. According to a Hay-Huggins study done for the PBGC, the administrative costs associated with maintaining a defined benefit plan, rose during the 1980's on average between 9 and 10 percent a year. According to a soon to be published report by the Committee for Economic Development, (Who Will Pay For Your Retirement? The Looming Crisis, Lawrence A. Weinbach, Chairman, William J. Beeman, Project Director, December 20, 1994, *Draft*, page 117) in 1991 small plan administrative costs (15 or fewer employees) were equal to about one-third of the benefits accrued in that year. That means for every $3.00 contributed to a pension plan $1.00 went to pay for the cost of maintaining the plan.

According to this same report the number of defined benefit plans peaked at just over 175,000 in 1983 and subsequently declined by 24 percent in the 1984-1989 period. In fact by 1989, for every defined benefit retirement plan that was being created three were terminated. While terminations increased by 37%, net plan formation fell by 67%. The picture for 1990 was even more bleak: for every defined benefit plan which was created, more than eight were terminated. Although there has been overall growth in the number of defined contribution plans since the mid-1970's even this type of plan is not immune to the increasing administrative costs. In 1990, more defined contribution plans, the other major form of retirement plan, were terminated than created.

Indeed, part of the decline in the number of defined benefit plans may be associated with the shift from manufacturing industries which traditionally sponsor defined benefit plans to service based industries, which do not. However, most observers believe that the legislative changes noted above had a major deleterious effect on plan formation.

The Committee for Economic Development cites a survey conducted in 1992 in which 50% of the respondents stated that they terminated their defined benefit plans because federal regulations were too costly or burdensome. Furthermore, the data indicates that a large number of employers who terminated defined benefit plans did not replace them with successor pension plans of any kind, and most of those who did so opted for defined contribution plans. The report recognizes the important role that defined contribution plans play in the viability and growth of our nation's pension system. It concludes, "these trends indicate that it is critical that policy makers simplify and stabilize regulations pertaining to defined contribution plans in order to reduce compliance costs. In addition, survival of the remaining 130,000 defined benefit plans and the retirement security of their 40 million participants, may depend to a significant degree on policy makers' actions that influence plan administrative costs." (Who Will Pay For Your Retirement? The Looming Crisis, December 20, 1994, *Draft*, page 119).

Pensions Are How America Saves

At the very time pension plans were being burdened by negative legislative and regulatory policies, there was a general collapse in personal savings. This further increased the burden on employer sponsored plans. The EBRI reports in Retirement in the 21st Century Ready or Not, (edited by Dallas L. Salisbury and Nora Super Jones, 1994, page 40) that the national savings rate fell from 7.1 percent during the 1970's to 3.8 percent during the 1980's and to 1.8 percent thus far in the 1990's. Business and personal savings accounted for about one-half of the decline and the federal deficits accounted for about one-half of the decline.

The pension system represents a significant store of wealth for retirement security and overall economic growth. According to the EBRI, annual accumulations in such plans are not fully accounted for in traditional measures of savings (EBRI, Retirement in the 21st Century, Ready or Not, page 40). In fact the one bright spot in the otherwise dismal domestic savings picture

during the 1980's and 1990's has been the growth in pension assets. Americans' accrual of significant wealth in their pension plans resulted in an astounding fact: the total increase in real (inflation-adjusted) pension assets in the 1980's exceeded the total real increase in this country's wealth (i.e. the money available for investment). In other words the growth in pension assets was greater than 100% of net national savings. (APPWP, Return on Investment: Pensions Are How America Saves, Professor John Shoven, Stanford University Economics Department, September 1991, page 22). Clearly this form of national savings has been vital not only for the economic security of retirees but also for the necessary investments for national economic growth and global competitiveness.

Pension Tax Expenditures

Besides its enormous size and its role in national savings, pensions represent the most egalitarian form of capital formation. A 1987 study conducted for the U.S. Census Bureau showed that the largest beneficiaries of tax deferrals afforded to pension plans were workers with yearly incomes between $15,000 and $50,000. These workers paid 35.6% of all federal income tax collections but actually received 60.7% of accrued pension benefits. Those workers with yearly incomes of more than $50,000 paid 61% of the federal taxes but received only 38.1% of the accrued pension benefits. (Fat Cats, Bureaucrats and Common Workers: Their Piece of the Pension Preference Pie, Gordon P. Goodfellow and Sylvester J. Scheiber, The Wyatt Company, May 5, 1993, p.15).

Rank and file employees are indeed benefitting under pension plans. For instance, a 1991 study by the EBRI showed that U.S. workers earning less than $50,000 a year made up 92% of the nation's work force and 89% of the participants participating in pension plans. (EBRI, Issue Brief #134, February 1993, p.17). No other form of savings so broadly attaches to the middle class.

Yet, the magnitude and distribution of the "tax expenditure" for pensions repeatedly has been used as a justification for tax policy that has damaged the pension system in this country. "Tax expenditures" represent the cost to the government as a result of granting tax incentives. The tax expenditure estimates for pensions are calculated by placing a cost on the granting of a tax deferral to employees for contributions made by their employers to pension plans. The most current estimates of the tax expenditure attributable to pension contributions and earnings, including both public and private sector plans, is $72.5 billion in 1995. Approximately one-half of this figure is attributable to public plans and one-half is attributable to private sector plans. (United States Senate, Committee on the Budget, Prepared by the Congressional Research Service, Tax Expenditures, December, 1994, page 477).

The estimate does not take into account the fact that the tax is deferred not forgone. Thus, the fact that contributions to a plan will be paid out in the form of benefits at a later date and subject to tax at that time is ignored. In addition, the role of pensions in the economy and its investment value is totally missed. There are, in addition, a number of mathematical and methodological problems with the calculations. For example, the tax expenditure estimate includes consideration of pension contributions made by governmental and tax exempt employers. In addition, demographic effects such as the maturity of the plans' work forces are ignored. Yet as the population ages the tax expenditures will lower automatically. Also, the calculation ignores the fact that coverage, and the value of that coverage, typically increases during a career and that tax rates could rise and some people will actually pay higher taxes as a result of the deferral. Finally, the calculations completely ignore the funded status of the plans.

Recommendations

Future economic growth in America and the economic security not only of retirees but of all of our workers and their families depends on readily available capital for investment. Our most important ally in increasing our capital pool over the last decade and a half has been pension funds. According to the Committee for Economic Development private savings is only a fraction of that needed to enable future retirees to fulfill their economic expectations in retirement. One recent study showed that the baby-boom generation needs to triple its rate of

accumulation of assets in order to maintain its pre-retirement standard of living during retirement. (Merrill Lynch, Is the Baby Boom Generation Preparing Adequately for Retirement?, *Technical Report*, 1992, B. Douglas Bernheim, Stanford University Economics Department, formerly of Princeton University, and Summary Report of the same title, 1993, page 1).

We can and we must streamline and simplify the rules applicable to pension plans. Congress has twice passed legislation in 1992 which would begin to untangle the legislative and regulatory gridlock currently ensnaring the pension system in this country. However, the legislation was attached to a broader measure that was vetoed for unrelated reasons. We must encourage the formation and funding of pension plans and limit compliance costs. Based on the current population survey, the greatest percentage of workers not covered by pension plans in this country work for employers that do not sponsor a plan. We believe that legislation simplifying the rules applicable to pension plans would give a tremendously needed jump start to the formation of plans.

Tax policy affecting the pension system should allow employers the flexibility to use the plan design which is most appropriate for their work force and their business. As I mentioned earlier administrative burdens have made the adoption and/or maintenance of a retirement plan increasingly unattractive to employers. This is particularly true in the case of defined benefit plans. We urge you to look for ways to make these plans attractive to employers once again.

Defined contribution plans have accounted for virtually all the growth in the number of active workers covered by private plans. Between 1975 and 1987 the proportion of covered workers with a defined contribution plan as their primary plan rose from 13% to 32%. Most of the growth in defined contribution plans is occurring in a type of plan known commonly as a Section 401(k) plan, in which the participant makes a contribution and the employer makes a matching contribution. (EBRI, National Academy on Aging, Pensions in a Changing Economy, Edited by Richard V. Burkhauser and Dallas L. Salisbury, 1993, page 25). These plans have become attractive to employers in part because of the shift to a service oriented economy but also because of their simplicity and understandability. However, even these plans are not immune from legislative and regulatory complexity.

The single most unattractive feature about these plans is the complicated nondiscrimination test which must be performed annually. This test generally does not affect the highest paid employees whose contributions are limited by the dollar caps on contributions. Instead the effect of this test is to reduce the amount that can be contributed by and on behalf of the middle income wage earners. Unfortunately, the affected workers are often older and are trying to maximize their contributions in order to prepare for retirement. We urge you to include in pension simplification legislation a meaningful safe-harbor which would eliminate the necessity of employers having to run the expensive and unnecessary nondiscrimination test applicable to Section 401(k) plans.

As defined contribution plans have grown and a wider range of investment opportunities have become available to participants, employers have recognized the need to educate their employees about the importance of participating in pension plans, investment for the long term and saving generally. The market has responded with a wide variety of educational materials. Since this is a relatively new area for employers and those servicing retirement plans, it is unclear what affect the educational efforts are having on participant behavior. However, early indications are that the efforts are being rewarded. There are currently a number of studies underway to help determine what educational approaches work best and what effect education has had thus far. However, it is clear that the more Americans are made aware of the importance of savings, early participation in pension plans and their responsibility for both, the better their chances for being prepared for retirement. We urge Congress to be very careful that policies adopted in the name of protecting and empowering participants do not hurt the ability of employers to provide useful and much needed retirement planning and investment education to their employees.

We also urge you to reconsider and correct the calculation of the tax expenditure associated with the pension system in this country. In addition, national policy should not sacrifice the future of America's workers and their children by giving in to the temptation to pay for the federal

deficit with pension savings. The federal deficit eats away at national savings. Congress should not address that problem by weakening our greatest source of savings, pensions.

We support and encourage your efforts to expand personal savings but caution you to recognize that increasing personal savings by reducing the incentives for employers to maintain pension plans will not solve the savings crisis in this country. In addition, Americans must be encouraged to save by creating attractive savings vehicles. This may include allowing early access to the savings. However, no one component of savings - personal or pension - should be favored in this regard. The favorable tax treatment traditionally granted in America to pension contributions and the earnings thereon stand as a monument to the recognition of the importance of the economic security of our retirees and the significant role that pensions play in our nation's overall economic well-being. Thank you.

Chairman ARCHER. Thank you, Mr. Walker. Your timing was perfect.

I will yield my time for inquiry to Mr. Bunning.

Mr. BUNNING. Thank you, Mr. Chairman.

Mr. Porter, you mentioned in your testimony the special connection between equity investment and productivity growth that leads you to emphasize specific changes in tax treatment of equity and debt. Would you mind elaborating why that is so?

Mr. PORTER. Yes, Congressman. Equity has a special role in boosting productivity and creating economic growth because equity capital is what companies use to finance intangibles like R&D and entering new markets. You cannot use debt—there is no collateral for those kind of investments. And when you are building new products and entering new markets, you really finance that out of equity. Debt is what you use to finance safe things where you have hard assets.

Also, equity capital allows you to add debt capital on top of it, so you can get a double whammy. I believe that we must place particular attention on the incentives for equity investment, and, among equity investment, long-term equity investment. Because it is long-term equity investment that is really what funds the things that drive our economy forward.

Mr. BUNNING. Also, today our economy grows between the rate of 3 to 4 percent on an annual basis. I was taught in economics 1 and 2 when I went through school that that was good, and even 5 and 6 percent was better. I also was taught that low interest rates were good, and I was taught that inflation—high inflation—was bad.

What has happened in the thinking of the Federal Reserve—or whoever is trying to set the economic policy in this country—that all these things are not as good as they might be because we are at full capacity? And why are we at full capacity if we are only growing at 3 or 4 percent?

Mr. PORTER. I think that is a very important question, and it is not very often discussed.

The fact that at only 3 or 4 percent economic growth we are straining at capacity and worried about inflation I think is a function of the very low rate of net investment in the economy. Remember what I said earlier was that in the sixties and seventies our net investment, which is investment after depreciation in the corporate sector, was 3 to 4 percent of GDP. Now it has fallen to 2 percent of GDP.

So if the economy is growing at 3 or 4 percent and the net investment is at 2 percent, you can see why we are straining at capacity. And unless we can boost the rate of net investment in the corporate sector, particularly as in the ways I have discussed, we are going to face that situation for a long time. We will have a cap on how fast our economy can grow without setting off inflationary pressures.

Mr. BUNNING. Ms. Walker, you mentioned in your testimony about capital gains and the length of time that we hold capital assets that we should probably adjust how we deal with that asset in direct relationship to how long we hold it. You mentioned 3 and 5 years.

Is there anything that you would like to add to that? In other words, I would like to see us get into indexing at least and at least try to do something if we could phase in a capital gains tax reduction over a 5-year period. I am willing to do that just to get it going.

Ms. DEBORAH WALKER. And the AICPA supports indexing.

The problem is, when we look at the provisions for indexing and even look at provisions that have been introduced in the past, we very quickly get into rules that are just too complicated, and then our thoughts go to, well, because we have to keep these extra records and find GDP deflators and make all these calculations and project forward, would it not be easier if we just had a different exclusion based on the holding period of assets?

So the capital gains exclusion takes into account what indexing otherwise could do as a simpler way to get to the same point. Does it exactly do what indexing would do? Of course not.

Mr. BUNNING. No, but it allows us to take a capital asset and at least consider the fact that there has been inflation and the longer we hold the asset the less value it has as far as the asset is concerned.

Ms. DEBORAH WALKER. Or the less of the gain that should be taxed, because the more of the gain that is really inherent inflation. Correct.

Mr. BUNNING. Correct.

Chairman ARCHER. Would the gentleman yield just briefly?

Mr. BUNNING. Yes.

Chairman ARCHER. The unfortunate reality, Ms. Walker, is that it can end up not even being a rough approximation of indexing if inflation becomes very rampant. A mere sliding scale holding period cannot accommodate the destruction of capital—real capital savings if you are taxing portions of inflation. If you assume inflation is going to stay constant at 3 percent, you could perhaps adjust a scale of taxation. But we all know that that is not the way life works. So I would simply point that out from a policy standpoint that would not work.

There is also another problem which we have run into every time we have considered a sliding scale of holding periods. You create cliffs and you then begin to impact on economic judgments and I think Mr. Terry said we want to keep as level a playingfield as possible out there. So your solution creates its own set of problems.

I thank the gentleman for yielding.

Mr. BUNNING. Well, thank you. I yield back.

Chairman ARCHER. Mr. Kleczka.

Mr. KLECZKA. Thank you, Mr. Chairman.

I have a question for Professor Porter. In your statement there is a lot of which I agree with. However, you do have a section here on overinvestment in real estate, and you indicate that the tax consequences are some $82 billion. However, I think your recommendations will not do much, if anything, to decrease that tax consequence. Even if you cap interest and principal on mortgages at $350,000, that is not going to net very much at all.

You do not cite a figure for restricting the free tax rollover, but the question I have is—and it is probably more in the form of a statement—that for the bulk of Americans, their main asset is

their home. And, yes, because that is the case, the tax consequences will be relatively high. But if we are to start tampering with the tax-free rollover, what I find in my district is a young couple, before the kids, they buy a little starter home with two bedrooms; they move into the next home with four bedrooms; roll over that profit, and that is how they increase their major asset.

So I think your statement here that we are overinvesting in real estate is somewhat misstated, because, for the people I am talking about and the folks I represent, they do not have the wherewithal and the money to buy blocks of IBM and GM and help with equity capital and things of the type you have talked about.

Mr. PORTER. May I respond briefly, sir?

Mr. KLECZKA. Yes, please.

Mr. PORTER. I guess the point I want to make about real estate is simply, first of all, the balance. I think the number we discovered from doing the calculations is that 50 percent of all the net investment in the U.S. economy is in residential real estate. Fifty percent. And I guess the idea is that that sounds high in terms of an economy where we are trying to grow our economy, create new jobs, and create a rising standard of living.

My recommendations are about trying to limit this incentive for affluent people. So I said our premium is if the combined first and second home equity is $350,000, then we will cap the deduction at that. And the same applies to the rollover.

The idea is if—you know, you can roll over maybe $100,000 of tax-free gains. But if you are rolling over $2 million, we are no longer talking about the middle-class person. We are no longer talking about that struggling young couple. I think we have to have the wherewithal and the courage to start scaling back some of these investments if we are really serious about boosting investment in the private sector.

That is my only point.

Mr. KLECZKA. But if we would adopt the program you are recommending, I would say that we will take that 50 percent figure you just used of investing in real estate, and we will probably reduce that to maybe 48 percent. Thank you.

Mr. PORTER. It is true that the absolute dollars are in the $5 to $10 billion range, but that is still a lot of money per year.

Mr. KLECZKA. I would not minimize it because, knowing full well that investments in homes and building homes, the spinoff is throughout our whole community, not only the jobs in construction but the other services and items that are purchased for the home. So the spinoff is pretty good also. Pretty widespread.

Mr. PORTER. But not as high as a company investing in a new plant and creating 100 new jobs.

Mr. KLECZKA. That is true, but the bulk of the people who are in that 50 percent category do not have the assets to do that.

Chairman ARCHER. Mr. McCrery.

Mr. MCCRERY. Thank you, Mr. Chairman.

Mr. Porter, you were answering Mr. Bunning's question, and my attention was diverted, and I missed part of your explanation. I am very interested in what you said at the very end. I think I heard you say that there would be a cap on growth for the next few years. Is that what you said?

Mr. PORTER. What I said, sir, was that, given that the net rate of investment in fixed plant and equipment in the U.S. economy is only 2 percent of GDP, which it used to be much higher, used to be double that, if we grow at faster than 2 percent of GDP, eventually we are going to run out of capacity. And instead of investing in new plant and equipment, what American industry has been doing in the last 10 years is they have been buying back stock and making acquisitions.

I am not against either of those things, but what I am saying is those do not create net new capacity in the economy that allows us to have true economic growth. It changes ownership.

So that is why I, in my testimony, put special attention on how we can increase the flow of equity capital, which is what really fuels investment in creating new plants, new businesses and new jobs.

Mr. MCCRERY. I am just a lawyer, I am not an economist, but if we have growth in productivity, then we can increase economic growth to 4, 5 or 6 percent, like Mr. Bunning wants, and not have inflation. Is that a fairly correct general statement?

Mr. PORTER. Yes. But, again, you cannot increase productivity without also increasing capacity or you really cannot have growth.

Another problem we have had is the downsizing process. And that allows us to make our existing assets more productive, but it has not allowed us to really expand.

I think what is happening is that there is an imbalance developing between the amounts of new investment and—for example, I show in my statement a calculation about productivity growth. What it shows is that almost all the productivity growth spurt in the last 10 years has been productivity in volume terms. You hold the price constant, and you can make more of the same products.

But if you look at the value productivity growth, the dollar value of the output, actually productivity growth continues to be very, very slow. What is happening is that industries are not able to sustain price increases. They are not producing new products that they can charge high prices for. We are getting more efficient in cranking out the old products, but we are not expanding and upgrading enough to support rising wages.

I have some charts on that in my testimony.

Mr. MCCRERY. Is there any provision in the Contract With America—I assume you have looked at the provisions in the Contract—that would help solve that problem?

Mr. PORTER. Well, I believe that the single most powerful provision is the long-term capital gains incentive. As I said in my testimony, I, myself, believe that we should limit that to equity capital, equity investment in corporations, because I do not believe that other forms of investment, like collectibles and so forth, have the same leverage for economic growth.

I would also make that long-term investment truly a long-term incentive, either through a significant—more than 1 year—holding period or some kind of a step-up, as my fellow panelists suggested, recognizing the Chairman's concerns with the step-up are well taken.

And in order to lower the cost of that proposal, which is, I know, a large one, I would make it prospective. That is, I think that al-

though it is tempting to think in terms of the old investment that you are going to unlock, I think it is much better to create incentives for the new investors today to be choosing investment projects that they plan to hold.

Mr. McCRERY. Are there any tax provisions in the Contract that you think would be disadvantageous?

Mr. PORTER. I think there are tax provisions that we can debate in terms of their value versus their cost. But I don't think they would work against long-term equity investment, as I understand them.

Mr. McCRERY. Thank you.

Ms. DEBORAH WALKER. Indexing of capital gains, I think, might do that, where you do not index the debt because that will encourage debt acquisition as opposed to equity acquisition.

Mr. PORTER. Fair enough.

Ms. DEBORAH WALKER. Indexing capital gains without paying attention to the debt is a significant problem.

Mr. McCRERY. Thank you.

Chairman ARCHER. Has the gentleman completed his questioning?

Mr. McCRERY. Yes.

Chairman ARCHER. You still have 1 minute left, if you would not mind yielding to me.

Mr. McCRERY. Be happy to.

Chairman ARCHER. In that regard, the difficulty with indexing the debt is that you have to index both sides of the debt, and you get some very, very untoward results. So, in theory, you might say that that levels the playingfield. It distorts the level playingfield in the mind of a debtor who cannot take the deduction for the full amount of the interest because you have eroded the value of the interest payment.

So you have to be very, very aware of all the ramifications of what you are talking about.

I thank the gentleman for yielding.

Mr. Ramstad.

Mr. RAMSTAD. Thank you, Mr. Chairman.

I want to thank this panel of expert witnesses for your testimony. I would like to address my question, please, to Mr. Walker.

I certainly share your concern for the low rate of savings. In fact, I am alarmed—and I use that term advisedly—when I read Dr. Feldstein's studied conclusion that were we to put all of our personal savings into plant and equipment in this country today, we could not sustain long-term economic growth. I think that is a real indictment. It certainly goes to the point that not only you, Mr. Walker, but the others on the panel made.

But in addressing my question to you, you talk about the importance of the private pension system and promoting savings. You also mention some of the complexities that have been layered into the private pension system over the past few years. Would you just elaborate on the complexity? How it has affected growth and the viability of the pension system?

And, in particular, how, in your judgment, have the tax policies of the last 10 to 15 years affected the private pension system? And

now that we are looking at reforming those tax policies, how would you prioritize the reforms?

I guess those are three—at least a three-part question, but I am primarily interested in this: In your judgment, how would we reform the Tax Code to undo some of the damage?

Mr. DAVID WALKER. Thank you.

First, let me say that I believe that the elective and regulatory requirements that apply to qualified pension plans are probably the most complex of any in Federal law. I spend full time practicing in the compensation benefits area, and it is extremely difficult for me to be able to stay on top of these issues. And now we are having to have subspecialists in various areas because it is almost impossible to stay up. Which means there is a tremendous amount of cost, there is a lot of administrative burden, and frankly, it is almost impossible for people to be able to comply with the law even if they wanted to comply with the law.

Specifically, what has happened, I think over the last several years is, all too frequently policy has been dictated by short-term revenue results rather than long-term savings and investment objectives. We have made a number of decisions as a country that are myopic, that have tunnel vision implications.

In particular, I think we need to look very hard at what we have done in the area of the contribution in benefit limitations, where we have continuously eroded those, where we have placed arbitrary limits on the ability of defined benefit plan sponsors to adequately fund their pension promises. And, in some cases, it has had not only a deleterious effect on savings but also on retirement security.

I think that we have to look at regulatory burdens and particularly the 600, roughly, pages of nondiscrimination regulations that apply to pension plans, especially defined contribution plans.

I think that we need to—I could probably go on for quite a length of time, and I would be more than happy to provide some additional information for the record, if you would like, because APPWP has done a tremendous amount of work and has a number of studies that I think that might be helpful to you and other members to get into more specificity. But we have to take a longer term view.

[The information is being retained in the committee files.]

Mr. DAVID WALKER. And the last thing is we have to revise how we calculate tax expenditures. I am a CPA, among other things, and it is amazing to me that the Congress does not employ present value methodologies in calculating tax expenditures. The country is not going to go away in 3 to 5 years.

The fact of the matter is that many of the tax expenditures that are accorded, or so-called expenditures accorded to pension plans, are actually timing differences. They are not permanent differences. It is not a matter of whether or not you are going to get tax revenue, it is when you are going to get it, who is going to pay it and at what rate. If we look at it on a present value basis, I would say we would probably be making a lot different policy decisions than we have made in the past, and we need to.

Mr. RAMSTAD. Well, thank you, Mr. Walker. If you could provide that input, it would be appreciated.

And, again, thank you to all the witnesses.

Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Ford.

Mr. FORD. Thank you, Mr. Chairman.

Ms. Walker, I have a couple of questions for you. I think on H.R. 6, on page 8 of your testimony, you talked about the marriage penalty. You oppose the marriage penalty proposal in the Contract as being too complex, unworkable and bearing very little relationship to the magnitude of the marriage penalty in our current system. In your opinion, would the Contract proposal eliminate the marriage penalty for anyone?

Ms. DEBORAH WALKER. My understanding of how the marriage penalty would work that is in the proposal is that all taxpayers that were subject to the marriage penalty would somehow be put in a category and then we would divide up the $2 billion of tax expenditure and allocate it among those people.

So if that is the way it is intended to work, it would not eliminate it for anybody. It would eliminate a small piece for everybody subject to it.

The problem I see is really the complications in making this calculation, which, of course, the legislation does not outline how we would figure out how everybody is—what pieces they are subject to the marriage penalty, and then allocating the $2 billion.

Mr. FORD. Do you support the elimination of the marriage penalty completely?

Ms. DEBORAH WALKER. Completely. I support the elimination of the marriage penalty completely.

But I think there are ways to do it—and many States do this—is tax the two earners where you can choose married filing jointly or file as a single taxpayer and allocate your deductions and exemptions.

Mr. FORD. Which other part of the American dream proposal in this Contract would you replace with the approximately $14 billion a year for the marriage penalty, for this section to be removed. Is there any swap that you would like to see in the Contract that is before the committee?

Ms. DEBORAH WALKER. Well, that is probably an economic or social policy call.

Mr. FORD. You are a CPA. I am asking not you personally but from your industry.

Ms. DEBORAH WALKER. Within the American dream savings account—are you looking at the family tax credit? The American dream savings account and the elimination of the marriage penalty; and if we talk about the elimination of the marriage penalty, which other one would we support?

Mr. FORD. You could use it that way. Just stay within the American dream tax piece under this proposal with the Contract.

Ms. DEBORAH WALKER. That is a tough call.

Mr. FORD. That is a tough call.

You stated that the Contract's marriage penalty proposal would force all married couples to prepare as many as five Federal tax returns. Could you explain how this would happen?

Ms. DEBORAH WALKER. Well, married filing jointly, married filing separately, and two single returns, and it would be two married filing separately returns. And then, I think in the testimony I also

pointed out that, of course, they would be calculating minimum tax and regular tax at the same time.

Now, with computers, that can all be done certainly more easily than it could have been done 10 or 15 years ago. But, notwithstanding, that we still do not like—I don't believe we like our taxpayers to think there are 10 different ways that you can pay your taxes and you get to figure out the cheapest.

Mr. FORD. But I am still—how much of the marriage penalty would the proposal alleviate for a typical taxpayer under this Contract's proposal?

Ms. DEBORAH WALKER. I believe in the ABA's testimony they computed it would be a credit of $91.

Mr. TERRY. It ends up, Mr. Ford, if you take the $2 billion and you apply it across the board—let us assume that half the people that file joint returns would get some benefit, should get some benefit. We calculate the annual amount to be $91. A total of $91 aftertax benefits. Not a very large amount in the overall picture.

Mr. FORD. But how does this compare with the amount of the average marriage penalty, Mr. Terry?

Mr. TERRY. It is considerably less, I would say, although we have not run the figures. I would say that that is substantially less than most of the—than the average would be. It is not a very large piece of the problem, put that way, for most taxpayers that have the problem.

Mr. FORD. And with the proposal in the Contract on the marriage penalty, the $2 billion would be thrown into the problem. Would you have a comment, as Ms. Walker might have said earlier, about the elimination of the marriage penalty?

Mr. TERRY. Mr. Ford, we do have a specific suggestion which—really, I guess we approach it this way. Since there is only a certain limited amount of money available to "throw at the problem," we would suggest that you approach it in a little bit different way and look strictly at the earnings.

The proposal, as drafted, suggests that you solve the marriage penalty with respect to all income, all earnings, both earned and unearned. We suggest that you focus on the earned income of the two married people and you apply a simpler credit to the earnings of the lower earning individual. This is very similar to a proposal, or something that was in the law several years ago.

We think that is simpler; that it does attack the problem, and it goes at it in a way that is understandable and administrable. So we do have a specific thought on this in the record.

Mr. FORD. My time is up; but, Ms. Walker, would you support that concept?

Ms. DEBORAH WALKER. Yes, we would. Because I think what people think is most unfair is the earnings tax as opposed to unearned income being taxed subject to the marriage penalty. On the other hand, if you really want it to be truly fair, you would take all income.

The one other thing I was going to add is I believe the Congressional Budget Office had statistics that said $16 billion is the annual marriage tax penalty. You could probably check that, but that would say that $2 to $16 billion is a very minuscule portion.

Mr. FORD. Thank you, Ms. Walker.

Chairman ARCHER. The gentleman's time has expired.

Mr. Hancock.

Mr. HANCOCK. Thank you, Mr. Chairman.

Mr. Porter, I was intrigued by your statement about capital gains and equity capital. Have you come to the conclusion that over the past 50 years that we maybe have overemphasized the real estate investment aspect of our economy?

Mr. PORTER. Well, I believe that we have—yes, that is my conclusion. It is really quite striking if you look at the allocation of the Nation's total pool of investable capital and where it actually goes. If you, again, correct for depreciation, more than half of it actually goes not for business real estate—I am not even counting that—but just for residential real estate.

Now, it is anybody's guess how to prove whether that is too much or too little—it is a very complicated calculation—but we know that it is not an accident. We know there is a whole array of subsidies for residential real estate. The biggest, of course, is the home mortgage deduction. The second biggest is the rollover of capital gains.

And I guess my suggestion is, if we are serious about long-term economic growth and creating jobs, it is probably time to start scaling those incentives back, starting with the people that are truly affluent people. And that is what my recommendations are addressed at.

Mr. HANCOCK. Basically, I think I am hearing you say that a $1 million home, after it is built, does not really add that much to the economy.

Mr. PORTER. Well, certainly somebody has to build it, and, temporarily, there will be some jobs created to build it. But, say, if you compare $1 million in investing in a home and $1 million in building a new plant to produce a new product, the return for the long term of the economy is really substantially greater in the plant.

Mr. HANCOCK. Is it also true that immediately following World War II a Harvard economist advised the Japanese to invest in economic production and the same economist advised the American people to build houses?

Mr. PORTER. Well, I cannot speak for that economist, because I know exactly who it is. But it is true that in our country, I believe, although it is very hard to do these calculations, we allocate a very large percentage of our investment budget to single-family housing and residential real estate.

Again, I do not want to come across as being against the American dream of owning your own home. I am talking about the size of these incentives and the degree to which they apply to really affluent people who perhaps do not need that kind of subsidy. And perhaps we should apply those resources to provide more incentives for investment in equity capital, in industry, if we are, again, serious about long-term economic growth.

Mr. HANCOCK. I have one other question I would like to ask the panel. As part of the Contract With America, we have the $500-per-child tax credit. The family tax credit, I fully support it, and I think every member of our side of this committee supports it.

However, I think we should take a real good look at it. Could that $117 billion be used to benefit more people, including the people that have a family? Like, for instance, a zero capital gains tax

rate on the first $2,500 of capital gains, or a zero tax on the first $1,000 of interest savings?

Could that be broadened to where it would benefit everybody rather than just people that happen to have children between the ages of 1 and 18?

Mr. PORTER. Well, again, I am not an expert in this area, but the general answer is yes.

In my testimony, I talk about the individual retirement account. And the concept there is that if you earn $30,000 a year it makes sense maybe to give somebody an incentive for the first dollar of savings in an IRA. But if you earn $100,000 a year, you should have to put $5,000 in your IRA before you receive any incentive.

And I think, again, if we could income meter these incentives, I think we could broaden their impact dramatically and actually increase net saving rather than just give a person a break on something they would already have set aside.

Mr. HANCOCK. Ms. Walker, I noticed when I mentioned the thousand dollars tax free in interest earnings, you nodded like that sounded like it might have some appeal.

Ms. DEBORAH WALKER. Well, I think you have to look at whether it is—you could do the same thing on a broader scale by taking the $500 credit and rolling it into the personal exemptions, and that does not limit it to children under age 13; or roll it into the standard deduction. In other words, increase the standard deduction and that would target, of course, families that claim the standard deduction and do not itemize their deductions.

The reason I smiled when you said the thousand dollars of interest exclusion is that that goes right to increasing savings, and that is what we——

Mr. HANCOCK. I think this hearing is designed to explore ways to encourage savings and investment. That is what why I brought it up.

Ms. DEBORAH WALKER. That is true, and that is why everybody here has said we need to encourage savings and investment. So perhaps an interest exclusion or a dividend exclusion, if we want to focus on equity instead of debt.

Mr. HANCOCK. Mr. Walker.

Mr. DAVID WALKER. Thank you, Mr. Hancock. I think it is very much appropriate to see how you can increase savings. But I think another element that needs to be focused on by the committee is, and I am sure you are, is how are you going to pay for this and what is the collateral effect going to be? There are only so many tax dollars available in order to provide incentives.

You also need to look at what is going to provide the greatest savings incentive and for whom. What level of income are those individuals going to be, both vertical and horizontal equity? And in that regard, I would suggest do not lose sight of employer-sponsored plans, because, generally, you get more horizontal and vertical equity in that than you do in some of the other individual savings arrangements.

Chairman ARCHER. The gentleman's time has expired.

Mr. English.

Mr. ENGLISH. Thank you, Mr. Chairman.

Mr. Porter.

Mr. PORTER. I can answer one more. I have to chair a meeting this afternoon in Massachusetts.

Mr. ENGLISH. I will not detain you too long. It is delightful to have you here because I know you have done a lot of the seminal thinking on the factors that affect the competitive position of different countries.

And I wonder if you would generalize just briefly on the effect that the Tax Code has as it is structured right now on the competitive position of the American economy. And, specifically, what impact it has on certain sectors of the American economy. And here I have in mind manufacturing, which I believe is disproportionately affected by the Tax Code.

Is it fair to say—using an old term—that we have in place an industrial policy in this country in the Tax Code, which, in effect, puts some of our manufacturers at a competitive disadvantage? And would you recommend that this committee look at addressing that problem?

Mr. PORTER. Well, I certainly do. I have looked at a lot of economies around the world and have paid particular attention to the environment for investment in industry. This involves a complicated set of policies, but I think it is really quite striking how the United States is one of a group of countries that includes Great Britain and Canada and former British empire countries, all of whom are very low investors, chronically low investors. I think that is because all those countries share a certain number of similar characteristics.

They reward consumption and not investment. Almost every other major economy has very low or excluded long-term capital gains incentives. We also have a whole variety of other rules and regulations that actually work against emerging companies and high R&D companies. I do not have time and am not prepared to go through all of those, but I would be happy to submit to you a statement with some of the details.

But I think it is fair to say that we are working against our own economic interest with the tax structure we now have in place.

[The information is being retained in the committee files.]

Mr. ENGLISH. Is it fair to say that the tax structure that we have in America today, as it applies to manufacturing, puts American workers at a competitive disadvantage worldwide?

Mr. PORTER. I believe so. I think manufacturing is more capital-intensive, requires more investment in fixed capital, and often requires heavier formal R&D investments. To the extent that we are disincenting those kinds of investments, we are actually driving our own economy away from manufacturing and in other directions.

Mr. ENGLISH. Thank you. Obviously, this discussion could take up a lot of time, but I appreciate your making those basic points. We will look forward to hearing more from you.

I would personally be very interested in your findings on the subject and particularly on the importance of investment in inner cities. And I appreciate your presence here.

And, Mr. Chairman, I yield.

Mr. PORTER. Thank you.

Mr. BUNNING [presiding]. Mr. Gibbons.

Mr. GIBBONS. Mr. Walker, you mentioned the problems that the Social Security system and the Medicare system face and their long-term outlooks. One of the things that I had planned to do as chairman this year, which of course I am not, was to look at the Social Security financing. I have come to the conclusion that our problems are really easily repaired.

It seems the real problem in Social Security over the long term is our overindexing of benefits. If I understand the figures correctly, the benefits in the Social Security system will rise rapidly in the outyears; that we face prospects of a beneficiary having approximately three times as much purchasing power in the outyears as the beneficiaries do today; and that, therefore, we can solve that savings problem just by a simple readjustment of the indexing of benefits in the Social Security system.

I wonder have you looked at that and what your views are on that subject.

Mr. DAVID WALKER. Mr. Chairman—pardon me—Ranking Minority Member Gibbons, I know this is a topic that you have been very involved with for a number of years. My personal view is, with regard to Social Security—now I am speaking just of OASI, not Medicare, which is a different story.

Mr. GIBBONS. Yes.

Mr. DAVID WALKER. With regard to OASI, our latest projection is that the trust funds will run out of funds in 2036. That has come closer every year over the last several years. I believe that we can salvage Social Security. We must salvage Social Security. We need to take some steps sooner rather than later to do that.

I think one of the issues we have to look at, we have to look at indexing. We have to look at when benefits commence. We have to look at both the normal retirement age and early retirement age. We have to look at the factors that are used to reduce the early retirement benefit. I think we have to look at a variety of factors.

I think the bottom line is Social Security can, should and must be salvaged, but we have to act on it sooner rather than later. And it is going to be both revenue and benefit modifications that will get us there.

Mr. GIBBONS. I am sorry Mr. Porter had to leave, but perhaps some of the rest of the panel will have some views on this. There seems to be no doubt in the consensus of the opinion of economists and others in our society that we have overstimulated investment in real property, and it is my hunch that most of it has ended up really in inflated values in real property. By our overstimulation we have just increased investment in that area; therefore, increased the price and made it no easier, really, for low-income people to get started in a house.

One of the biggest stimulations is the home mortgage interest deduction. I notice in Canada, right next to us, that has a good stock of housing, it has no home mortgage interest deduction. I don't propose to do away with the home mortgage interest deduction, but, in your opinion, should we limit the home mortgage interest deduction?

Any of you want to take a shot at it?

Mr. TERRY. Mr. Gibbons, I will respond indirectly to that. It is interesting, but the interest deduction, which used to be a fairly

simple provision in the Internal Revenue Code, is now viciously complex, particularly the investment interest limitations, even the mortgage deduction interest, which is so important to so many low- and medium-income people.

One of the things I think this committee could do very productively would be to try to simplify that thing so that the people—and these are the run of the mill taxpayers that have these kinds of deductions, primarily—and I think one thing that would help considerably would be to simplify the mortgage interest deduction across the board. I think there are ways to do that.

Mr. GIBBONS. Well, I guess I lost my principal witness, Mr. Porter, when he had to leave, so I will suspend my questions here. Thank you.

Mr. BUNNING. Mr. Ensign.

Mr. ENSIGN. Thank you, Mr. Chairman.

I actually wanted to address some of this questioning to Mr. Porter, but maybe, Ms. Walker, if we could get your perspective on it. It has to do with the idea of encouraging investment in low-income areas such as inner cities.

I have been doing some research into that as well, in trying to come up with ways maybe to zero capital gains taxes in inner cities, possibly raising the expensing provision for capital equipment up to $100,000 to $200,000, items such as those, and in that process have run across some questions.

Some people have explored these in the past. They have talked about the problem being that people take older assets, move them into those areas strictly for the tax advantages instead of investing new capital. Could you just address some of the issues, if you have looked into this area.

Ms. DEBORAH WALKER. Well, I have not looked at this area significantly.

And I guess the other thing that comes to mind—I will speak to yours in 1 minute—but the other thing that comes to mind is defining what are those areas, and I think that might be more complex.

Mr. ENSIGN. Well, I think the administration recently has designated empowerment zones and enterprise zones. Areas such as those would be pretty easy to piggyback on top of.

Ms. DEBORAH WALKER. There are rules, antichurning rules, that are in the depreciation rules. And those rules you could piggyback off of to avoid what you are talking about, which is selling to a related party in order to qualify for the credit or the deduction.

Mr. ENSIGN. OK. Obviously, we are dealing with welfare reform on this committee as well. One of the reasons that I have such an intense interest in this, is that the complaints we hear are that there are no jobs in the inner cities, there are no jobs for these people that we are trying to get into workfare-type programs.

What is your feeling? Do you think this will increase incentives to generate jobs there? Do you think businesses will take the incentives in these areas? Are the financial incentives great enough to overcome the security problems, the various other local issues that you deal with?

Ms. DEBORAH WALKER. In dealing with clients, that is going to be just a purely individual client decision. But there are going to

have to be significant incentives to overcome the risk that you talk about and the aggravation.

Mr. ENSIGN. Mr. Walker.

Mr. DAVID WALKER. I would say, Mr. Ensign, that, in general, I think that there is an increase in corporate social responsibility in this country. And I think more and more corporations and other business enterprises are recognizing that it is our problem, and there is a lot more volunteerism and activism that is happening.

And you are right, there is a tradeoff between the economic tax incentives and the other considerations, but I think more people are recognizing we have to deal with these issues, and they are part of the solution in trying to do that.

Mr. ENSIGN. Thank you, Mr. Chairman.

Mr. BUNNING. Mr. Zimmer will inquire. He is not here.

Mr. Houghton.

Mr. HOUGHTON. No questions.

Mr. BUNNING. Mr. Levin.

Mr. LEVIN. Thank you.

Like others, I was sorry that Professor Porter had to leave because his suggestion would be quite different than what is in the Contract, and I think it would be worthy of our having some discussion of it, excluding all investments other than equity investments and making it prospective only. That is really quite a different proposal, both in what is covered and also in its fiscal implications.

But let me just ask the three of you, whoever would like to comment, about the implications of capital gains proposals in the Contract and otherwise for tax shelters. What concerns do you have about their recurrence?

Mr. TERRY. Mr. Levin, analyzing the provisions in the Contract, one of the things that we point out with respect to the 50-percent capital gains deduction, we do think that will lead to increased tax planning.

You know, tax lawyers are called upon to figure out ways to achieve capital gains, and it results in attention by tax lawyers in figuring a way to convert ordinary income into capital gains. And although that is not traditionally referred to as a tax shelter in the same sense that in the eighties, late seventies you had these fancy deals that were marketed, nevertheless, that does—and we indicate in our statement—that does present some concerns. We think it will increase transactional complexity, and we think it is something that should be taken into account by the committee.

Mr. LEVIN. Anybody else? Yes, Ms. Walker.

Ms. DEBORAH WALKER. In my testimony I give an example of how the lack of indexing the debt can increase the rate of return.

Basically, if you assume that somebody buys stock for $1,000 and purchases that with a loan, and the loan pays 8 percent interest and inflation is 5 percent. So the interest rate is a little higher than inflation. And now let us assume 1 year later the property has appreciated 10 percent. So we have earned $100 on our thousand dollars' worth of stock. That is a 10 percent before-tax rate of return. With the 50-percent capital gains deduction, it is really an 8 percent aftertax rate of return, assuming a 40 percent tax rate—39.6.

So, if we index that gain—remember, I said we were going to assume it appreciated 10 percent, but half of that is going to be inflation. So if we index that gain, now we have a 9 percent aftertax rate of return instead of the 10 percent that you would have just with the capital gains—or instead of the 8 percent you would with the capital gains exclusion.

And you get to the negative rate of return by the fact that we get to deduct the $80 interest against ordinary income rates. By deducting the interest that we paid on this $1,000 investment, we have increased our rate of return to 12.2 percent when an asset only earned 10 percent before tax.

It is really the interplay of the interest expense deduction and the capital gains exclusion and the indexing that gets you a negative tax rate.

Mr. LEVIN. This has been the dynamic problem all along, and it was presumably diminished and now may be increased.

Ms. DEBORAH WALKER. That is true.

Mr. LEVIN. I think we have to look at it.

One other thing. As I understand it, there was some testimony about IRAs suggesting that they not apply to rollovers. Does anyone wants to expand on that?

Mr. TERRY. Mr. Levin, we addressed that in our written statement. I think the primary focus of our comments, that there is nothing in the IRA proposal which would, in the case of the rollover, that would eliminate the possibility of someone rolling amounts from—large amounts—from qualified plans within this little window period, couple-year window period, that is provided for the new super savings accounts. The new IRAs.

And, having those amounts, they are taxed as they go in; but then, under usual rules, there is an obligation that you make distributions of that and put it back into the income stream promptly. The provisions in this bill, as currently drafted, do not require that kind of distribution, that kind of withdrawal. And we think that could be a problem.

Other than that—and that is primarily a technical problem, and I think it particularly applies after death. The way it now reads you could continue these amounts on for generations without having them ever come out of the account. That, I think, is extreme.

So those are our thoughts on the rollover problem.

Mr. LEVIN. My time is up. Thank you.

Mr. BUNNING. We want to thank the panel for their testimony, and we would invite the second panel to—the third panel, actually—to move forward.

Mr. Forsythe, Ms. Obermayer, Don Strong, Tom Diedrich, Steven Cohen, and Henry Davis.

And the gentleman from Minnesota, I yield to him for an introduction of two of the members of this panel.

Mr. RAMSTAD. Thank you, Mr. Chairman.

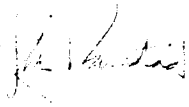
Mr. Chairman, it is a pleasure to welcome this panel, particularly, as you mentioned, two of the witnesses are from Minnesota, John Forsythe and Tom Diedrich. Jack, to those of us who know him well, Forsythe is vice president for tax and public affairs of Ecolab in St. Paul and is testifying on behalf of Ecolab's sales force employees. Welcome, Jack.

And Tom Diedrich, who is also a constituent—in fact, from my hometown of Minnetonka, Minn.—is here on behalf of the Bureau of Wholesale Sales Representatives. Mr. Diedrich is president of The Diedrich Group of Minnetonka.

So welcome to the panel, particularly to my good friends from Minnesota. I look forward to your testimony.

Thank you, Mr. Chairman.

[The prepared statement follows:]



STATEMENT OF REPRESENTATIVE JIM RAMSTAD
WAYS AND MEANS COMMITTEE
HEARING ON CONTRACT WITH AMERICA
February 1, 1995

Mr. Chairman, it is a pleasure to welcome this panels -- particularly since two of the witnesses are from Minnesota: John Forsythe and Tom Diedrich.

Mr. Forsythe is Vice President for Tax and Public Affairs of Ecolab, St. Paul, MN, and is testifying on behalf of Ecolab's Sales Force Employees.

Mr. Diedrich of the Diedrich Group, Minnetonka, MN, is here on behalf of the Bureau of Wholesale Representatives.

I am very pleased we have two witnesses from Minnesota who know how much this tax relief will help the self-employed and other workers who conduct their business at home.

Clarifying the home office deduction would make a major difference to thousands of small businesses in the Third Congressional District and throughout Minnesota and the country. The home office deduction provision is one of several initiatives in the Contract with America that recognizes the important contribution small businesses make in our economy. Small businesses create over 80 percent of the new jobs in America.

The home office deduction provision is on the cutting-edge of job trends as more Americans choose to "tele-commute" by computer or utilize other methods to work at home. We should especially help parents with young children who want to spend more of their working hours at home.

The Contract With America's Job Creation and Wage Enhancement Act includes a provision allowing taxpayers to qualify for the home-office deduction if the home-office is (1) used exclusively for business purposes, (2) used on a regular basis, (3) used to perform tasks that could not easily be performed elsewhere and (4) is essential to the taxpayer's business.

Mr. Chairman, thank you again for assembling such an excellent panel. I look forward to hearing from all of our witnesses today.

Mr. BUNNING. I want to advise you that we are under the 5-minute rule, and if you would condense your written statements they will be entered into the record.

And, Mr. Forsythe, you may begin.

STATEMENT OF JOHN G. FORSYTHE, VICE PRESIDENT, TAX AND PUBLIC AFFAIRS, ECOLAB, INC., ST. PAUL, MINN., ON BEHALF OF ECOLAB'S SALES FORCE EMPLOYEES; ACCOMPANIED BY DICK LANE

Mr. FORSYTHE. Thank you, Mr. Chairman and members of the committee and particularly Mr. Ramstad. Thank you in particular for the invitation to be here with you today to discuss the home office deduction.

I am accompanied by Dick Lane here on my left, an employee in our sales force who maintains a home office to perform his job for Ecolab.

Ecolab is the leading developer and marketer——

Mr. BUNNING. Mr. Forsythe, would you please move the mike a little closer?

Mr. FORSYTHE. Yes, thank you.

Ecolab is the leading developer and marketer of premium cleaning, sanitizing and maintenance products and services for the hospitality, institutional and industrial markets. That means we make soap and detergents. Our customers include hotels, restaurants, food service and health care facilities, dairy plants and food and beverage processors around the world.

Founded in 1924, Ecolab is a $1 billion sales Fortune 500 company based in St. Paul, Minn., and we operate in all 50 States. We employ 7,500 people. The home office deduction has no impact on the tax liability of Ecolab, but it is a serious tax problem for many of our employees.

On behalf of approximately 2,000 of those entrepreneurial employees who work out of their homes selling our products to local restaurants and other businesses, I applaud the provision in the Contract With America which would clarify that more of our employees can deduct the cost of maintaining a business office in their home, and we applaud the fact that this issue is one of your first 100-day agenda items.

At Ecolab, we serve our customers through a sales and service network of territory managers, many of whom, like Dick, travel great distances between calls. In their home offices, Ecolab's territory managers store inventory, assemble equipment, perform 7 to 10 hours of administrative work each week and return customer phone calls.

My written remarks include a more detailed description of the problem with the current law. But, fundamentally, the problem is many taxpayers now need professional tax advice to determine whether they are entitled to a tax deduction for the home office. And certain groups of employees, who spend most of their time on the road and with customers, are inherently disadvantaged under the Internal Revenue Code and the standards that are set forth in the *Soliman* case.

The Job Creation and Wage Enhancement Act would amend the code to allow a home office to qualify for a deduction as the prin-

cipal place of business if it is where the taxpayer regularly and systematically conducts essential administrative and management activities and the taxpayer has no other location to perform those activities. The provision retains the current law requirement that the office be used exclusively for business and the convenience of the employer.

At Ecolab, we support the proposed changes for the following reasons:

First, it promotes a better balance between business considerations and family needs for those who can meet the revised standard of deductibility. Our people are on 24-hour call.

Second, it is consistent with the new technological advances that make it more common and efficient for many types of employees to work out of their homes.

And, finally, there is a fairness issue here. When customers come to your home office you get to take the deduction. When you have to provide services onsite, as is the case with our sales personnel, you do not.

One other thing. It is a significant simplification of the Internal Revenue Code, and that will greatly ameliorate a needless area of controversy between the taxpayers and the IRS.

Most of our sales force spend the majority of their time serving customers at the customers' place of business. Important business activities like matching our products with our customers' needs are conducted at the customers' place of business. The place where the preparation, administrative and management activities are performed are generally done in the home office, and the home office should be treated as a deductible place of business for tax purposes, especially when there is no other office available.

For the Ecolab sales force, home offices are the most efficient and cost effective way to create productive and high-paying sales jobs. Commuting to a separate place of business to perform essential administrative and management functions simply is not practical nor necessary from a business point of view. The tax law should not encourage or demand practices that do not make sense from a business perspective.

The legislation proposed before the committee makes sense, and Ecolab supports it. Thank you. Both Dick and I will be happy to respond to questions.

[The prepared statement follows:]

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John G. Forsythe
Vice President - Tax and Public Affairs

Statement on "Contract With America"

John G. Forsythe
Vice President of Tax and Public Affairs,
Ecolab Inc.

Before the

Committee on Ways and Means

February 1, 1995

Mr. Chairman and Members of the Committee, I appreciate your invitation to be here today and discuss the home office deduction. I am accompanied by Dick Lane, an employee in our sales force who maintains a home office in South Dakota to perform his job for Ecolab. Ecolab is the leading developer and marketer of premium cleaning, sanitizing, and maintenance products and services for hospitality, institutional and industrial markets. Our customers include hotels and restaurants, foodservice and health care facilities, dairy plants, and food and beverage processors around the world. Founded in 1924, Ecolab is a $1 billion Fortune 500 company based in St. Paul, Minnesota and operating in all 50 states. We employ 7,500 people. The home office deduction has no impact on the tax liability of Ecolab, but rather is a serious tax problem for many of our employees.

On behalf of our approximately 2,000 entrepreneurial employees who work out of their homes selling our products to local restaurants and other businesses, I applaud the provision in the "Contract with America" which would clarify that more of our employees can deduct the costs of maintaining a business office in their home, and the fact that the issue is one of your first 100-day agenda items. At Ecolab, we serve our customers through a sales and service network of Territory Managers, many of whom travel great distances between calls. In their home offices, Ecolab's Territory Managers store inventory, assemble equipment, perform seven to ten hours of administrative work each week, and return customer phone calls.

The Job Creation and Wage Enhancement Act (H.R. 9) would amend IRC section 280A, to allow a home office to qualify for a deduction as the "principal place of business" if it is where the taxpayer regularly and systematically conducts essential administrative and management activities <u>and</u> the taxpayer has no other location to perform these activities for the business. The provision retains the current law requirement that the office be used exclusively for business and for the convenience of the employer. We support the proposed change for the following reasons:

- It promotes a better balance between business considerations and family needs for those who can meet the revised standard of deductibility.
- It is consistent with technological advancements that make it more common and efficient for many types of employees to work out of their homes.

- It provides a fairer rule for those whose employers maintain no local business office and who maintain a business office in their homes for essential business activities.
- It substantially eliminates the arbitrary preference shown for some businesses which can deduct the cost of operating a business office out of a personal residence because customers are served there, while other types of businesses which require the taxpayer to spend significant periods of time working outside of the home are denied the deduction for an equally essential home office.
- It is a significant simplification of the Internal Revenue Code that will greatly ameliorate a needless area of controversy between taxpayers and the IRS.

The Tax Reform Act of 1976 added the long-standing rule in IRC Section 280A(c)(1), which provides that the "portion of the dwelling unit which is exclusively used on a regular basis .. [as] the principal place of business ... of the taxpayer" (emphasis added) is exempted from the general rule that prohibits a business expense deduction for a portion of the cost of a personal residence. However subsequent judicial activity has imposed severe restrictions on the ability of taxpayers to make use of this provision. In the 1993 case of Commissioner of Internal Revenue v. Soliman, the U.S. Supreme Court reversed earlier decisions of the Tax Court and the Fourth Circuit Court of Appeals and established new guidelines for home offices to qualify as a "principal place of business." Currently, it is not sufficient to show that the activities performed in the home office are essential to the business; rather it must be established that the functions performed in the home are the most significant events relative to the business in question. Taxpayers must consider the relative importance of activities performed at each business location and focus on whether revenue is generated or services are performed in their home offices. The court further held that taxpayers should compare the amount of time spent at home with time spent at other places where business activities occur. The Court noted that this comparative analysis may reveal that no principal place of business exists, as it does not demonstrate that the principal place of business is the taxpayer's home - in which case - the taxpayer is not entitled to a deduction for the home office.

The result is that many taxpayers now need professional tax advice to determine whether they are entitled to a tax deduction for a home office, and certain groups of employees who spend most of their time on the road and with customers are inherently disadvantaged under the IRC section 280A rules and the standards set forth in Soliman.

In the Soliman case, the taxpayer was an anesthesiologist. The Court noted that the taxpayer spent 10 - 15 hours of essential administrative and preparation time in his home office as compared to 30 to 35 hours performing services in three hospitals. In Soliman, the Court stated that if the nature of the business "requires the taxpayer to meet or conference with a client ... or to deliver goods or services to a customer, the place where that contact occurs is often an important indicator of the principal place of business." Since Soliman met no patients at home, no deduction was allowed. Our employees face a similar fact pattern. Ecolab's sales force is comprised of people who similarly perform essential business activities in their home, but rightly spend significant time with customers in the field, matching our products with our customers' needs. It is doubtful that many of our employees can demonstrate that they are entitled to deduct the cost of their home offices under the Supreme Court's overly strict standards in Soliman. Many will feel they need professional advice to make this determination. This is unfortunate because, as described earlier, our sales force generally has no place of business, other than their offices at home, in which to perform essential administrative and management activities. The kinds of business expenses disallowed include a portion of the cost

of utilities, insurance, home repairs, security systems, and depreciation, and business mileage incurred in earning their livings.

The holding in Soliman allows the nature of the taxpayer's business to dictate whether the taxpayer's home office is deductible. Some types of businesses clearly have principal places of businesses; others do not. If the taxpayer is a dentist that uses the home office to treat patients, it is deductible. If the taxpayer is in a service business that performs the actual service or selling functions at the customer's job site, then the use of the home office, and equipment therein, for essential management and planning functions, is not deductible. This is an unfair and artificial distinction.

Most of our sales force spend the majority of their time serving customers at the customers' place of business. Many of the important business activities, like matching our products with our customers' needs, are conducted at the customers' place of business. The place where the preparation, administrative and management activities are performed is generally a home office, and it should be treated as the principal place of business for tax purposes where there is no other office available. Commuting to a separate place of business to perform essential administrative and management functions simply is not practical nor necessary from a business point of view. The tax law should not encourage, or demand, practices that do not make sense from a business perspective. For the Ecolab sales force, home offices are the most efficient and cost-effective way to create productive and high paying sales jobs.

Congress needs to take the first real step in ensuring equitable tax treatment for people working out of their homes by statutorily providing for the home office deduction in cases where the taxpayers would have been permitted to deduct the same expenses if they had rented office space. The legislative proposal before the committee would define principal place of business to include offices where management activities essential to the conduct of the business are performed on a systematic basis and where the office is necessary because the taxpayer has no other location for the performance of these activities. Ecolab strongly supports legislation to this effect. It would reduce the inequities in the current rules and adjust the tax code to comport better with the growing trend of employees working out of their homes.

Mr. BUNNING. Thank you.

Dr. Obermayer.

STATEMENT OF JUDITH OBERMAYER, PH.D., CHAIRMAN, NATIONAL ASSOCIATION FOR THE SELF-EMPLOYED, WASHINGTON, D.C., AND OWNER, OBERMAYER ASSOCIATES, WEST NEWTON, MASS.

Ms. OBERMAYER. Thank you, Mr. Chairman, members of the committee. Thank you for inviting me to testify today.

I am Judith Obermayer, owner of Obermayer Associates, a home-based business in Newton, Mass. I am testifying as chairman of the board of the National Association for the Self-Employed, and my testimony has been endorsed by the Massachusetts delegation to the White House Conference on Small Business, which I chair.

I am testifying also in favor of the home office provisions of H.R. 9, which seek to negate a recent Supreme Court decision which severely restricts the ability of many home-based businesses to take any deduction for home office expenses.

Basically, the court ruled that customers must physically come to the office and that business income must be generated within the home office itself, not from transactions outside. The decision effectively treats the administrative activities of the business—record-keeping, bookkeeping, regulatory compliance—as unimportant.

There are a large number of people affected by this change in the rule. You just heard about one set of people. Independent sales representatives of all kinds are affected. But so are electricians and contractors and consultants all over the country.

There are a huge number of people affected by this change. If you look at tax returns, 12.2 million people indicate that they are self-employed. We believe that several million of those people are home-based. Within our own organization of 320,000 people, most of whom have businesses of 5 or fewer employees, we estimate 65 percent are home-based businesses. And, in most cases, we are talking about very small businesses, where the deduction in question is not that large but it can be very important to a small, struggling business.

Actually, there has been a trend toward home-based business generally in the economy. The nature of business has changed today. We have been affected by competitive forces, technological changes that both allow us to do business almost anywhere with a computer and a modem and a fax machine and a cellular telephone. Any place is an office in terms of being able to do things. People have changed the way they do things.

There has also been a move toward the information- and service-based economy, which also goes along with this whole trend. And there is also a factor that has to do with people being concerned about balancing work and family, especially in dual-income and single-parent families. For many of them, home-based business is a very important option.

In my State of Massachusetts, we had the "Massachusetts Miracle" of the eighties—followed, unfortunately, by the recession of the nineties. We saw the restructuring of the computer industry, the collapse of the real estate industry, cutbacks in defense, and competition from abroad. All of those forces brought us to the point

of reengineering and downsizing throughout the economy. And the industries hit were not just things like the computer industry but the financial services industry and, even now, the health insurance industry.

What happens to all those tens of thousands of people who are laid off? For many of them, it is very difficult. If you are over 50 and laid off from a job your chances of getting full-time employment are really very small. Even when the economy picks up again, these people have often been replaced by younger, cheaper workers. One of their most viable options is to look at the process of starting a business for themselves.

And that is also true of anybody who has any kind of professional, business, marketable skills. It is also true of people who have technical ideas who now might take the opportunity to start a new business. And almost always when these businesses started they are home-based. You do not have to put in a very big investment to do a home-based business. A few pieces of office equipment or lab equipment and you can go ahead.

We really should be encouraging this kind of trend. These are the businesses we hope ultimately will grow, and many of them will move out of the home, we hope. But that is where the best place is for them to start, and we should be doing things to encourage them. We should not be putting impediments in the way of people trying to do this kind of thing.

In conclusion, I would like to say that the National Association for the Self-Employed strongly supports the home office deduction provisions of H.R. 9. We have also been joined by nearly 40 associations with over 2 million members in this effort.

We look forward to working with House Ways and Means to ensure enactment of this important provision for small business. Thank you very much.

[The prepared statement follows:]

TESTIMONY OF JUDITH OBERMAYER
NATIONAL ASSOCIATION FOR THE SELF EMPLOYED

Chairman Bill Archer, Ranking Member Sam Gibbons, and House Ways and Means Committee members, thank you for inviting me to testify today. My name is Judith Obermayer, owner of Obermayer Associates, a home-based business located in West Newton, Massachusetts. I am here to testify today as Chairman of the Board of Directors for the National Association for the Self-Employed. It is with pleasure that I inform you that my testimony has been endorsed by the Massachusetts delegation to the June 1995 White House Conference on Small Business, a delegation of small business owners which I chair.

As the operator of a home-based business, I provide financial and management consulting services to high technology companies. My firm helps these companies develop business plans and strategies for raising money to fund business expansion. Of significance, many of these high technology companies started out as home-based businesses.

On behalf of the NASE, I am pleased to testify on the home office tax deduction. The NASE represents over 320,000 small business persons from throughout the United States. Over 85 percent of the NASE members are business owners with 5 or fewer employees. The membership is involved with a very wide range of businesses, notably in the consulting and retail fields. The home office deduction is extremely important to the NASE. We project, based on a recent survey, that about 65 percent of our members operate home-based businesses.

Home-Based Businesses In the 1990s

The U.S economy changed during the nineteenth and twentieth centuries from an agricultural to a manufacturing-based economy, and is now moving rapidly to a service and information-based economy. The factory and commercial office buildings of only 10 or 20 years ago are rapidly declining in importance as companies re-engineer their work places and tap into the desires of the work force to use modern telecommunications tools to work where it is most convenient. Often that means working at home. The recession both accelerated these trends and provided a means for workers to go it alone, if necessary, through the operation of home-based businesses.

Everyone is familiar with the phrase "Massachusetts Miracle", which was used to refer to the business climate in my state of Massachusetts prior to the 1989-1992 recession. In the middle to late 1980's, my state was booming economically. Computer companies, such as Digital, Prime, and Wang Corporations, were selling high technology products throughout the United States; and as a result, were hiring thousands of new workers to fill office and factory buildings along Boston's famed Route 128 corridor. Real estate, and banking and financial institutions -- like Fidelity Investments -- were booming as well in the 1980's.

By 1989 the Massachusetts Miracle was no more. The recession resulted in the layoff of tens of thousands of workers in my state. The downsizing of Massachusetts's computer companies and financial institutions involved the layoff of blue-collar individuals -- and highly skilled persons such as engineers, marketing and sales representatives. Unemployment for these people often meant that starting a home-based business was their only option for finding a "job."

In testifying about home-based businesses today, the NASE is calling on Congress to overturn a 1993 U.S. Supreme Court decision (described in greater detail below) which dramatically cut back on the availability of the home office tax deduction. The home office deduction is not a tax incentive for the wealthy. It is a deduction important to (among others) consultants of all types, private nurses, independent sales representatives, plumbers, and persons in the construction trades. With the development of new technologies (such as facsimile machines, modems, personal computers, etc.) home-based businesses have become extremely popular because they make sense to the work force of the 1990s.

According to a 1994 survey by the LINK Resources Corporation, over 43 million people now do some portion of their work at home, a figure which includes self-employed persons, telecommuters, and individuals with employee status. Based on the number of 1992 tax returns reporting the payment of federal self-employment tax, there are about 12.2 million self-employed individuals in the United States. We believe several million of these persons operate home-based businesses.

By fostering home-based businesses, Congress would be taking steps to increase productivity and spur economic growth. Home offices are popular in the 1990's because they make sense for businesses, families, and individuals.

H.R. 9, the Job Creation and Wage Enhancement Act of 1995

The NASE strongly supports the home office deduction provisions of H.R. 9, the Job Creation and Wage Enhancement Act. These provisions provide much needed clarification to the small business community regarding the availability of the home office deduction. We want to thank Chairman Archer for introducing H.R. 9, and others members of the House Ways and Means Committee for being original cosponsors of the bill. Among other objectives, the legislation provides for reform of the home office tax deduction in light of the 1993 U.S. Supreme Court decision in the *IRS Commissioner v. Soliman* case. This case substantially narrowed the availability of the home office deduction to America's small business community.

Home office deduction reform enjoys broad-based bipartisan support. The NASE commends Representative Nancy Johnson for her introduction of a home office deduction reform measure in the last Congress. Moreover, numerous Republican and Democratic members of the Ways and Means Committee joined Representative Johnson in this effort in 1993 and 1994. We applaud their efforts.

In the aftermath of the 1993 *Soliman* case -- tens of thousands of owners of home-based businesses found themselves disenfranchised from taking a legitimate business deduction on their tax return. For this reason, within weeks of the public release of this 1993 Supreme Court decision, the NASE began building a coalition of associations supporting legislation to overturn the court decision. Nearly forty associations have joined the NASE in this effort, a coalition representing over 2 million businesses in the United States..

The IRS Commissioner v. Soliman Decision

In order to be eligible for a home office deduction under Internal Revenue Code Section 280A(c), the business owner must use the office on an exclusive and regular use basis, and the office must either be (a) his principal place of business; (b) the place where he meets or deals with patients, clients, or customers in the normal course of his trade or business; or (c) a separate structure which is not attached to the dwelling unit. Moreover, a person claiming a home office deduction may not claim a deduction for more than the revenues of the business (in other words, a $100 deduction can not be claimed when business revenues amount to only $50).

The *Soliman* decision revolves around the definition of "principal place of business." Under this U.S. Supreme Court holding, an anesthesiologist was found not to be entitled to a home office deduction because the doctor's principal place of business was determined by the court to be the hospitals where the doctor performed services for patients. The court ruled in this fashion even though the anesthesiologist saw patients in several hospitals, none of which provided him with an office. The doctor contacted patients, set up appointments, did billings, and kept his business records at the home office.

The U.S. Tax Court and the U.S. Ninth Circuit Court of Appeals ruled in favor of the doctor. Seeking to overturn the pro-taxpayer decisions of the lower courts, the IRS appealed the *Soliman* case to the U.S. Supreme Court. It was a surprise to many people that the Supreme Court ultimately reversed the lower court decisions in favor of the IRS by disallowing Soliman's home office deduction.

Mr. Leslie B. Samuels, Assistant Treasury Secretary for Tax Policy, testified before the House Ways and Means Committee on January 10, 1995 regarding the home office deduction and other provisions contained in the Contract With America. In describing the *Soliman* decision, Mr Samuels stated, "[T]he Supreme Court held that the principal place of business should be defined to include only the place of business where the activities most crucial to the operation of the business occur...For example, activities crucial to certain service businesses require personal contact with customers outside the service provider's home office. In such cases, the home office would not be regarded as the principal place of business, even if no other principal place of business existed."

In effect, the Supreme Court seems to be requiring two new tests in order for an individual to qualify for the deduction. The court decision effectively requires (1) the customers of a home business to physically visit the home office and (2) that the business income be generated within the home office itself -- not from transactions that occur outside the home office.

The NASE firmly believes the holding in the *Soliman* case to be extremely shortsighted -- especially since the decision ignores the way business is conducted today. Offices have changed dramatically in the last twenty years. That is, personal computers, facsimile machines, computer networks, and overnight delivery services have made it unnecessary to bring customers through the home office. The holding is also shortsighted as local zoning ordinances often prohibit home-based businesses from bringing customers to the home office.

The *Soliman* decision creates significant problems for a broad range of industries and professions. The list of people potentially losing the deduction includes independent sales representatives, plumbers, electricians, remodeling specialists, home builders, veterinarians, travel agents, and others. Now, as a result of *Soliman*, these business persons must effectively bring their customers through the home office in order to qualify for the deduction.

The Recordkeeping and Bookkeeping Functions of the Business

By holding that the home office must itself generate revenue, the *Soliman* decision effectively treats the administrative activities of the business as unimportant. That is, the *Soliman* holding serves to minimize the importance of the recordkeeping and bookkeeping functions of the business, as well as its tax and regulatory compliance activities. Ironically, it is the government itself, notably the IRS, which generates the demand for many of these activities.

This problem is clearly addressed under Section 12003 of (H.R. 9) the Job Creation and Wage Enhancement Act. The entrepreneur's home office would qualify under the Act as a principal place of business (and thus, be eligible for the home office deduction) if: (A) the taxpayer conducts his essential administrative or management activities at the home office; (B) such activities are conducted at the home office on a regular and systematic basis; and (C) the home office is the only office utilized by the business person.

H.R. 9 shows an appreciation for the conveniences home-based businesses offer American families. A home-based business provides a spouse (including a single parent) the emotional benefits of taking care of his or her children at home while earning money at the same time. In addition, as described above, the measure is an excellent response to the current spate of corporate downsizings which have resulted in the layoffs of tens of thousands of workers. They, like many other people, are now attempting to live the American dream by starting businesses out of their homes.

Storage of Product Samples

Internal Revenue Code Section 280A(c)(2) permits an independent sales representative and others to generally take a home office deduction for the space used on a regular basis in the home with respect to a storage unit of inventory held for resale. This sales person is eligible for the home office deduction -- under the Code provision -- as long as the dwelling unit is the only location of his trade or business.

Section 12004 of H.R. 9 modifies Code Section 280A(c)(2) by expanding the definition of a storage unit to include a place where product samples may be stored. The NASE views Section 12004 as a positive measure for small business. We believe the measure will contribute to economic growth by fostering the sale of products at the retail and wholesale levels.

In conclusion, the NASE strongly supports the home office deduction provisions of H.R. 9. We look forward to working with the House Ways and Means Committee to ensure enactment of these important provisions for small business.

Mr. BUNNING. Thank you, Dr. Obermayer.
Mr. Strong.

STATEMENT OF DON STRONG, PRINCIPAL OWNER, BROTHERS STRONG, INC., HOUSTON, TEX., ON BEHALF OF THE NATIONAL ASSOCIATION OF THE REMODELING INDUSTRY, ARLINGTON, VA.

Mr. STRONG. Mr. Chairman, honorable members of the committee, I am honored to provide testimony in support of the proposed restoration of the home office deduction.

My name is Don Strong, and I am principal owner of Brothers Strong, Inc., a small remodeling firm specializing in residential remodeling. Brothers Strong operates out of a separate suite of offices located in my home. I currently have five full-time employees and six subcontractors. Two employees spend all day in the office, and I spend about one-third of my life in that office.

I am also a member of the Houston chapter of the National Association of the Remodeling Industry. NARI is a not-for-profit trade organization with nearly 6,000 member companies nationwide and represents 40,000 remodeling industry professionals. NARI members are primarily residential home improvement contractors and include national manufacturers and distributors of home improvement products and services.

Residential remodeling constitutes a $100 billion industry and has grown 130 percent in the last 10 years. In fact, we are close to surpassing new home construction in total dollars contributed to the economy.

I appear today in complete support of efforts made by you, Mr. Chairman, this committee and others, to restore the home office deduction provisions that were significantly reduced by the U.S. Supreme Court ruling, *Commissioner of the IRS* v. *Nader Soliman* in January 1993.

The Court's ruling put a severe crimp in the ability of small businessowners like myself to further grow their home-based and/or startup businesses. Before the Court's ruling, I could deduct a reasonable portion of my home office expenses, just as other businesses can if they operate in another location. I simply prefer to keep my business in my home. I think it is unfair having lost this deduction.

The Court's ruling added two new eligibility tests that remodelers simply cannot meet. First, the Court and the law now require that businessowners must have customers come to their home office. In service-based businesses, such as residential remodeling, it is I who must travel to the customer's home to discuss possible home improvement projects. I need to see what their project consists of, its location, size, and scope. It is inconceivable for a remodeler to develop a remodeling project site unseen.

Second, the law now requires that business income must be generated within the home office, not from transactions that occur outside the home office. Again, it is impossible for a remodeler to remodel a home from his home office. The income-generating activities are conducted at the client's home.

So if I am selling jobs in the community and doing the remodeling on location, what is it I do that makes the home office so important, the IRS might ask. Why do I deserve this deduction?

I use my home office to perform all the activities that any remodeler needs to do to effectively run his or her business. I prepare estimates, contracts, plans and marketing materials. I develop leads, make the business phone calls, organize business materials and deliveries, solicit subcontractor bids and research industry trends. I record all business transactions, receipts, and expenses. I maintain all relevant regulatory information and, most importantly, the IRS recordkeeping. This is where I pay my bills, and this is where I contribute to the U.S. Treasury.

In my home office, I have three separate phone lines, a fax machine, three computers, a printer, a small copying machine—everything an office needs to conduct business. If I prefer to rent an outside space, my entire overhead would be deductible without question. But because I choose to remain at home, I can no longer deduct those real expenses. But I have no need for outside space. My business has grown to a comfortable level working at home.

Please allow me to speak for my fellow remodelers. Since remodeling is not a high-profit business, you have to love it to get into it and sweat it to stay in it. The mortality rate is extremely high. What I am saying is we need every break we can get not only to survive but to continue to grow and to help the economy.

I am at the point where I would like to hire another production manager, but I am hesitant. With the recent reduction in business deductions contained in the 1993 budget, and this Supreme Court ruling, frankly, I am sometimes not sure the government wants me to stay in business and continue to grow.

Previously, I was allowed to deduct my home office expenses because I had no other office available. My home office space is dedicated solely to my business, and I generated more than enough income to cover the value of the deduction. I never tried to use the office deduction to create a loss situation. I just want to be able to deduct reasonable expenses that other businesses are entitled to.

I am now denied an annual deduction of $3,330 and will incur $910 in additional tax liability. This means I have to generate approximately $20,000 in new sales just to get back where I was before the deduction was removed. This money could have gone back into my business in the form of equipment, trucks, ladders, sprayers. It could have gone into my retirement. It could have gone into anything—back into the economy.

I understand there is widespread support for restoration of this home office deduction among broad-ranging groups, many of which are represented here today and in Congress. NARI strongly supports restoration of this home office deduction. A survey conducted by our membership showed overwhelming support to restore the deductions. Even companies that had an office outside their home approve of it because they probably started at home.

We are pleased to see this home office deduction find its way into the Contract With America. Congress has a big opportunity to restore that which the Court has taken away. Personally, I will be thrilled to see Congress act in a way to help the small entre-

preneurs. We have shouldered too many regulatory burdens over the years.

Again, thank you, Mr. Chairman, and your staff for inviting me to appear before you today to bear witness to the need for this legislation. I am willing to answer any questions. Thank you.

[The prepared statement follows:]

NATIONAL ASSOCIATION OF
THE REMODELING INDUSTRY
4301 North Fairfax Drive, Suite 310
Arlington, Virginia 22203-1627
703 276-7600 Fax: 703 243-3465

Statement of
Don Strong, Brothers Strong, Inc.
and the
National Association of the Remodeling Industry
before the
House Ways and Means Committee
regarding the
Restoration of the Home Office Deduction
February 1, 1995

NARI

Mr. Chairman, honorable members of the Committee, I am honored to provide testimony in support of the proposed restoration of the home office deduction. My name is Don Strong and I am the principal owner of Brothers Strong, Inc., a small remodeling firm specializing in residential remodeling. I currently have five full-time employees and six subcontractors. I operate out of a separate office located in my home. I am also a member in good standing of the National Association of the Remodeling Industry (NARI). I appear today in complete support of efforts taken by you, Mr. Chairman, this Committee, and others to restore the home office deduction provisions that were significantly restricted by the U.S. Supreme Court ruling, *Commissioner of the IRS v. Nader Soliman*, in January 1993.

The Court's ruling put a severe crimp in the ability of small business owners, like myself, to further grow their home-based and/or start-up businesses. Before the Court's ruling I could deduct a reasonable portion of my home office overhead expenses— just as other businesses can if they operate out of another location. I simply prefer to keep my business in my home. I think it is unfair having lost this deduction.

The Court's ruling added two new eligibility tests that remodelers simply cannot meet. First, the Court and the law now require that business owners *must have customers come to their home office*. In service-based businesses, such as residential remodeling, it is I who must travel to the customer's home to discuss possible home improvement projects. I need to see what their home is like, what they want done, and where. It is inconceivable for a remodeler to develop a remodeling project site unseen.

Second, the law now requires that the business' *income must be generated within the home office*— not from transactions that occur outside the home office. Again, it is impossible for a remodeler to remodel a home from his home office. The income generating activity is conducted at the client's home.

So if I am out selling jobs in the community and doing the remodeling on location, what is it that I do in my home office that is so important, the IRS might ask. Why do I deserve this deduction?

I use my home office to perform all the activities any remodeler needs to do to effectively run his or her business. I prepare estimates, contracts, plans, and marketing materials in my home office. I develop leads, make business phone calls, organize material deliveries, solicit subcontractor bids, and research industry and product trends in my home office. I record all business transactions, receipts and expenses, tax responsibilities in my home office. I maintain all relevant regulatory information such as OSHA MSDS sheets, hazard communication and worker protection safety plans, EPA lead-based paint rules, and IRS record keeping requirements in my home office. This is where I pay my bills. This is where I contribute to the U.S. Treasury.

In my home office, I have three separate phone lines, a fax machine, three computers and a printer, and a small copier machine— everything a small office needs to conduct business. If I preferred to rent an outside space, my entire overhead would be deductible without question. Because I choose to remain in my home, I can no longer deduct reasonable office expenses. But, I have no need to rent space. My business has grown to a comfortable level and runs efficiently from my home office.

Previously, the law allowed me to deduct that portion of my home office expenses because 1) I had no other office available, 2) my home office space is dedicated solely to my business, and 3) I generated more than enough income to cover the value of the deduction. I never tried to use the office deduction to create a loss situation. I just want to be able to deduct reasonable expenses that other businesses are entitled to. Now I cannot deduct these overhead expenses and will incur $910.00 in additional tax liability. This money could have gone into my business, perhaps a new truck or ladder or computer. This money could have gone into my grandson's college fund. This money could have gone into my personal retirement account. This money could have gone to my favorite charity, Northwest Assistant Ministries .

I understand there is widespread support for restoration of the home office deduction among broad ranging groups, many of which are represented here today, and in Congress. NARI is a strong supporter of restoring the home office deduction. A survey conducted of our membership showed overwhelming support for the restoration. Even companies that had an outside office supported the move, perhaps because many successful remodelers started in their homes. Last year, NARI pushed for enactment of H.R.3407, co-sponsored by Representatives Peter Hoagland and Nancy Johnson and S. 1924, by Senators Hatch, Exon, and Lieberman.

We are very pleased to see the home office deduction find its way into the Contract with America. Congress has a unique opportunity to restore that which the Court has taken away. Personally, I will be thrilled to see Congress act in a way to help small entrepreneurs. We have shouldered too many regulatory burdens over the years. This legislation is a step in the right direction. We stand ready to assist in its passage however we can.

Again, I thank you Mr. Chairman, for inviting me to appear before you and your committee today to bear witness to the need for this positive legislation. I am willing to answer any questions I can.

Respectfully Submitted,

Don Strong
Brothers Strong, Inc.
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NARI is a not-for-profit trade association with nearly 6,000 member companies nationwide, representing over 40,000 remodeling industry professionals. NARI members are primarily residential home improvement contractors, and include national manufacturers and distributors of home improvement products and services.

Residential remodeling constitutes a $100 billion industry that has grown over 130 percent in the last ten years. With over 50 years of experience, NARI is committed to enhancing the professionalism of the remodeling industry and serving as an ally to homeowners. NARI is dedicated to the growth and betterment of the remodeling industry and related small businesses. For more information about NARI, contact Patti Burgio, director of government affairs, NARI, 4301 North Fairfax Drive, Suite 310, Arlington, VA 22203, 703/276-7600.

Mr. BUNNING. Thank you, Mr. Strong.
Mr. Diedrich.

STATEMENT OF TOM DIEDRICH, THE DIEDRICH GROUP, MINNETONKA, MINN., AND TREASURER, BUREAU OF WHOLESALE SALES REPRESENTATIVES, ON BEHALF OF THE NATIONAL ASSOCIATION OF THE REMODELING INDUSTRY, ARLINGTON, VA.

Mr. DIEDRICH. Mr. Chairman and members of the committee, thank you for the opportunity to appear before you today.

My name is Tom Diedrich, and I am an independent salesperson living in Minneapolis, Minn. I am also an active member of the Bureau of Wholesale Sales Representatives and currently serve as treasurer of this organization. The bureau is an Atlanta-based national association of approximately 10,000 apparel or kindred merchandise sales representatives. I am married, and my wife, Lynn, is also an independent sales representative.

I own and manage a wholesale apparel business, The Diedrich Group, and my only office is in my home. It appears I am part of an ever growing number of entrepreneurs and independent businesspeople who choose to work out of their homes. The January 7, 1995, program, "How to Succeed in Business," on CNBC stated that approximately 25 million people may soon be working out of their homes.

It is often said that the majority of American businesses started out in someone's home. Well, I can report to you that today the reverse is true. A great number of American businesses, some small and some not so small, are moving back into the home.

You might ask why. As commercial rental costs rise and as technology progresses, the home becomes a more efficient place to do business. The home continues to be the birthplace of the majority of successful new business ventures.

As an independent sales representative, I am responsible for the wholesale marketing of several lines of apparel. I present these lines to retail buyers and obtain orders from retailers to carry these lines in their stores.

In my industry and in many others, the sales function is highly reliant upon personal contact. I meet with my customers at regional markets and trade shows or by means of personal, one-on-one presentations in retail stores throughout my territory.

I drive in excess of 25,000 miles each year to see these customers, and I attend approximately 25 trade shows each year as well. My territory consists of a six-State area in the Upper Midwest. I spend more time in hotel rooms than in my own bed, and my four-star hotel is not the Ritz, but the Red Roof.

The tools of my trade are the samples of the clothing that I represent. These samples must be steamed, hung and grouped in garment bags. When traveling, sales reps hang these bags in show vans or full-size cars, often larger than we would otherwise choose but necessary for us to carry our samples and other business supplies like spotlights, order forms, garment racks and suitcases. Our business trips can be as short as 1 day or as long as 2 weeks. But when we are at home, we must store our samples, which consume a full room at our home.

Though important, the personal presentation is only one element of selling, and it is not the definitive close to the large majority of my sales. More critical and often more productive is the pitch-and-shovel work done on the telephone, the fax machine or through the mail.

This is why my office is so vital to my business. It is the very nerve center, the very base of operations. And, of course, like any small business I must maintain massive volumes of records in order to meet Federal, State and local tax-reporting requirements. My office, whether it is in an apparel mart or at home, is essential to successfully managing my business.

For many years, I maintained an office in the Minneapolis Apparel Mart. My office in the mart was never subsidized by any of the manufacturers I represented. The costs of maintaining that office continued to rise and, at the same time, new technologies enabled me to conduct my business from home. The choice to move home became obvious to The Diedrich Group. I am not alone in making this decision, especially in our industry.

Independent sales representatives work on a commission basis. We have no corporate credit cards to cover hotel rooms, no company car allowance, no company-paid health care or retirement plans. We are independent in every sense of the word, and yet we are dependent upon tax policies that will give us the opportunity to compete and prosper.

The *Soliman* ruling sets certain standards for determining the deductibility of a home office. My home office does not meet those standards because I do not routinely meet with customers in my home. But the fact is that my office is absolutely essential to my business, and it should be treated as a business expense for tax purposes.

In my office, you will find file cabinets with records, a desk and chairs, fax machine and copy machine, separate telephone lines with an answering machine, a computer and a printer. This room is used strictly for business purposes.

Also in my home, in a separate room, I have 30 feet of pipe rack to store samples, which are the tools of my industry; a steamer that is used to steam wrinkles out of the samples; spotlights that are portable for shows—which I carry with me to the trade shows; six rolling racks that I use to move and display my samples; and huge travel bags, called garment bags in the industry, that protect my samples from damage.

All of these items are vital to my profession. At one time, all were found in a separate office outside my home. When I rented my office 15 miles from my home, I was able to deduct that expense. Today, however, when more people seek to work from their home and when technology makes working from home not only feasible but highly efficient, the Federal Government effectively punishes the home-based business by taking away the home office deduction.

We, the independent sales representatives of this Nation, ask you to give back what the Supreme Court took away in 1993. We ask only for what was legitimately ours: The right to deduct a place of business regardless of its location. This deduction should be available for the office space that is required to run a small business

as well as for the space required to store the tools of our trade—in my case, samples. We ask that you correct this inequity and restore our right to the home office deduction.

The solution to solving the home office deduction problem for bureau members requires legislative action. The suitable solution for independent sales representatives must include language to resolve the issue of storage of product samples, as well as generic language to permit active and ongoing small businesses to take a home office deduction.

The solution should also instruct the IRS and the courts to reject using numerical tests as the basis for determining the importance of the home office as the principal place of business.

Last year, Congressman Wayne Allard of Colorado introduced legislation to address the concerns of bureau members regarding home office deductibility and deductibility of space devoted to storage of product samples. Congresswoman Johnson, a member of this committee, also introduced general language that incorporated both the product samples issue as well as broad-based solutions for home office deductions. This language is also included in the legislation that you have recently introduced as part of the Contract With America.

Mr. BUNNING. Mr. Diedrich, your time has expired.

Mr. DIEDRICH. Thank you.

[The prepared statement follows:]

TESTIMONY OF TOM DIEDRICH
MINNETONKA, MINNESOTA

Chairman Archer and members of the Committee, thank you for the opportunity to appear before you today.

My name is Tom Diedrich, and I am an independent salesperson living in Minneapolis, Minnesota. I also am an active member of the BUREAU OF WHOLESALE SALES REPRESENTATIVES and currently serve as Treasurer of this organization. The Bureau is an Atlanta based national association of approximately 10,000 apparel or kindred merchandise sales representatives. I am married, and my wife Lynn is also an independent sales representative.

I own and manage a wholesale apparel business, The Diedrich Group, and my only office is in my home. It appears I am part of an ever growing number of entrepreneurs and independent business people who choose to work our of their homes. The January 7, 1995 program of How to Succeed in Business on CNBC stated that 25 million people will soon work full time our of their homes!
It's often said that the majority of American businesses started out in someone's home. Well, I can report to you that today, the reverse is true. A great number of American businesses, some small, some not so small, are moving back into the home. As commercial rental costs rise, and as technology progresses, the home becomes a more efficient place to do business. The home continues to be the birthplace of the majority of successful new business ventures.

As an independent sales representative, I am responsible for the wholesale marketing of several lines of apparel. I present these lines to retail buyers and obtain orders from retailers to carry these lines in their stores.

In my industry and in many others, the sales function is highly reliant upon personal contact. I meet with my customers at regional markets or trade shows, or by means of personal, one-on-one presentations in retail stores throughout my territory. I drive in excess of 25,000 business miles each year to see these customers, and I attend approximately 25 trade shows each year as well. My territory consists of a six-state area in the Upper Midwest. I spend more time in hotel rooms than in my own bed, and my four-star hotel is not the Ritz, but the Red Roof.

The tools of my trade are the samples of the clothing that I represent. These samples must be steamed, hung and grouped in garment bags. When traveling, sales reps hang these bags in showvans or full size cars, larger than we would otherwise choose but necessary for us to carry our samples and other business supplies, like spotlights, order forms, garment racks, and suitcases. Our business trips can be as short as one day or as long as two weeks, but when we're at home, we must store our samples, which consume a full room, at home.

Though important, the personal presentation is only one element of selling, and it is not THE definitive close to the large majority of my sales. More critical and often more productive is the pitch-and-shovel work done on the telephone, fax machine, or through the mail. This is why my office is so vital to my business. It is the nerve center, base of operations. Of course, like any small business, I must maintain massive volumes of records in order to operate efficiently and to meet federal, state and local tax reporting requirements. My office, whether it's in an apparel mart or at home, is essential to successfully managing my business.

For many years, I maintained an office in the Minneapolis Apparel Mart. My office in the Mart was never subsidized by any of the manufacturers that I represented. The costs of

maintaining that office continued to rise, and at the same time, new technologies enabled me to conduct my business from home. The choice to move home became obvious for The Diedrich Group. I am not alone in making this decision, especially in our industry.

Independent sales representatives work on a commission basis. We have no corporate credit cards to cover hotel rooms, no company car allowance, no company-paid health care or retirement plans. We are independent in every sense of the word and yet we are dependent upon tax policies that will give us the opportunity to compete and prosper!

The Soliman ruling set certain standards for determining the deductibility of a home office. My home office does not meet those standards, because I do not routinely meet with customers in my home. But the fact is that my home office is absolutely essential to my business, and it should be treated as a business expense for purposes of tax liability.

In my home office, you will find: file cabinets with records; a desk and chairs; Fax machine and copy machine; separate telephone line; a computer and printer. This room is used strictly for business purposes. Also in my home, in a separate room, I have: 30 feet of pipe rack to store samples, which are the tools of my trade; a steamer to steam the wrinkles out of the samples; spot lights that are portable, which I carry with me to trade shows; six rolling racks that I use to move and display my samples; and huge travel bags, called "garment bags" in the industry, that protect my samples from damage.

All of these items are vital to my profession. At one time all were found in a separate office outside my home. When I rented office space 15 miles from my home, I was able to deduct that expense. Today, however, when more people seek to work from home and when technology makes working from home not only feasible but highly efficient, the federal government effectively punishes the home based business by taking away the home office deduction!

We -- the independent sales representatives of this nation -- ask you to give back what the Supreme Court took away in 1993. We ask only for what is legitimately ours: the right to deduct a place of business, regardless of its location. This deduction should be available for the office space that is required to run a small business, as well as for the space required to store the tools of our trade (in my case, samples). We ask that you correct this inequity and restore our right to the home office deduction.

The solution to solving the home office deduction problem for Bureau members requires legislative action. The suitable solution for independent sales representatives must include language to resolve the issue of storage of product samples, as well as generic language to permit active and ongoing small businesses to take a home office deduction. The solution should also instruct the IRS and the courts to reject using numerical tests as the basis for determining the importance of the home office as the principal place of business.

Last year, Congressman Wayne Allard of Colorado introduced legislation to correct the concerns of Bureau members regarding home office deductibility and deductibility of space devoted to storage of product samples. Congresswoman Johnson, a member of this Committee, also introduced general language that incorporated both the product samples issue, as well as a broad-based solution for home offices.

This language is also included in the legislation that you recently introduced, Mr. Chairman, as part of the "Contract with America," specifically in Sections 12003 and 12004. We are pleased to note that this language is nearly identical to the proposal introduced last year by Congresswoman Johnson, which was endorsed by many members of Congress, and of this Committee.

In closing, I would also note that, because of the nature of our business, it is often difficult to interpret statutory language of this kind as it applies to our industry. I would therefore suggest that the Committee consider clarifying report language, that would leave no doubt as to the intent of this body in respect to the impact of this legislation on independent sales representatives.

Thank you for the opportunity to appear before you today, and I am available for any questions you may wish to ask.

Mr. BUNNING. Thank you very much for your testimony.
Dr. Cohen, please.

STATEMENT OF STEVEN J. COHEN, D.V.M., MOBILE VETERINARY SERVICES OF NORTHERN VIRGINIA, ON BEHALF OF THE AMERICAN VETERINARY MEDICAL ASSOCIATION, WASHINGTON, D.C.

Dr. COHEN. Mr. Chairman and members of the committee, good afternoon. Thank you for the opportunity to testify before you today. My name is Dr. Steven J. Cohen, and I am affected by the *IRS* v. *Soliman* ruling. I represent many veterinarians throughout the United States who, as small business men and women, have an interest in the home office deduction issue. I am also here as a member of the American Veterinary Medical Association, a national veterinary organization representing over 56,000 practicing veterinarians.

The AVMA supports the restoration of the home office deduction and is a part of the effort on this with the National Association of the Self-Employed.

Since 1980, I have operated a veterinary house call practice in northern Virginia. That is, I see my patients and their owners in their homes. My practice fills a niche for many situations. There are those clients who prefer to have their pets treated at home simply as a convenience. Many of these owners have multiple pet households. There are owners, particularly the elderly or disabled, where transportation of their animals is difficult as well as inconvenient.

Furthermore, my practice facilitates prompt medical care to those animals whose owners have medical, transportation or time constraints that could obstruct their ability to seek necessary or critical professional veterinary care in a timely manner for their animals.

As a sole proprietor business, my primary job is to practice veterinary medicine. However, in order to do this, my other job is being a small business owner and operator. As a practitioner owner, the two jobs cannot be mutually exclusive.

As with any business, an office must be maintained. Business records, tax records, patient files, business telephone lines, professional and business references are maintained in my office—which happens to be a room in my house used exclusively for this purpose.

My home office is obviously convenient for me. I do not incur an additional expense renting space elsewhere to accommodate my needs. I do not waste additional time commuting to my office. Obviously, I already spend a great deal of time on the road, and this decreases energy expenditures and costs as well as personal safety risk.

I do consult with owners over the phone from my home office, but I do not see patients there. House call appointments are set up and patient records are maintained in my home office.

If I conducted a conventional veterinary practice in a facility away from my home, all of the costs incurred in running that business, including the business office where the primary activity of

practicing veterinary medicine is not performed, would be deductible as a business expense on my schedule C tax return.

By comparison to most conventional veterinary practices in northern Virginia, I am a very small business. I only see about 650 different owners each year as compared with 1,500 or more that my colleagues see. Due to travel time constraints, I see about 8 to 10 owners and their pets per day versus 35 or more in a conventional practice. Because of this, I must minimize costs. One way to do this is to maintain an office in my home.

As you are well aware, the recent Supreme Court ruling held that unless the primary job function is performed in the home office, this deduction is disallowed. If one is running a business, it follows a business office is a necessity. The location of that business office should be irrelevant as far as the Tax Code is concerned.

Before the recent court ruling, my home office saved me about $700 a year. This is money that I could invest in new equipment, improve my library, enhance my skills through continuing education and, of course, save for the future.

Those of us who do professional consulting at multiple sites should have the same tax advantages as our conventional counterparts. As an added bonus, with less time spent traveling to a separate business office, I am able to spend a little more of the precious little time there is with my family.

Thank you, Mr. Chairman. I will be happy to address your questions and those of the members of the committee.

Mr. BUNNING. Thank you for your testimony.

Mr. Davis.

STATEMENT OF HENRY DAVIS, PRESIDENT, HENRY DAVIS CONSULTING, NATICK, MASS., ON BEHALF OF THE NATIONAL HOME OFFICE ASSOCIATION

Mr. DAVIS. Thank you.

My name is Henry Davis, president of Henry Davis Consulting, a home-based business. I am here today representing the National Home Office Association.

My company is a good example of how the new breed of information workers provide services and what they are capable of doing from their homes. I specialize in providing new product consulting to companies that use or produce technology-based goods and services. Our services include product planning, introduction, marketing, definition and assessment.

Prior to starting Henry Davis Consulting, I spent 20 years employed in the semiconductor and software industries. I have authored over 130 articles and papers on computer and semiconductor technology and its applications. My contributions to industry have been recognized by Electronics Magazine, the American Electronics Association and others.

For the last 3½ years, I have consulted to big companies, such as IBM and Texas Instruments, while providing guidance to small emerging companies like BEARAK REPORTS, a financial services company.

Modern computer technology, coupled with networks like the Internet, provide the infrastructure I need to maintain an electronic presence for my customers no matter where I am physically

located. My home office provides the physical location for computers, phones and facsimile communications. The telephone network and Internet allow me to appear as if I am in my office even if I am halfway around the world. Modern technology permits me to work where I am—on a plane, in a hotel room or even here at these hearings. Communication with my office and customers is a phone call away. Even a cellular phone will work.

The very idea of an office is changing throughout business. Time-sharing offices, called hotelling, are becoming more popular among companies whose employees spend most of their time at client sites, on the telephone or in front of a computer.

For the home-based business, the home office becomes sort of a communications central. These rapid and profound changes in how we do business demand changes in how our businesses are managed and how we account for our expenses.

The current tax regulations governing deductibility of home offices are hopelessly outmoded. New technology and new ways of doing business mean that for a growing segment of both home-based and -operated workers, the office is becoming an electronic presence visited only to perform necessarily administrative functions. This improves financial productivity, reduces the commuting burden on our roads and highways, is environmentally beneficial and increases the amount of time we have to spend with our families.

Home-based businesses are the fastest growing segment of businesses in the United States. In the last economic recovery, home-based businesses created millions of productive new jobs. Projections are for these small businesses to continue their phenomenal growth and create at least 12 million new jobs by the year 2005. There are an estimated 24 million people who operate businesses from their homes today.

It is time for legislative change to remove the penalties home-based businesses face simply because they happen to be located in a residence.

Let me personalize the impact of home office deductions. Twenty-five percent of my home is dedicated to maintaining an office and professional library. My office serves the usual functions, including a place to write and maintain business records. The office is used only for business and is unusable by my family in my absence. Most importantly, my office provides an electronic presence, including voice mail and 24-hour-per-day computer access when I am away.

In 1993, I traveled over a half million air miles to work with clients at their locations. I was away from my home office more than 90 percent of the time. In 1994, my work kept me out of the office 80 percent of the time. If I had my office in a commercial office building, my office costs could have been deducted as a cost of doing business. But, because my income was based on work performed outside my home office, I am effectively precluded from claiming the deduction.

In my case, my home office would have been worth the tax savings of $1,050 in 1994. To put the value of home office deductions in perspective, my tax savings could have paid for "2 hours of business telephone calls so I could find 5 more clients, or paid for 8

months of classified advertising and found 8 more clients, or paid for direct mail program to gain 5 more clients or, alternatively, paid all expenditures for attendance at a trade show.

This would have resulted in additional taxable income of $25,000. At the marginal tax rate of 28 percent, that $1,050 home office deduction could have produced a net tax revenue increase from my business of at least $5,950.

The way in which we do business is changing rapidly. When I travel around the world, I can use my home office-based computers by using a notebook computer and modem. While I may be sitting in a hotel, on an airplane or in a client's office, work is being done electronically in my home office. Faxes, messages and information are all routed to me in my home office and can be available to me anywhere in the world at the push of a button. I don't need to be in my office, but I do need the office. I work in my office electronically.

Home-based businesses are mostly cash-flow-based businesses. We do not have a ready equities market. There is little in the way of business loans. And lines of credits are generally not available to us. We run our businesses based on short-term positive cash flow and controlling costs. Having our offices in our homes is one way of controlling overhead.

Big business turns to home-based business for outsourcing. We reduce costs and can often do a better job. These same big businesses are able to deduct the cost of office space that is not even occupied. It is empty or shut down. At the same time, home-based businesses have barriers in the way of deducting dedicated home offices just because we do not spend all of our time in the office.

It is not right. It is not reasonable. It is bad for business. Its bad for the country.

Thank you for your attention.

[The prepared statement follows:]

TESTIMONY OF HENRY DAVIS
NATICK, MASSACHUSETTS

My name is Henry Davis, President of Henry Davis Consulting--a home-based business. I am here today representing the National Home Office Association. My company is a good example of how the new breed of information workers provides services, and what they are capable of doing from their homes. I specialize in providing New Product Consulting to companies that use or produce technology-based goods and services. Our services include product planning, introduction, marketing, definition, and assessment. Prior to starting Henry Davis Consulting, I spent 20 years employed in the semiconductor and software industries. I have authored over 130 articles and papers on computer and semiconductor technology and its application. My contributions to industry have been recognized by *Electronics Magazine*, the American Electronics Association, and others.

For the last three and one-half years, I have consulted to big companies, such as IBM and Texas Instruments, while providing guidance to small, emerging companies like BEARAK REPORTS, a financial services company. Modern computer technology, coupled with networks like the Internet, provide the infrastructure I need to maintain an electronic presence for my customers no matter where I am physically located. My home office provides the physical location for computers, phones and facsimile communications. The telephone network and Internet allow me to appear as if I am in my office, even if I am half way around the world. Modern technology permits me to work where I am--on a plane, in a hotel room, or even here at these hearings. Communication with my office and customers is a phone call away. Even a cellular phone will work.

The very idea of an office is changing throughout business. Timesharing offices, called hotelling, are becoming more popular among companies whose employees spend most of their time at client sites, on the telephone or in front of a computer. For the home-based business, the home office becomes a sort of communications central. These rapid and profound changes in how we do business demand changes in how our businesses are managed, and how we account for our expenses.

The current tax regulations governing deductibility of home offices are hopelessly out-moded. New technologies and ways of doing business mean that for a growing segment of both home-based and corporate workers, the office is becoming an electronic presence visited only to perform necessary administrative functions. This improves financial productivity, reduces the commuting burden on our roads and highways, is environmentally beneficial, and increases the amount of time we have to spend with our families.

Home-based businesses are the fastest-growing segment of business in the United States. In the last economic recovery, home-based businesses created millions of productive new jobs. Projections are for these small businesses to continue their phenomenal growth and create at least 12 million new jobs between 1992 and the year 2005. There are an estimated 24 million people who operate businesses from their homes today.

It's time for legislative change to remove the penalties home-based businesses face simply because they happen to be located in a residence.

Let me personalize the impact of home office deductions. Twenty-five percent of my home is dedicated to maintaining an office and professional library. My office serves the usual functions, including a place to write and maintain business records. The office is used only for business and is unusable by my family in my absence. Most importantly, my office provides an electronic presence, including voice mail and 24 hours per day computer access, while I am away.

In 1993, I travelled over 500,000 air miles to work with clients at their locations. I was away from my home office more than 90% of the time. In 1994, my work kept my out of the office 80% of the time. If I had my office in a commercial office building, my office costs could have been deducted as a cost of doing business. But, because my income was based on work performed outside my home office, I am effectively precluded from claiming the deduction.

In my case, my home office would have been worth a tax savings of $1,050 in 1994. To put the value of a home office deduction in perspective, my tax savings could have:

- paid for 112 hours of business telephone bills to find 5 more clients
- paid for 8 months of classified advertising to find 8 more clients
- paid for a direct mail program to gain 5 more clients
- paid all expenditures for attendance at a trade show.

This would have resulted in additional taxable income of $25,000. At the marginal rate of 28%, that $1,050 home office deduction could have produced a net tax revenue increase from my business of at least $5,950.

The way in which we do business is changing rapidly. When I travel around the world, I can use my home office-based computers by using a notebook computer and modem. While I may be sitting in a hotel, on an airplane or in a client's office, work is being done electronically in my home office. Faxes, messages, and information are all routed to me in my home office and can be available to me any where in the world at the push of a button. I don't need to be In my office, but I do need the office. I work in my office electronically.

Home-based businesses are mostly cashflow-based businesses. We don't have a ready equities market, there is little in the way of business loans, and lines of credit are generally not available to us. We run our businesses based on short-term positive cashflow and controlling costs. Having our offices in our homes is one way of controlling overhead.

Big business turns to home-based businesses for outsourcing. We reduce costs and can often do a better job. These same big businesses are able to deduct costs of office space that isn't even occupied; it's empty and shutdown. At the same time, home-based businesses have barriers in the way of deducting dedicated home offices just because we don't spend all of our time in the office.

It isn't right. It isn't reasonable. It's bad for business and the country.

Thank you for your attention.

Mr. BUNNING. Thank you, Mr. Davis.

Mr. McCrery will inquire.

Mr. MCCRERY. Mr. Chairman, I don't really have any questions. I appreciate the testimony of the witnesses. I think they made some excellent points.

About the only thing that I am concerned about with respect to this issue—and maybe I will just throw this out to the panel—what about potential for abuse of this? I agree that we need to clarify and we need to, as Mr. Davis says, make it easier to take the deduction, but how do we prevent somebody from taking advantage of this and abusing the home office deduction if we do expand it?

Mr. DAVIS. If you look at the way the Tax Code had been originally set up or prior to this Supreme Court ruling, to the extent that my home office was not greater than income derived, then I was able to take that as a deduction. In other words, I could not use it to create a tax-loss situation.

I think, by and large, as home-based businesses become more the norm, and with 40 million people today earning some kind of a living at home, people become more aware of how to deal with the Tax Code. If you make it simple and make it easy and straightforward, then there is not much in the way of motivation for people to rip off the government.

What is really at work here is putting the capital, putting the money in people's hands who can best use it. And in my case, I gave you an example where there is a 25-to-1 payback, and, not only that, a 6-to-1 payback in new taxes.

It seems to me that the small amount of abuse that might occur is more than offset by everybody's here ability to create more income and more tax as a result.

Mr. MCCRERY. Anybody else like to comment? No? Nobody is worried about potential abuse?

Ms. OBERMAYER. I think that one of the things you need to look at is that the code, as it was before this decision, was actually quite restrictive in the use of this anyway. You must use the place strictly for your business and for no other use.

And my understanding from my accountant is that if you really try to take any significant deduction in that area you are inviting a red flag. That is, the IRS has really been very, very hard on people in this area; and you do not do it unless you are really sure that you have a clean case.

Mr. FORSYTHE. I would comment that in my function as vice president of tax for Ecolab we talk to auditors all the time, and I think that she is very right. This is a red flag. And it is the type of thing that you are either going to be able to prove it pretty easily or you are going to lose it, I think.

Mr. MCCRERY. OK.

Well, again, Mr. Chairman, I think the testimony has been excellent; and I don't mean to imply that that concern of mine will override my other concern, which is to make the Tax Code simpler and easier to use for home office deductions. So I am hopeful that we will get something out of committee to give you some relief. Thank you.

Mr. BUNNING. Mr. Ramstad.

Mr. RAMSTAD. Thank you, Mr. Chairman.

I, too, applaud the excellent testimony we received from this panel. What is most refreshing, I believe, is the real-world input that you provide. Under the new regime we have made a real effort to get people who are directly affected rather than academics and ivory tower types and policy wonks who we have seen too many of in the Congress. And it is very refreshing to see real-world people testify about real-world policies and how they are impacted.

As one who shares the consensus here that clarifying the home office deduction would make a major difference to thousands of small businesses across this country, I was very interested, Mr. Forsythe, in your testimony. You remarked that for the Ecolab sales force that home offices are the most efficient and most cost effective way to create productive and high-paying sales jobs.

I would just ask if you have any way of quantifying or projecting—if not empirically, anecdotally—how many jobs—how much impact this change, this clarification might have?

Mr. FORSYTHE. Well, I think it would affect the majority of our 2,000 direct sales personnel, but I think a very graphic explanation could be afforded by Dick Lane as to what he goes through in a typical day. Dick.

Mr. LANE. Thank you.

I am from South Dakota, and I have a territory that covers Nebraska and North Dakota. And by not having the home business deduction now, and a person that travels a lot, my typical day would be to get up in the morning and drive probably 200 to 250 miles, work with my account and drive back home that night. And then the next day turn around and drive 120 miles north and work with an account and drive back.

And by doing that, and not having the home office deduction, I have to claim that as personal miles. I think that by having to do that, it makes you do one of four things: One is, it encourages you to get an office out of the home, downtown or somewhere; number two, it encourages you to stop at a local account or a close account, that you would not really necessarily have to stop there every day. And you get to be pretty good friends with them, just stopping in, so that is considered your first stop.

I think the third thing it encourages you to do is to stay out overnight so that you do not drive back and have to encounter the personal miles coming back. And then, fourth of all, the last thing, is you claim it on personal miles.

I think by doing that—the first three things—it is an expense to my company, Ecolab, because they have to add it on to the cost of the good; and, in turn, it gets added on to the consumer. So the consumer pays for it in the long run.

And then, last, if I have to use it as personal miles, it taxes me, I think, unfairly for just trying to do an honest and fair job. Thank you.

Mr. RAMSTAD. Well, Mr. Chairman, I appreciate that. Again, that is very real world, very graphically explains the needs for this change in the law, and I am very pleased by the testimony of people who know how much this tax relief will help the self-employed and other workers who conduct their business at home.

This is really a big deal to many people I know in the Third District of Minnesota and throughout our State and country, and I appreciate again the testimony.

I just have one question I would like to ask Mr. Diedrich. You do not maintain an outside office currently?

Mr. DIEDRICH. No, sir, I do not.

Mr. RAMSTAD. What would be the comparable rent if you had to maintain such an office?

Mr. DIEDRICH. I had maintained an office and the rent structure was approximately $525 a month.

Mr. RAMSTAD. So it does not make a lot of financial sense to be required to maintain an outside office in order to be eligible for a corresponding deduction.

Mr. DIEDRICH. Absolutely. The function of my job has not changed. In fact, I am finding by working at home I function much better. I have less interruptions. The job I do at home is exactly the same job I would have done in the office, but I literally have more time working out of the office providing that same function.

Mr. RAMSTAD. Well, again, I want to thank all of the witnesses for your very helpful testimony.

Thank you, Mr. Chairman.

Mr. BUNNING. Mr. Payne.

Mr. PAYNE. Thank you, Mr. Chairman.

I have no questions but also wanted to thank the witnesses for their testimony. I think it has been very helpful.

As we all know, we are now approaching 25 million who are working in offices in their homes. As we are getting more and more into an information age that number will only increase. I think it is important that we act on what you have testified on here today. Thank you very much.

Mr. BUNNING. Mr. Ensign, if you would make sure that it is short, we would like to finish this panel before we go to vote. Thank you.

Mr. ENSIGN. I have a couple of quick comments.

Dr. Cohen, I appreciate your testimony, being a veterinarian myself.

By the way, if you ever get elected to Congress, you lose the doctor and you become a mister.

Mr. COHEN. My mother would not like that.

Mr. ENSIGN. Yes.

Addressing Mr. McCrery's comments, I want to ask why penalize all the honest people because of a few people that are going to take advantage of the situation? Sure, in any system that you set up, there will be fraud. Obviously, we have to do everything that we can to stop fraud, but should we penalize honest businesspeople because a few are going to take advantage of that?

I think you have given excellent testimony on the reasons why we should enact this legislation. And because a few people are going to abuse the system does not detract, in my opinion, from why we should give legitimate businesspeople, such as yourself, that legitimate business deduction.

Thank you, Mr. Chairman.

Mr. BUNNING. I would like to thank the panel for their very fine testimony, and we will recess to vote and then we will be back. Thank you.

[Recess.]

Mr. ENSIGN [presiding]. Welcome, panel.

Why do we not just go ahead and start with Mr. Foster and then Mr. McNutt, Mr. Turner, Mr. Lange, Mr. Thigpen, and then Mr. True.

Mr. Foster, we are under a 5-minute rule, so if you would please try to keep your testimony within the 5 minutes, we would appreciate that. Thank you.

STATEMENT OF J.D. FOSTER, PH.D., EXECUTIVE DIRECTOR AND CHIEF ECONOMIST, TAX FOUNDATION

Mr. FOSTER. Thank you, Mr. Chairman.

My name is J.D. Foster, and I am the executive director and chief economist of the Tax Foundation. I do appreciate the opportunity to appear before the committee to discuss the Federal gift and estate tax.

The Tax Foundation is a nonprofit, nonpartisan research and public education organization. We are not a trade organization. We do not lobby specific legislation. We just try to assess the economics of taxes as best we can.

My written testimony provides a short history of the estate tax, some graphical analysis of estates by size and composition and a short discussion about estate tax relief targeted toward family businesses.

The estate tax is most often justified as a revenue source, by the perceived needs to ensure a particular sense of fairness in the overall tax system, and to govern who receives the fruits of our economic system. Against this social policy must be weighed the questions of fairness to the individuals paying the tax and the economic costs imposed on the taxpayer and on society as a whole.

The gifts and estate tax is obviously a tax on capital and, as such, is a disincentive to saving and investment. Anyone facing the tax has a tremendous incentive to dispose of his or her resources either through personal consumption or charitable contributions. Consuming more just to reduce estate taxes wastes precious resources, which we cannot afford to do in this country with our low savings rate.

For many businessmen, the estate tax also poses a disincentive to the long hours and hard work associated with success. Successful businessmen, at some point, face the prospect that after all the Federal, State, and local taxes have been paid and the remainder is saved and plowed back into the business, that the Federal Government will take up to half of what is left through the estate tax. And, at some point, they must surely ask themselves whether it would be better to continue to work so hard or to spend more time with their family or in other nonbusiness activities.

So the estate tax discourages work effort by some of the Nation's most productive and gifted citizens: The dreamers and visionaries whose hard work, skill, and luck have created new jobs and new markets.

The question is just how great a disincentive the estate tax is to this sort of productive activity. It is not an easy question to answer because the estate tax is a very different type of tax than one we are used to looking at.

Unlike sales and income taxes, we have little solid intuition or research about disincentive effects on taxes. To develop some intuition, we created a model that compares the disincentives of the estate tax with that of the income tax. Specifically, the model allows us to calculate how high the top income tax rate would have to rise to achieve the same disincentive as the estate tax.

Expressed another way, the model allows us to compare two scenarios: In one, an entrepreneur's life experience of work, saving, wealth creation and business expansion is considered in the context of the current tax law—individual, corporate and estate.

In the second scenario, the estate tax is eliminated, and the individual and corporate income tax rates are raised until they produce the same aftertax bequest as under the first scenario.

Simulations conducted using this model showed that the estate tax has roughly the same effect on entrepreneurial incentives as a doubling of income tax rates. In other words, Federal income tax rates would need to be nearly twice their current levels to produce the same disincentive as the current estate tax.

Now, just for an example, consider a businessman who is currently paying at the top income tax rate and whose noncorporate business is expected to allow him or her to leave an estate valued at $5.2 million. Under current law, this estate faces an effective marginal estate tax rate of about 44 percent. To achieve the same degree of disincentive through income taxes, it would be necessary to raise the effective individual income tax rate to 68 percent.

Now, since the Superbowl was played 3 days ago, I want to conclude with a sports analogy. Imagine a rule that says that for every touchdown scored by an individual player the team gets 6 points. But every time an individual player scores more than 1 touchdown, at the end of the game the team must give up 3 points per extra touchdown scored.

Now, Jerry Rice of the 49ers scored 3 touchdowns in the Superbowl, giving the 49ers 21 points. But if the NFL had an estate tax rule, at the end of the game the 49ers would have to give back 3 points for every touchdown they scored. He scored three. That means they have to give back 6 points.

Now, under these rules, Jerry Rice is not going to try as hard to score that second or third touchdown, particularly as he was playing with a dislocated shoulder. But that is what the estate tax looks like to a successful entrepreneur.

Analysis indicates that the estate tax creates a powerful influence on some of society's most productive workers—those whose effort has allowed them to create jobs and opportunities for others by offering goods and services demanded by others in the economy.

There is a very good reason why Adam Smith called his famous work on the power of the free market economy to create prosperity "The Wealth of Nations." The estate tax is a tax on that wealth, and, as such, a direct levy on prosperity.

Thank you, sir.

[The prepared statement and attachment follow:]

Statement of

J.D. Foster, Ph.D.
Executive Director and Chief Economist

Tax Foundation

on

The Gift and Estate Tax and Economic Performance

February 1, 1995

Mr. Chairman and Members of the Committee, my name is J.D. Foster and I am the Executive Director and Chief Economist of the Tax Foundation. It is an honor for me to appear before your committee today on behalf of the Tax Foundation to discuss the Federal gift and estate tax.

The Tax Foundation is a non-profit, non-partisan research and public education organization that has monitored fiscal policy at all levels of government since 1937. The Tax Foundation is neither a trade association nor a lobbying organization. We do not take positions on specific legislation or legislative proposals. Our goal is to explain as precisely and clearly as we can the current state of fiscal policy and the consequences of particular legislation in the light of established tax principles, so that you, the policy makers, may make informed decisions.

Aside from its ability to raise revenue for the federal government, the estate tax is most often justified by the need to ensure a particular sense of fairness in the overall tax system and to govern who receives the fruits of our economic system. Against this social policy are raised the questions of fairness to the individuals paying the tax and the economic costs imposed on the taxpayer and on society as a whole.

The federal gift and estate tax is a unique feature of the federal tax system. It is not a tax on income, though it can influence the incentives to earn income; it is not a tax on consumption, though it can affect lifetime consumption; nor is it a tax on a particular activity. It is a tax on the net economic product of an individual after all other economic activity has concluded. As such, analysis of the distortions it imposes on the economy are unique and these will be the subject of my testimony.

Taxes distort the allocation of resources in the economy by altering the relative prices of goods, services, and factors of production like capital and labor. In the absence of taxes and other government policies, the economy tends to allocate its resources to produce those goods and services that are most in demand. Prices are the signals that indicate where resources should flow. Goods and services that command relatively high prices in the market, such as cars and medical attention, attract a greater flow of capital and labor than do products that command relatively low prices. Taxes alter the prices that direct the allocation of resources so that resources are directed towards less productive and less valuable uses, thereby reducing the quantity and value of the economy's product.

The nature of the disincentives imposed by the estate tax varies according to the economic state of the original wealth holder. For example, for an entrepreneur seeking to build a farm or business, the greatest disincentive effect is probably on his or her labor. The value of the business is the capitalized value of the entrepreneur's past and prospective personal efforts. As the estate tax looms larger, the disincentive grows and the amount of effort spent on building the business tends to decline. For those who have inherited wealth or who have sold their businesses after building them up, the estate tax creates a powerful incentive to consume this wealth since much of it will otherwise be lost to the federal government.

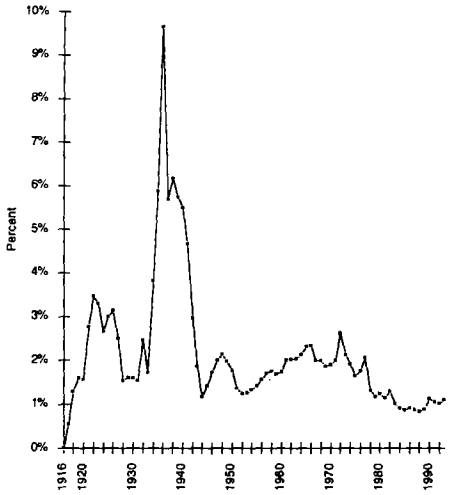
The Federal Gift and Estate Tax

The federal gift and estate tax is a system of tax rates, exemptions, credits, and special rules designed to transfer wealth from families to the federal government. This policy has two underlying justifications. The first is to raise revenue for the federal fisc and the second is to inhibit the accumulation of wealth beyond a certain level.

In total, there are 17 marginal transfer tax rates ranging from 18 percent to 55 percent. There is also a unified tax credit of $192,800 applying to lifetime gifts and bequests. And there is a rule which gradually phases out the benefit of the unified credit and progressive rate schedule by imposing an additional 5 percent tax on that portion of a transfer in excess of $10 million but less than $21.04 million.

The combined effect of the unified credit, graduated rate schedule, and benefit phase out rule is to

Figure 1
Transfer Taxes as a Percent of Federal Receipts
(1916 – Present)



Source: Internal Revenue Service.

federal revenue, though the nominal value of estate and gift tax receipts has grown steadily. In 1992, the U.S. government collected $11.1 billion in transfer taxes, predominately estate taxes, representing about 1 percent of total federal revenue.

Few changes in the transfer tax were made following the war until a series of legislation passed in 1976, 1981, and 1986 overhauled and modified the federal transfer tax system. Portions of the separate estate and gift tax systems were unified and levies were imposed on generation-skipping transfers. These Acts also lowered marginal transfer tax rates and significantly reduced the number of transfer tax returns filed each year by raising the filing requirements. See Figure 2 on page 4.

Two recent tax Acts have partially reversed some of the changes made over the previous 11 years. The Omnibus Budget Reconciliation Act of 1987 extended until 1992 the top marginal rate of 55 percent. This rate had been scheduled to fall to 50 percent. By enacting an additional 5 percent tax on transfers between $10 million and $21.04 million, the Act also phased out the benefits of the unified credit and graduated rate schedule over this range. These provisions expired on December 31, 1992, but were retroactively reinstated in the Omnibus Reconciliation Act of 1993. See Figure 3 on page 5.

Who Pays the Gift and Estate Tax

The value of the wealth reported on the estate tax returns filed for 1989 decedents (the latest year for which data is available) totaled almost $87.7 billion. The lion's share of this wealth, 31 percent, or slightly over $27.2 billion, was held by estates valued between $1 million and $2.5 million. The next largest share, 22.8 percent or $19.9 billion, was held by estates valued at between $600,000 and $1 million. Estates valued over $20 million held 14.1 percent of this wealth, or $12.3 billion. About 250 large estates (those with over $20 million in assets) file with the IRS each year. These estates are composed largely of business assets, such as closely held stock, farm assets, limited partnerships, and other non-corporate businesses. See Figure 4 on page 6.

Nearly one-half of all estate tax returns filed for 1989 decedents were for estates whose gross value exceeded $1 million. However, these estates accounted for nearly 96 percent of the total transfer tax receipts. Alternatively more than half of all returns were for $1 million or less, and these estates paid less than five percent of all estate taxes. Figure 5 on page 7 shows the distribution of federal estate tax returns for 1989 decedents by estate size. More than half of these returns, were filed for estates valued at between $600,000 and $1 million, while only 0.5 percent were filed for estates valued at $20 million or more.

Table 1
Marginal and Effective Transfer Tax Rates (1993)

Taxable Transfer (000s)	Statutory Marginal Tax Rate	Marginal Pre-credit Tax	Cumulative Pre-credit Tax	Cumulative Tax-Unified Credit	Effective Marginal Tax Rate	Effective Average Tax Rate
$10	18%	$1,800	$1,800	$0	0%	
			0%			
20	20	2,000	3,800	0	0	0
40	22	4,400	8,200	0	0	0
60	24	4,800	13,000	0	0	0
80	26	5,200	18,200	0	0	0
100	28	5,600	23,800	0	0	0
150	30	15,000	38,800	0	0	0
250	32	32,000	70,800	0	0	0
500	34	85,000	155,800	0	0	0
600	37	37,000	192,800	0	0	0
750	37	92,500	248,300	55,500	37	7.40
1,000	39	97,500	345,800	153,000	39	15.30
1,250	41	102,500	448,300	255,500	41	20.44
1,500	43	107,500	555,800	363,000	43	24.20
2,000	45	225,000	780,800	588,000	45	29.40
2,500	49	245,000	1,025,800	833,000	49	33.32
3,000	53	265,000	1,290,800	1,098,000	53	36.60
4,000	55	550,000	1,840,800	1,648,000	55	41.20
5,000	55	550,000	2,390,800	2,198,000	55	43.96
10,000	55	2,750,000	5,140,800	4,948,000	55	49.48
21,040	55	6,624,000	11,764,800	11,572,000	55	55.00
30,000	55	4,928,000	16,692,800	16,500,000	55	55.00
40,000	55	5,500,000	22,192,800	22,000,000	55	55.00
50,000	55	5,500,000	27,692,800	27,500,000	55	55.00
100,000	55	27,500,000	55,192,800	55,000,000	55	55.00

Source: Internal Revenue Service

create a range of effective marginal and average transfer tax rates that differs markedly from the statutory schedule, as shown in Table 1 on page 2. For example, while the statutory marginal tax rate on transfers between $600,000 and $1 million was 37 percent, the effective average tax rate on such transfers ranged from 0 percent to 15.3 percent.

A Short History of the Tax

The nation's first transfer tax was enacted in the final years of the 18th century when strained relations with France compelled the U.S. to develop a powerful navy. This force was funded by the Stamp Act of 1797, which required that federal tax stamps be purchased when transferring property from an estate. The cost of the stamp required to transfer property depended on the value of the estate and the size of the transfer. This tax was repealed in 1802.

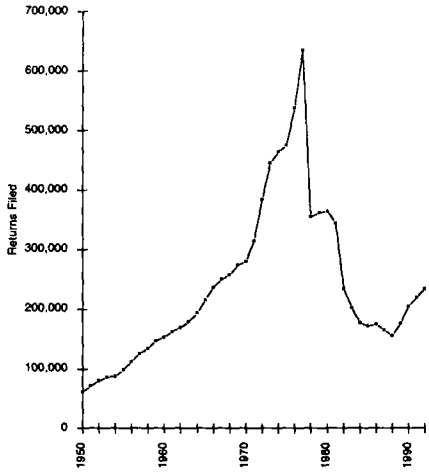
The federal government resorted once again to transfer taxes in the 1860s when the Civil War and subsequent reconstruction forced the Congress to look for additional federal revenue. A series of Acts passed in 1862, 1864, and 1866 created and refined the first federal inheritance tax. In 1870 Congress repealed this tax as demands for federal revenue eased. The transfer tax was once again enacted in 1898 to help finance the Spanish-American War. The tax was repealed in 1902. Prior to 1916, therefore, the federal government did not rely on transfer taxes as a permanent source of revenue, but, rather, levied the tax as a temporary source of revenue during national emergencies.

In 1916, the federal government enacted the estate tax along with the federal income tax. Sixteen years later, largely to prevent avoidance of the estate tax, the Congress enacted the gift tax. When it was enacted, the estate tax was imposed on estates in excess of $50,000 (about $650,000 in 1995) and the rate ranged from 1 percent to 10 percent.

The transfer tax reached its peak as a source of federal receipts in the period from 1932 to 1941, when transfer taxes accounted for as much as 9.7 percent of total federal receipts. However, while other taxes were raised during the Second World War, the transfer tax remained unchanged so that transfer tax receipts fell to 1.4 percent of total revenue by the end of the war. See Figure 1 on page 3.

With the exception of the mid-1930s, transfer taxes have never represented a significant share of

Figure 2
Total Transfer Tax Returns Filed
(1950 – Present)



Source: Internal Revenue Service.

The composition of estates varies significantly as the size of the estates increases. For example, as Figure 6 on page 8 shows, the percentage of the estate represented by business assets (closely held stock, farm assets, limited partnerships) grows steadily with estate size, while real estate and cash tends to decline as a share of estates as the estate size increases.

The Disincentive Effects of the Estate Tax

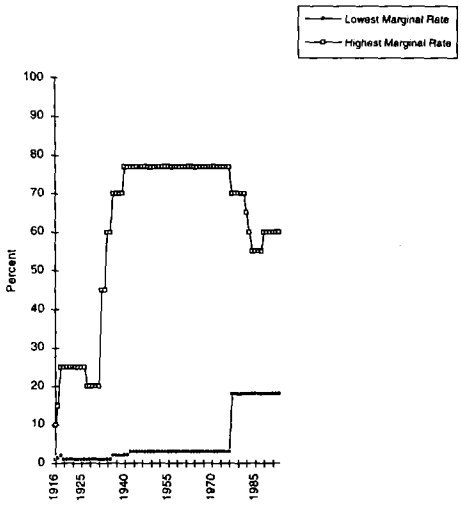
The gift and estate tax is a tax on capital and is universally recognized as a disincentive to save and invest. Anyone facing the tax has a tremendous incentive to dispose of his or her resources rather than let them be confiscated by the federal government. These dispositions may take any number of forms of personal consumption or charitable donations. While the latter may represent socially desirable behavior, increasing personal consumption to minimize the savings exacted by the federal government is a counterproductive dissipation of precious resources, particularly for a country that has such a low private saving rate.

For many taxpayers who are building up their personal wealth through their own labor, the gift and estate tax is also a powerful disincentive to the hard work and long hours associated with success. Successful businessmen at some point face the prospect that, after the federal, state, and local governments have imposed their income, property, and sales taxes on current income and assets, and the remainder is saved and plowed back into the business or other savings, the federal government will come along and take up to half of what is left through the estate tax. For individuals such as these, at some point they must surely ask themselves whether it would be better to continue to work so hard or to spend time with the family or on other, non-business related activities.

Thus, the transfer tax discourages work effort by some of the nation's most productive and gifted citizens—the dreamers and the visionaries whose hard work, skill, and luck have created new jobs and new markets. The question is, however, just how great a disincentive the estate tax is to this kind of productive activity.

This is not an easy question to answer because the estate tax is a very different type of tax than we are accustomed to examining. When a sales tax is levied, the effect is either to raise the price of the product being taxed or to shift the tax onto labor in the form of lower wages or onto capital in the form of lower after-tax earnings for a given level of pre-tax earnings. In each case, however, expe-

Figure 3
Estate Tax Marginal Rate Ranges
(1916 – Present)



Source: House Ways and Means Committee, 1993.

rience with sales taxes offers some intuitive sense of the consequences of a sales tax change of a certain size on a particular type of product.

Similarly, experience offers a relatively clear picture of the effects of income taxes on the disincentives to work. Research indicates, for example, that for males earning low to upper-middle income wages, the disincentive effect of higher marginal tax rates is fairly low, while that for all women tends to be higher. Research, in accord with common sense, also tells us that the disincentive effect of higher marginal tax rates rises rapidly once an individual's income reaches a certain level because the trade-off between the work required to earn an additional dollar of after-tax wages and enjoying the fruits of leisure quickly tilts in favor of leisure over labor.

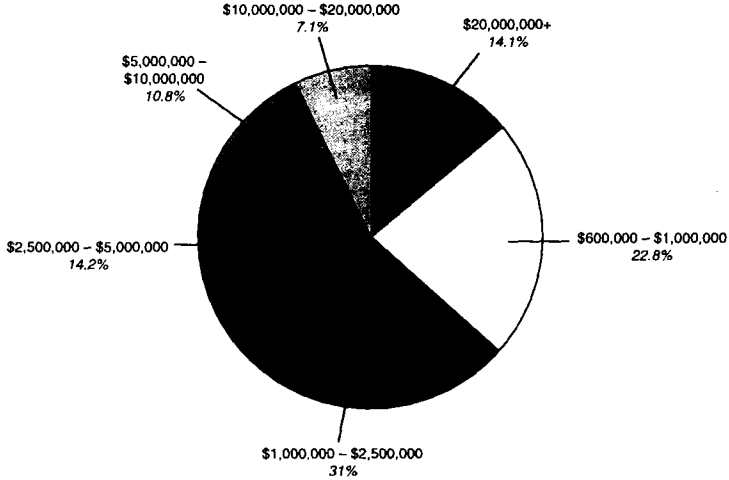
To clarify the effects of the estate tax on the incentive to work, the Tax Foundation developed a model that allows a comparison of the disincentive effects of the estate tax and the income tax. Specifically, the model allows a calculation of how high the top income tax rate would have to rise for it to achieve the same level of disincentive effect as the current estate tax regime.

Another way to think about the model is that it allows us to compare two scenarios. In the first scenario, an entrepreneur's life experience of work, saving, wealth creation, and business expansion is considered in the context of the current individual, corporate, and estate tax law. In the second scenario, the estate tax is eliminated and the individual and corporate income tax rates are raised until they produce the same after-tax bequest as under the first scenario. (The model is described in the Appendix to this testimony.) (pages 4 through 7 of the paper)

The various simulations conducted using this model showed that the estate tax has roughly the same effect on entrepreneurial incentives as a doubling of income tax rates. In other words, federal income tax rates would need to be nearly twice their current levels to produce the same disincentive as the current estate tax. For example, consider an entrepreneur who is currently paying at the top income tax rate and whose non-corporate business is expected to allow him or her to leave an estate valued at $5.2 million. This estate under current law faces an effective marginal estate tax rate of about 44 percent. To achieve the same degree of disincentive through income taxes it would be necessary to raise the effective individual income tax rate to about 68 percent. According to this research, this pattern of implied income tax rate appears for a wide variety of estate sizes and business growth patterns.

These results indicate that the estate tax creates a powerful influence on some of society's most productive workers, those whose effort has allowed them to create jobs and opportunity for others by

Figure 4
Distribution of Total Estate Wealth by Estate Size
(1989 Estates)



Source: Internal Revenue Service.

offering goods and services demanded by others in the economy. There is a very good reason why Adam Smith called his famous work on the power of the free market economy to create prosperity: "The Wealth of Nations". The estate tax is a tax on that wealth and, as such, is a direct levy on prosperity.

Since the Super Bowl was played just three days ago, a sports analogy seems appropriate. Imagine a rule that says that for every touchdown scored by an individual player, the team gets six points. And, anytime a player scores more than one touchdown, the team must give up three points at the end of the game per extra touchdown scored. Jerry Rice of the San Francisco 49ers scored three touchdowns in the Super Bowl, giving the 49ers 21 points during the game, counting the extra point kicks. But, if the NFL had a rule similar to the estate tax, at the end of the game the 49ers would have to give back three points each for every touchdown scored after the first, so they would have to give back six points. Under these rules, is Jerry Rice going to try as hard to score that second or third touchdown, particularly since he was playing with a dislocated shoulder? That is what the estate tax looks like to a successful entrepreneur.

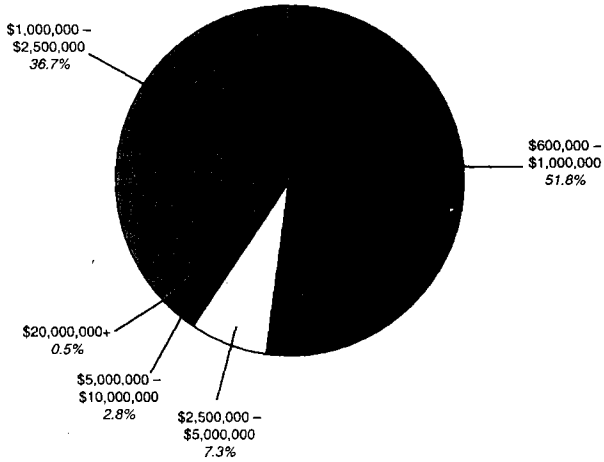
Estate Tax Reform and the Family Business

Estate tax reform that reduces the burden of the tax is a clear statement that society no longer deems the economic cost of the tax, or the unfairness of the tax to the taxpayer, to be a reasonable price to pay for the tax's social policy goals. Such reform may be made in a number of ways. The most simple would be to reduce the tax rates or to increase the amount of the unified credit, and to index all elements of the tax. All of these changes would reduce the economic cost of the tax system.

This cost may also be reduced by targeting the relief towards particular segments of society. For example, it may be suggested that the tax relief would have its greatest effect on reducing economic costs while having the least effect on society's notions of tax fairness by reducing the estate tax burden on the estates of businessmen who started or inherited businesses and developed them into larger, thriving enterprises—what I call first-generation wealth. The supposition inherent in such targeted relief is that society generally is inclined to hold it fairer that an individual who creates wealth through his or her own efforts should be allowed to keep a larger fraction of that wealth than should somebody who inherits wealth.

A narrower policy goal is to reform the estate tax so as to allow family businesses to be inherited by

Figure 5
Distribution of Estate Tax Returns by Size
(1989 Estates)



Source: Tax Foundation.

other family members. The estate tax can impose an enormous financial burden on a family business. Even medium-sized businesses cannot readily access the financial resources necessary to pay the tax, and certainly not without accepting financial burdens that can severely damage the viability of the firm. Consequently, the inheritors of a family business must often sell part or all of the business to outside interests. Targeted estate tax relief could dramatically improve the possibility that a family business could be inherited.

There is an important distinction, however, between a policy that would offer enough relief so that a family business could remain in the family, and relief that is so constraining as to become a policy of requiring that the family business remain in the family in order to qualify for the relief. These constraints may be politically necessary, but the price is less of a reduction of the economic cost of the tax as far as the entrepreneur is concerned in those cases whenever it is not possible or not desired that the business be passed on to other family members. If the intent of the reform is to reduce as far as possible the disincentives facing entrepreneurs in the process of creating first generation wealth, then the relief will have its greatest effects if it comes with the fewest limitations and constraints as possible.

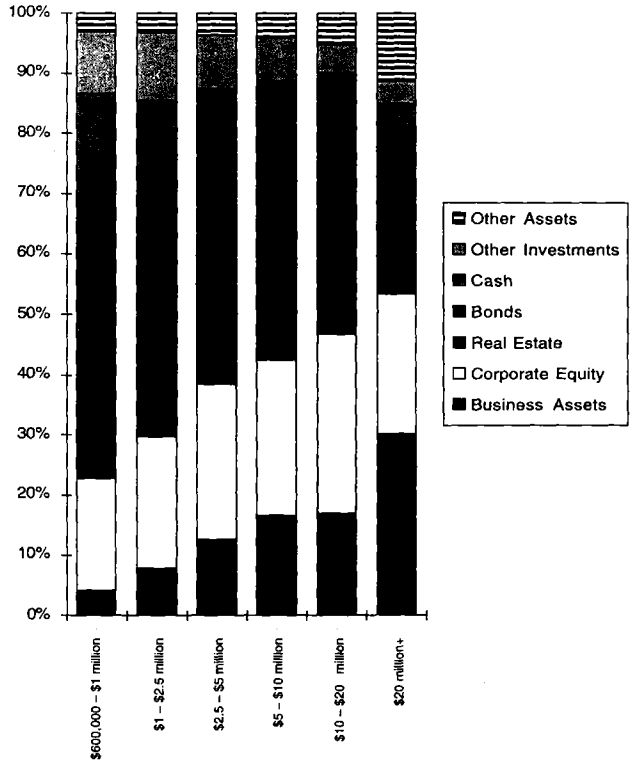
In other words, if the predominant policy goal to be attained in reform of the estate tax is to keep family businesses in the family, then limitations to the reform to that effect are appropriate. However, if the predominant goal is to reduce the disincentives facing the entrepreneur building a successful business, then these limitations can be highly counterproductive. The difference is whether the policy is to make it possible for the family business to continue as such, or to require that it do so to receive the benefits.

Comprehensive Tax Reform and Estate Tax Reform

Comprehensive tax reform is widely anticipated, motivated largely by a recognition that the federal tax system remains harmful to economic growth and international competitiveness, and that its complexity and compliance burdens go far beyond the bounds of reason. There are a number of tax reform plans, both in the Senate and in the House, that have been introduced and that together represent a rough starting point. Whatever their form these plans all have the reduction of the tax burden on saving as a key element. What is little recognized is that these plans all tend to put additional pressure on the estate tax system.

A tax principle likely to undergird any tax reform effort is that all income should be subject to tax once and only once. Since many of the tax reform proposals would only tax income when it is used for consumption, income that is saved and that ultimately becomes part of the individual estate will

Figure 6
Composition of Estates by Estate Size
(1989 Estates)



Source: Internal Revenue Service.

not be subject to tax except through the estate tax. Also, the partial or complete elimination of the tax bias against saving that tax reform promises means that individuals will increase their savings rate. This, in turn, means that estate sizes will be much larger in the future than they would have been without tax reform.

For these reasons, the estate tax is likely to play a far more integral role in the overall federal tax system following tax reform than it does today. Because of the complexity of any comprehensive tax reform effort it is likely that the estate tax would not be given the attention it needs at that time, and so it may be advisable to complete much or all of the desired reform of the estate tax prior to the reform of the federal income tax system.

Conclusion

The federal gift and estate tax lies at the crossroads between redistributionist social policy and economic policies to foster prosperity. The tax poses a tremendous disincentive to work, save, and invest. This disincentive can be acutely felt by entrepreneurs trying to build their businesses.

Estate tax reform may be either general or targeted in nature. If estate tax relief is targeted specifically to reduce the disincentives facing entrepreneurs, then the relief should include as few limitations and constraints as possible because these limitations also limit the effect of the relief. If the relief is intended to allow for businesses to remain in the family, then Congress will need to be careful in deciding between a policy of allowing the business to remain in the family versus a policy of requiring that it remain in the family to qualify for estate tax relief.

APPENDIX: A Model of Estate Taxes and Wealth Accumulation

The model referred to in the above testimony is a mathematical exposition of an individual entrepreneur's wealth accumulation and allocation decision. Because the process of accumulating and allocating wealth occurs over two distinct periods of an individual's life -- working and retirement -- the model is divided into two parts. The first illustrates how wealth is accumulated during an individual's working years. The second part details how a portion of this wealth may be consumed during retirement. Both parts of the model were constructed by combining six equations. These equations describe the following:

(1) The accumulation of wealth over time;

(2) The entrepreneur's total after-income tax income in each period;

(3) The entrepreneur's labor income in each period, which accounts for the disincentive effects of the personal income tax;

(4) A representation of the growth of the entrepreneur's business assets each year;

(5) An expression detailing the entrepreneur's accumulation of equity in the business; and

(6) An expression of the entrepreneur's personal consumption each year.

A short description of each of these equations, as well as a brief explanation of how they are combined is given below. A complete description of the equations and the solution to the model is available from the Tax Foundation.

During an individual's life, wealth will accumulate as income exceeds consumption. This is given by the simple equation:

$$W_j = W_{j-1} + I_j - C_j \tag{1}$$

where wealth at the end of the current year, W_j, is the sum of accumulated wealth from the prior year, W_{j-1}, plus income earned during the current year, I_j, less current year consumption, C_j.

During each year of an individual's life, income is received from any of three sources: (1) labor compensation; (2) the equity which accrues as a result of the growth of business assets; and (3) income from assets held outside the business, which is referred to here simply as interest. All labor income is received from the business and has two components: wages and distributions of equity. Interest is earned on all wealth that is not part of the business. Income is therefore given by the equation:

$$I = f_2[w, D, F, A, t_i, t_c] \tag{2}$$

where income received in any year, I, is the after-tax sum of wages received during that year, w, distributions of equity received that year, D, the interest earned on wealth held outside the business during that year, F, and the equity accrued from the growth of business assets during that year, A. Wage and interest income are assumed to be subject to the individual income tax, t_i. Income generated by the growth of business assets is assumed to be subject to either the individual or corporate income tax, t_c, depending on how the business is structured. If the business is structured as a taxable corporation, equity distributions are assumed to be subject to both the individual and corporate income taxes.

Each year an individual's labor income is given by the expression:

$$L = f_3[t_i, t_c] \tag{3}$$

Recall that an individual's labor income is composed of both wages and equity distributions. As a result, L depends on the individual and, in some cases, the corporate income taxes. To avoid undue complexity, this model does not account for payroll taxes imposed on wage income.

The growth of an entrepreneur's business assets is given by the expression:

$$A = f_4[t_i, t_c] \tag{4}$$

where A depends on the individual and, in some cases, corporate income taxes.

Each year, as the business grows, it generates income. As stated above, this income is subject to taxation by either the individual or corporate income taxes, depending on how the firm is structured. The model also allows the entrepreneur to consume a portion this income. When the firm is structured as a taxable corporation, the after-tax, unconsumed equity, E, that an entrepreneur acquires in any year is given by:

$$E = f_5[A, t_i, t_c, \gamma_1] \tag{5}$$

where E depends on growth of the business, A, the individual and in some cases the corporate income taxes, t_i and t_c, and consumption out of after-tax income generated by the growth of business assets, γ_1.

Individuals may consume out of all components of income. Therefore consumption is given by the expression:

$$C = f_6[w, D, F, A, \gamma_0, \gamma_1, t_i, t_c] \tag{6}$$

The marginal and average propensity to consume out of after-tax wage, dividend, and interest income is γ_0. Consumption out of after-tax income generated from the growth of undistributed business equity is given by γ_1.

The complete model of an entrepreneur's wealth accumulation and allocation decisions is created by combining the five equations described above. An entrepreneur's pattern of wealth accumulation may be mapped out by observing the value of W_j (equation (1)) each year. As stated above, during each year of an individual's career, income, I (expression (2)), is determined by labor income consisting of wages, w, and dividends, D; interest received on wealth held outside the business, F; the growth of business assets, A; and by the individual and corporate income tax rates, t_i and t_c. Labor income earned in any particular year is determined by the specific equation assigned to represent expression (3). The amount of interest bearing wealth held in any year is determined in prior years. The amount of business assets held in any particular year is determined by the specific equation assigned to represent expression (4). Consumption, C_j (expression (5)), during each year of an individual's career is determined by income and by the values assigned to γ_0 and γ_1. During each year of retirement, income is determined by the amount of interest bearing wealth that the individual has accumulated and by the continued growth of the business. Consumption during each year of retirement is assumed to be equal to that in the last year of the individual's career. The model is designed so as to allow for the consideration of a wide variety of income, wealth accumulation, and consumption profiles.

Mr. ENSIGN. Thank you.
Mr. McNutt.

STATEMENT OF LEE WILLIAM MCNUTT, JR., PRESIDENT AND CHIEF EXECUTIVE OFFICER, COLLIN STREET BAKERY, CORSICANA, TEX., ON BEHALF OF NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. MCNUTT. Thank you, Mr. Chairman.

I am Bill McNutt. I am president of the Collin Street Bakery in Corsicana, Tex. Corsicana is a community of 23,000 people, 50 miles south of Dallas, and my company is the primary employer there.

My family's business began with my father going stone broke during the Depression, along with millions of other Americans. He began rising from the ashes in 1933 with an $800 investment in a business in Corsicana from the money that came from my mother's $1,200 inheritance from her just-deceased father who was a small farmer. With the other $400, they invested in a house.

That is a rather humble beginning 62 years ago, but during those years has emerged what is a very successful, small, family-owned enterprise. I think we are typical of the success of American entrepreneurship, combining sometimes really backbreaking work on the part of my father in the early years with a lot of good fortune along the way.

We have grown to a place where now, in the third generation, we have sufficient assets in the company that, upon my death, it will probably have to be sold. In other words, the penalty for success with our death tax rates is just that punitive.

When my father passed away 23 years ago, the company—he had already transferred sums to me in the stock, and the company was not of sufficient value for there to have been an overwhelming estate tax. I got the rest of his stock through my mother before her death last year.

We have enjoyed really tremendous growth during the past 23 years, during which time our foreign sales have grown from zero to 25 percent of our total volume. We are quite proud that we are able to do something about our Nation's disastrous balance of payments and have been awarded the Department of Commerce's Presidential E Award for excellence in exporting.

We are a niche business. We have one product and that is a fruitcake that we market by direct mail only. We market it worldwide. We served over 400,000 customers last year, who ordered our beautiful little fruitcakes primarily as Christmas gifts, by phone, fax and written order.

During these past 23 years the growth cycle—primary growth cycle of our company—we have grown from 24 to 85 full-time employees. They have marvelous jobs. They have fully paid pension plans. They have a 401(k) plan that we match dollar for dollar. They have full health coverage. We really do not know how to be a better employer than we are.

I have steadfastly refused to let the company be sold into larger hands—and we have rather frequent opportunities—because I am convinced that we can best serve our customers and our employees and ourselves by remaining staunchly independent. Because if

some giant corporation were to take over our operation and see the way we operate, they would first think we were crazy, but they would alter the company, I am convinced, beyond recognition, to the point where in a few years it very well might not exist.

The second and primary reason for not wanting to sell the company is my wish to pass it along to my children—two sons and two daughters. My heir apparent is a 38-year-old young man who started to work at the bakery summers when he was 11 and 12 years old. I would take him to work for me at 8 o'clock in the morning, and he would sweep the curbs, go home for lunch and have the afternoons free. Very typical, I expect, of the way many fathers have brought their sons into the business.

He has worked in every department. He is very able, and he is ready to take over our enterprise. And nearing 70 years of age and after 37 years with the company, I am about ready to pass the baton.

But under current estate laws I fear that the baton will be passed on only temporarily because at the death of myself and my wife there is no way the money is going to be there to pay the estate taxes.

We have bought insurance to the extent that it is realistic. Well over half my assets are in our family-owned business. It may very well have to go under the hammer.

I have written memorandums to my children and told them on the death of their mother and myself that they are to sell every asset, everything that we own, everything that my wife and I have accumulated through our lifetime. I recommend: If you want to keep the Collin Street Bakery, you sell it off, sell the kitchen sink, sell the home, sell your mother's jewelry, sell the art. If it has a dollar value, you sell it, and it might bring you enough money, combined with a substantial bank loan, to allow you to keep our company. That is how punitive the tax rate is on a small family held business.

Mr. ENSIGN. Mr. McNutt, if can you wrap it up. Your 5 minutes is up. Can you wrap it up real quick?

Mr. MCNUTT. All right.

The gentleman who said the power to tax is the power to destroy could not have been more foresighted than he was. And you people on this committee particularly have the opportunity to reverse a 40-year trend toward socialism and redistribution of the wealth in this country and return us to the track of capitalism and free enterprise.

We pray your success. We urge your attention to the elimination of small businesses from estate tax laws so they can continue to operate within families.

Thank you very much.

[The prepared statement follows:]

TESTIMONY OF THE

NATIONAL FEDERATION OF INDEPENDENT BUSINESS (NFIB)

Witness: Lee William McNutt, Jr.
President / CEO, Collin Street Bakery
Corsicana, TX

Subject: Impact of the Estate Tax on Small Business

Before: House Committee on Small Business

Date: January 31, 1995

The National Federation of Independent Business appreciates the opportunity to submit testimony on the issue of estate taxes and their impact on small businesses. NFIB is the nation's largest small business organization representing over 600,000 small business owners from all fifty states. NFIB sets its public policy positions through regular polling of the membership.

Costs of the Estate Tax

The process the Committee and the Congress is now engaged in presents an historic opportunity to relieve America's small business owners from government-imposed burdens and to open the door to economic expansion and job creation in the small business sector. The federal estate tax represents perhaps the greatest burden today on our nation's most successful small businesses.

At roughly one percent of annual revenues, this tax is hardly worth the devastation it causes to family businesses and farms, entrepreneurship, and our nation's international competitiveness. The costs of such damage to small businesses and our nation's economy is unquestionably high.

Small Business: America's Path to Jobs and Independence

Evidence continues to suggest clearly that small business plays a rather remarkable role as a job creator and provider of personal opportunity, security and independence for millions of Americans. Consider the following:

Jobs. Since the early 1970s, small firms have created two of every three net new jobs in this country (created jobs minus lost jobs). The nation's small business job machine has

shown a capacity to produce in either good or tough times. From 1989 to 1991, a period of minimal economic growth, firms with fewer than 20 employees created virtually all net new jobs in the country.

Demographics. Almost all businesses are small businesses. There are approximately five million employers in the United States. About 99 percent of them are small employers. Small business as a whole employs more than half of the private sector workforce. Most small firms are not set up as C Corporations, but as proprietorships, partnerships, and subchapter S corporations.

Values. Small business holds out to our citizens great hope. Small business offers a road map to the American dream that allows any American with a good idea and talent to follow it to economic freedom and security by starting their own business and working hard to make it a success. And possibly the ultimate American dream is to be able to pass that successful business on to one's children.

Evidence indicates that the vast majority of America's small closely-held businesses are family businesses. Although it is difficult to precisely define a "family business", there are clear characteristics of the family business which distinguish it from others. While other businesses are usually driven entirely by return on investment, the family business is most often driven first by other priorities -- like relationships and longevity. Family businesses are generally much smaller than publicly-traded corporations, but possess certain advantages over these larger businesses. For instance, being private, family businesses do not have to worry about quarterly earnings reports for stock analysis, and can instead focus on long-term value enhancement, even if it means losing money in the short-term in some cases. Additionally, family businesses operate without a rigid bureaucracy, consequently, they can respond quickly and intuitively to changes in business environments. On the other hand, because of personal considerations, such as a desire to pass the business on to one's children, a family business may not always make purely rational decisions in a market-driven sense. Family businesses play a far greater role in this nation's economy than many might think -- estimates indicate that they produce roughly half of our nation's gross domestic product.

The Need for Estate Tax Reform

NFIB considers estate tax reform to be crucial to the continued survival of the small American family business. Current estate tax rates cripple a small business passed on to heirs, and often force them to liquidate a business they have worked in their whole lives. High estate taxes may provide government revenue in the short run, but the long-run losses far outweigh the gains -- a productive business is extinguished, many jobs are lost, and the American dream of growing a business and preserving it beyond one's lifetime by passing it on to heirs becomes impossible to achieve.

Because all assets are included in determining estate tax calculations, such as the decedent's home and other personal assets, many productive businesses worth far less than the

current exemption level become victims of the estate tax. Because so many small businesses operate on cash flow, often with extremely small or negative profit margins, current law allowing small businesses to spread their tax liability over ten years does not provide adequate relief.

Small businesses are also particularly vulnerable to the intricacies of estate tax law. Although some owners can ensure a successful transfer to heirs by purchasing life insurance and through other methods, many cannot afford this kind of planning or do not have the time to meet with estate planners because most of their energies are directed toward keeping the business running. Unfortunately, unlike a publicly traded corporation which continues operation regardless of how shareholders plan for their death, a closely held business, unless there has been careful planning, is usually devastated by the death of an owner.

Impact on Small Business

Current estate tax rates range from 37 to 55 percent. Faced with the tremendous burden imposed by this tax upon their death, a business owner will react in several of the following ways:

1) **The business owner will not expand the business**. Especially in later years of the business owner's life, large capital expenditures for long term growth make little sense when the family will soon be forced to sell or liquidate the business. This disincentive to growth means lost opportunities, lower productivity, and lost jobs. In fact, the existence of estate taxes can deter many potential entrepreneurs from starting a business at all.

2) **The children will not participate in the business**. Knowing that taxes will prevent children from continuing operation of a family business, the business owner will often discourage their children from working in the business and encourage them to gain experience elsewhere. If the children do actively participate in the business, their experience and knowledge will often go to waste when the business is forced to be sold off. A recent survey of family businesses by Mass Mutual Life Insurance showed that only 57 percent of owners planned on keeping the business in the family, down from 65 percent a year ago; taxes were cited as one of the prime reasons for plans to sell out.

3) **The business owner will pay dearly in estate planning costs**. Even if the business owner has the foresight to plan early for their death, the expense of this planning, in insurance, legal and accounting costs, can be enough to eliminate a business' small profit margin. These extra insurance, legal and accounting costs are especially burdensome because small businesses survive on cash flow, not profit. In the NFIB Education Foundation's survey entitled Small Business *Problems and Priorities*, cash flow ranked as the third highest problem for small business, behind only the cost of health insurance and federal taxation. Coming up with the cash to pay bills and make payroll is a constant challenge in a small firm. Money left in the business -- cash flow -- is the difference between life and death for most new businesses. The costs to small business and society as a whole are high -- instead of using these funds to expand, create

new jobs, and become more productive and competitive in the international marketplace, small businesses must spend the money on estate planning costs.

4) **Heirs may not be able to afford tax payments.** Despite some planning, heirs are often still imposed with some significant tax burden. Even paid out over time, taxes may be too much of a burden to survive in an internationally competitive marketplace.

Fire-Sale of the Family Business

What this means is that all too often the family business is sold-off, either before the owner's death or by the estate. Most often, a ready market does not exist for the sale of a small family run business. Consequently, the business is subject to a fire-sale -- either liquidated entirely or sold intact for a price far below its true value. Additionally, much of the value of a family business often comes from the experience and know-how of those who run it -- the family members. Their stewardship often makes the difference between a profitable, successful business enterprise, and a dying one.

All too often, the family business or farm will be bought-up by a large business such as a corporate conglomerate at a price that's a fraction of the real value of the business. While the large business may gain some of the assets of the small business, most of the real value of the former business is lost -- the entrepreneurial spirit, know-how and ingenuity, the small business' flexibility and usually most if not all of the jobs. What might have become an Apple computer instead becomes another division of a large cash register sales company.

Contrast this with what happens when a shareholder in a corporation traded on the New York Stock Exchange dies. Because there is a ready market for the stock, the estate can easily sell off enough to pay taxes. The value of that stock does not decline because of the sale. Although the stock may have new owners, the operation of the corporation continues completely unaffected by the shareholder's death.

Public Policy Reasons for the Estate Tax ?

The philosophy behind the estate tax started with early Americans who were trying to prevent the pooling of too much wealth in too few families, as had occurred in Europe. Today, however, this philosophy is fundamentally flawed. When applied to closely-held business assets, ironically, the tax produces just the opposite result -- often forcing family-owned businesses to sell-off to larger public corporations, further concentrating the wealth and power of this country and encouraging monopolistic controls of markets. This philosophy also ignores the tax's impact on communities that are dependent on these businesses, and its deleterious impact on our nation's international competitiveness against foreign countries like Japan and Germany who do not impose this kind of estate tax burden and who encourage the continuation of family-run enterprises.

NFIB Estate Tax Reform Proposal

NFIB strongly supports the Contract with America's Job Creation and Wage Enhancement Act proposal to raise the estate tax exemption from $600,000 to $750,000, and to index the exemption to inflation. It is a very needed first step. **We further propose that the value of closely-held business, farm and ranch assets in an estate be exempted from estate taxes altogether.**

Exempting closely-held business, farm and ranch assets from estate taxes would ensure that the business will continue and that the jobs of its employees will be protected. Moreover, this exemption would eliminate the strong disincentive that now exists for business owners to continue to develop their business and create jobs as they reach their later years in life. A recent study by the Tax Foundation found that today's estate tax rates have the same disincentive effect on entrepreneurs as a doubling of current income tax rate.

Total federal estate tax revenue represents only about $12 billion annually. Business assets represent roughly 12 percent of this $12 billion -- about $1.4 billion a year. **In other words, for $1.4 billion annually every closely-held farm, ranch, and small business in America could be exempt from the federal tax collector's axe.**

To ensure this exemption would be appropriately targeted to family businesses and farms that need it, the NFIB proposal would apply the exemption only to closely-held businesses that constitute a major portion of the decedent's estate, such that liquid assets are not available to allow the business to remain intact. Further, heirs would have to continue operation of the business for at least ten years, or some of the estate tax would be recaptured on a pro-rata basis. Finally, to prevent abuse, the proposal would exempt from estate taxes only those assets necessary for the active operation of the business.

By restoring incentives to continue operation of closely-held businesses in the family, this proposal would fuel economic growth in the sector which produces more than half of our nation's gross domestic product. Any loss of revenue by static analysis would likely be more than compensated by a greater tax base in the small business sector.

Conclusion

Current estate tax rates impose an often overwhelming burden on our nation's small family-run businesses. The small amount of revenue this tax generates is hardly worth the long term damage impacted on these enterprises -- in the long run the tax means less economic activity, job loss, and prevention of the continuation and fulfillment of the American dream of operating one's own business and passing it on to one's children.

Exempting business assets from estate taxation would remove the single greatest government burden imposed upon small family businesses, setting national priorities where they should be: encouraging the continued operation and expansion of family businesses through generations.

Mr. ENSIGN. Thank you for your testimony.
Mr. Turner.

STATEMENT OF JIM TURNER, CHAIRMAN, ESTATE AND GIFT TAX SUBCOMMITTEE; VICE CHAIRMAN, TAX AND CREDIT COMMITTEE, NATIONAL CATTLEMEN'S ASSOCIATION; AND A RANCHER, SARASOTA, FLA.

Mr. TURNER. Mr. Chairman and members of the committee, thank you for your concern about the estate tax impact on farmers, ranchers and other family businessowners. The National Cattlemen's Association appreciates the opportunity to discuss these issues with you today.

I am Jim Turner. I am vice chairman of the tax and credit committee of the National Cattlemen's Association; and, as such, I chair that committee's estate and gift tax subcommittee. I am also a practicing real estate and tax attorney and have done some estate tax work for families in agriculture.

Our family has owned a cattle and citrus enterprise in Sarasota County, Fla., for the last 50 years or so. My late father, Latimer H. Turner, is a past chairman of the tax and credit committee of the NCA and a past president of the Florida Cattlemen's Association.

One of the National Cattlemen's Association's top priorities this year—and, indeed, for many of the last several years—is estate tax reform. As Congressman Barrett testified earlier this morning, the average age of cattlemen in this country is now 55 years old. That statistic suggests that there are currently a lot of senior family members owning ranches whose families will soon face the burden of Federal estate taxes. The number of cattle operations in this country has declined 20 percent from 1981 to 1993, to the lowest level of the century. The impending burden of Federal estate taxes, we believe, is only likely to accelerate that trend.

We feel the burden of estate taxes has contributed to families selling their family farming and ranching enterprises, resulting in the concentration of these enterprises in fewer and fewer hands. This concentration, we feel, is leading to the deterioration of rural America.

The estate tax was implemented, as I understand it, out of some populist notion that the estate tax would prevent an accumulation of wealth in a few privileged hands. However, we believe it has done just the opposite. The estate tax has caused further concentration of ownership because when families have to liquidate their operations to fund estate taxes, the only buyers with enough capital to buy are large, publicly owned corporations. Family-owned businesses are spending what capital they have trying to plan around estate taxes, not planning to expand.

My written comments recommend a number of amendments to estate tax laws to soften their impact. However, we feel even more needs to be done. The estate tax acts as a huge drag on the retention and expansion of family-owned businesses. It provides a disincentive to savings and stifles the type of capital investment which could lead to higher productivity and more and better jobs.

A tax with a rate as high as 55 percent imposed on death, an event that no one has very much control over, when the family

business may not have the liquidity to pay the tax, is such a frightening thought that families spend an inordinate amount of time and resources planning around estate taxes rather than planning for growth and increased productivity.

The liquidity problem is what distinguishes family-owned businesses from estates of individuals holding marketable securities and other liquid assets. Coupon clippers can easily liquidate their holdings to pay estate taxes, but most family-owned businesses cannot.

Our family is a case in point. My grandfather bought our ranch in the early forties. The growth in southwest Florida has enhanced property values in our area. My father and uncle borrowed a large sum of money to buy my grandfather out over 20 years ago out of fear for the growing estate tax problem in my grandfather's estate. The resulting debt service has been a drain on our operation ever since. Our operation is already being taxed, you see, in a sense, to plan for estate taxes.

With the death of my father a couple of years ago, we are scared to death—or should I say we are scared of death. Our family is now buying life insurance on the lives of my mother and uncle to provide some liquidity to pay estate taxes on their deaths. This is additional money that could have been used to expand our operations that is now going toward estate tax planning. The sad fact is, despite all our planning, we will have to sell a substantial portion of our ranch to pay estate taxes when my mother dies.

The unified credit and section 2032A benefits are not big enough. The operation will not cover the debt service on section 6166's estate tax installment payments. We cannot afford to buy enough life insurance, and we cannot gift it away fast enough.

Furthermore, the buyer from my mother's estate will quickly grow houses, not cattle and oranges. My brother, who now runs our cattle operation, will be out of a job.

This is why my father encouraged me not to get into agriculture but into some service profession, knowing that estate taxes would take away our future in agriculture. This will also be a loss to the environment. Our operation was awarded the NCA's Environmental Stewardship Award for the State of Florida 2 years ago. We love and care for our land the way only long-term owners of land can love it.

The environment in our area would benefit from allowing families like ourselves to continue to own and ranch our land, rather than forcing us to sell it prematurely to develop it to pay estate taxes.

There is a proposal supported by a number of business groups, including the NCA, designed to reduce the estate tax burden on farmers and other businessowners. This proposal, which we hope will be introduced soon, is similar to H.R. 5032, the Family Preservation Act sponsored by Congressmen Brewster, McCrery and others in the 103d Congress.

This would be a strong incentive for successful entrepreneurs, including cattlemen, to keep working and creating jobs rather than selling out to others. It eliminates the estate tax for estates holding 50 percent or more of assets in family-owned businesses.

We urge your serious consideration of these proposals and, in the meantime, consideration of the amendments to existing law we have suggested in our written comments.

Thank you for the opportunity to speak to you.

[The prepared statement follows:]

TESTIMONY OF JIM TURNER
NATIONAL CATTLEMEN'S ASSOCIATION

Mr. Chairman, Mr. Gibbons, members of the House Ways and Means Committee, thank you for your concern about the estate tax impact on farmers, ranchers, and other family-owned businesses. The National Cattlemen's Association appreciates the opportunity to discuss these issues.

I am Vice-Chairman of the Tax and Credit Committee of the National Cattlemen's Association and Chairman of the Estate and Gift Tax Subcommittee. I am a cattlemen and a practicing attorney, concentrating on real estate and tax matters. While my tax background primarily involves real estate, corporate and partnership matters, I have done some estate tax work as well, particularly for families in agriculture. Our family has owned a cattle and citrus enterprise in Sarasota County, Florida, for the past 50 years or so. My father, Latimer H. Turner, who is now deceased, was a past chairman on NCA's Tax and Credit Committee and a past-President of the Florida Cattlemen's Association.

One of the National Cattlemen's Association's top priorities for the coming year is estate tax reform. Indeed, estate taxes have been a priority issue for the NCA for many years. Currently, 80% of beef cattle operations have remained in one family for 25 years or more, with 42% over 50 years, and 12% more than 100 years. Surveys indicate the average age of cattlemen is now 55 years. Those statistics suggest that there are currently a lot of senior family members owning ranches whose families will soon face the burden of federal estate taxation. The number of cattle operations has declined 20% from 1981 to 1993, to the lowest level of the century. The impending burden of federal estate taxes is likely to only accelerate that trend.

We feel the burden of estate taxes has contributed to families selling their family farming and ranching enterprises, resulting in the concentration of these enterprises in fewer and fewer hands. This concentration is contributing to the deterioration of rural America. Therefore, the NCA supports a number of proposals for modification of the federal estate and gift tax laws which would benefit farmers, ranchers, and other family business owners.

I will discuss several changes we support. We urge you to take this historic opportunity provided by the recent elections and fundamentally change estate tax laws as they apply to family businesses.

The NCA applauds your efforts in introducing the Jobs Creation and Wage Enhancement Act of 1995 (H.R. 9) which contains the provision to increase the Unified Estate and Gift Tax Credit to $750,000 and index the amount thereafter. Inflation has eroded the benefit of the current $600,000 Unified Credit Equivalent limit just as the benefit limit on Section 2032A has been eroded over the last several years, as discussed above.

The NCA encourages a re-examination of the entire estate and gift tax structure, and its impact on family owned businesses. There is a proposal supported by a number of business groups, including our organization, designed to reduce the estate tax burden on farmers, ranchers, and other family-owned businesses. This proposal, which we hope will

be introduced soon, is similar to H.R. 5032, the Family Preservation Act, sponsored by Congressmen Brewster, McCrery and others in the 103rd Congress, would eliminate the estate tax liability on family business assets when at least half the value of the estate is a family owned business. It contains several qualifications to prevent abuse. This is a strong incentive for successful entrepreneurs, including cattlemen, to keep working and creating jobs, rather than selling out to others. A June 2, 1994 study of the Tax Foundation concluded that estate tax laws can have roughly the same disincentive effects on entrepreneurial activity as a doubling of income tax rates. Such a burden cannot stand.

If the estates of farmers and ranchers are required to sell their agricultural holdings to pay estate taxes, particularly in our area of southwest Florida, the land will most likely be sold to corporate or foreign agricultural interests or to development interests and the development process will be accelerated. The members of the NCA know their land, they love their land and they have been good stewards. Most of the ranchers in our area want to stay in agriculture. The environment would benefit from leaving these lands as open space and in the hands of the current owners. However, the burden of estate taxes as currently imposed may take this decision away from them.

As mentioned earlier, several of the business groups that the NCA works with have listed estate tax reform as a priority issue, including the Independent Bankers Association of America, the American Farm Bureau Federation, National Small Business United, Small Business Legislative Counsel, the National Federation of Independent Businesses, and many more. The White House Conference on Small Business is currently holding conferences around the country in preparation for the national conference on June 11 through 15, 1995. We will use this forum to discuss and promote estate tax reform for family-owned businesses.

Cattlemen were actively involved in the initial discussions of Section 2032A, *Special Use Valuation*, which allows farmers and ranchers to value their property based on productive values rather than market value for estate tax purposes. We strongly support this very useful estate tax tool and request that the following changes be considered in the 104th Congress.

The maximum amount an estate can be reduced by electing Special Use Valuation pursuant to Section 2032A has been fixed for the past several years at $750,000 (for decedents dying on or after January 1, 1983). Therefore, the benefit of this reduction in estate tax valuation available to farmers and ranchers has been eroded. Congressmen Bill Thomas from California has introduced H.R. 520 to double the 2032A valuation limit from $750,000 to $1,500,000. Congressman Wally Herger from California has introduced H. R. 532, which indexes the $750,000 valuation limit. We applaud their efforts and support both of these bills.

Section 2032A, in addition to Internal Revenue Code Section 6166 (*Installment Payment of Estate Taxes*) both require recapture of the benefits provided by those sections if the farmland is cash-leased after death, even to a relative. We believe that a cash lease to

a relative satisfies the public policy goal of keeping farmland "within the family" after death. Therefore, Sections 2032A and 6166 should both be amended to allow farmland to be cash-leased to a relative after death without requiring a recapture of the benefits under 2032A and 6166. This idea has been endorsed by a number of Representatives and Senators over the years and has been introduced in various forms through several packages of legislation, but has not yet passed. Senator Kassebaum of Kansas and the then-Chairman of the Senate Finance Committee Bentsen of Texas engaged in a colloquy on the record March 13, 1992, suggesting that they would offer such an amendment in the anticipated Technical Corrections Legislation that year and encourage the Department of the Treasury and the Internal Revenue Service to suspend action in this area until Congress had the opportunity to correct this technical problem. However, the Internal Revenue Service and the Treasury have not withdrawn from this issue; they are still litigating it.

On a related matter, Section 6166 (*Installment Payment of Estate Taxes*) is often used in tandem with the special use valuations provisions of Section 2032A. Section 2032A allows property to be considered qualified if it is used and held for use as a farm or other closely-held business by the decedent or a member of his family such that a cash lease by the decedent to his family prior to death would qualify. However, for the purposes of Section 6166, farmland leased on a cash basis prior to death, even to a relative or to an entity owned by the same individuals as own the land, will not qualify as a closely-held business under Section 6166. Therefore, Section 6166 should be amended to conform with Section 2032A.

Furthermore, the Treasury Regulations under 2032A currently require compliance with a lot of detailed filing procedures for a farmer or rancher to be entitled to the benefits of Section 2032A. The regulations allow an estate the opportunity to cure procedural defects only if the original filing substantially complies with the regulations. There has been a lot of litigation over the question of the circumstances under which an executor has "substantially complied." We believe an executor should be allowed to supply any missing information within a reasonable period of time (not to exceed 90 days) after notification by the I.R.S. of a procedural deficiency without regard to the question whether the original filing "substantially complied" with the regulations. The current interpretation of substantial compliance, which is limiting, has resulted in hardship and, we feel, unintended results. A provision clarifying substantial compliance has been contained in Tax Simplification bills introduced by this Committee and the Senate Finance Committee each year for the past several years. We appreciate your support for that legislation, and would urge the "substantial compliance" provision dealing with Section 2032A be reintroduced and passed in the 104th Congress.

Congress needs to retroactively invalidate the effective regulations Section 20.2032A-8(a)(2), which was deemed to be invalid by the court in Estate of Miller v. U.S.A. (U.S. Dist. Ct. for Central Dist. Illinois, March 9, 1988) 88-USTC ¶13,757, thereby making clear that Section 2032A of the Internal Revenue Code does not require a 2032A election as to 25 percent of the estate, but merely requires that 25 percent of the estate

qualify for the election. I am enclosing a memorandum to the NCA's Tax and Credit Committee from me dated November 22, 1991 which further explains this issue.

Another problem with the regulations under 2032A is the requirement that every heir holding an interest in an estate, no matter how small, how contingent, or how remote, must sign the recapture agreement pursuant to the benefits of Section 2032A if the farmland is disposed of within ten years of the date of death of the decedent. There ought to be some provision pursuant to which the holders of small contingent interests, such as that actuarially valued as equal to or less than two percent of the total, do not have to sign the recapture agreement. The federal tax lien created by the Code on the subject farmland would be sufficient to enforce the Treasury's recapture rights under 2032A if the property was sold within the ten-year period.

Another issue that has become relevant in an estate in family-business estate that I am handling has to do with the full payment requirement which is a jurisdictional prerequisites to having a tax controversy heard in our federal district courts. The facts are as follows. A member of a family which owned a closely-held business died and the decedent's closely-held business interest was included in the estate. The estate qualified for Section 6166 installment payment of estate tax and made that election. The I.R.S. audited the estate and challenged the valuation of the closely-held business interests reported in the estate tax return. A deficiency letter was issued and our client was faced with the options of paying the amount of the deficiency and seeking a refund in the federal district court, which requires prepayment of the amount of the deficiency, or petitioning the tax court for review. For a variety of reasons, we would have preferred to go to the federal district court. However, the full payment rule would not only have dictated that our client prepay the full amount of deficiency in order to have jurisdiction to go to the federal district court, but our client would also have had to prepay the amount of taxed the estate admitted were due and owing but which had been deferred pursuant to Section 6166. The burden of borrowing the amount of the deficiency to prepay that amount together with borrowing the amount that had otherwise been legitimately deferred pursuant to Section 6166 was overwhelming, leaving our client no other choice but to go to the tax court. This situation needs to be changed. The full payment rule needs to be modified such that estates do not have to prepay the amount of taxes admittedly owing and deferred under Section 6166 but only have to prepay the amount of the deficiency in order to have jurisdiction to go to the federal district court. This proposal was endorsed by the House of Delegates of the American Bar Association in a vote taken August 12, 1992 (Resolution 101A) after a presentation by the ABA Section of Taxation.

Another issue that has popped up in the same estate in a Section 6166 context is as follows. Interest paid pursuant to a 6166 installment election to pay estate taxes is deductible against the taxable estate as an administration expense. However, the estate has the option to deduct the interest for income tax purposes, rather than deducting it against the value of the taxable estate for estate tax purposes. If it chooses to treat the 6166 interest as deductible for federal income tax purposes, the question arises whether the interest will be deductible or will be nondeductible "personal" interest. Section

163(h)(2)(E), added by the Tax Reform Act of 1986, provided that interest paid under Section 6166 on the deferral of estate tax continues to be deductible and is not considered to be "personal interest" under the general rule of Section 163(h), Internal Revenue Code. However, there is no similar authority providing that the interest paid pursuant to a commercial loan borrowed to pay federal estate taxes is deductible for federal income tax purposes. Interest on monies borrowed to pay federal estate tax purposes should be deductible either from the taxable estate as an administration expense (which is currently the law) or should be deductible for federal income tax purposes and not characterized as "personal" interest, regardless of whether the lender is the government pursuant to Section 6166 or whether the lender is a commercial lending institution. Interest on monies borrowed to pay federal estate taxes attributable to an interest in a closely-held business should not be considered to be "personal" interest, but should be deductible as a business expense, passive interest or investment interest, depending on the nature of the enterprise owned by the decedent.

Once again, I appreciate the opportunity to speak to this Committee. Thank you.

Mr. ENSIGN. Thank you.
Mr. Lange.

STATEMENT OF ROBERT T. LANGE, OPERATOR, WILLISBROOK FARM, MALVERN, PA.

Mr. LANGE. Thank you, Mr. Chairman and members of the committee. I appreciate the opportunity to testify in front of you today.

My name is Robert Lange, and I am a full-time farmer from Malvern, Pa. And Malvern is 24 miles west of Philadelphia, so we are in the southeast corner of the State of Pennsylvania.

Our farm is currently owned by my grandmother, who is 93 years old, and our farm has been in our family since 1896. I am here to testify today about a problem that is facing many farm families such as ourselves in the attempt to pass that farm from one generation down to the next generation, and that is what I perceive as an unintended impact of the Federal estate tax.

Our farm is 226 acres. I farm 100 acres of corn, 100 acres of soybeans, wheat, hay. In addition to that, I grow five acres of pick-your-own strawberries, five acres of pick-your-own pumpkins, vegetables, corn.

The proximity to Philadelphia is a blessing, and it is a curse. It is a blessing in that we have unlimited potential customers who come out to pick my produce. The curse is that, being close to an urban area, our fair market value of our land is astronomical. It is anywhere from 10 to 20 times the average farmland value in Pennsylvania.

Most heirs cannot afford the estate tax bill when the farm is valued in this manner. Even taking full advantage of the limited relief provisions in the tax law, including the unified credit and the deduction for donation of qualified conservation easements, farm families typically do not have the liquid assets to pay the estate tax of as much as 55 percent. Thus, the heirs are forced to sell a large portion of their farm just to pay these estate taxes off.

I believe the problem created by this manner of valuation is a unique problem for farm families. Most closely held businesses are valued for tax purposes under a formula that at least takes into account the receipts generated by the type of business undertaken. In the case of farms, on the other hand, the farm business is valued by looking at what the property could generate if it were used for the purpose other than farming, such as commercial development.

I do not believe that Congress would have intended the estate tax laws to force the sale of family farms in the United States in this manner. The special valuation rules for farmland contained in the Internal Revenue Code, section 2032A, appear intended to prevent this very result. However, the complexity of this section makes it very difficult for most farm families to understand or use. Moreover, the breakup of the family farms to pay estate taxes undermines the goals set forth in the U.S. farm policy—the protection of agriculture resources in the United States.

When I realized this problem back in 1988, I contacted my Congressman at the time, Richard Schulze. Mr. Schulze came out in the fall of 1988 and listened to our family's problem about the estate tax. The following year, he introduced legislation that would

help us and other farm families. This legislation was reintroduced with some modifications in the last Congress by Congressman Payne, and I want to tell you I really appreciate your keeping the issue on the front burner and giving us a shot at this.

This session, I understand Congressman Houghton will introduce and Congressman Payne will cosponsor the bill that we have been working hard on since 1988. And the solution contained in that bill and the one we seek today simply is to exclude from the estate certain farmland protected by a perpetual conservation easement. Such a provision would achieve two different goals: It would save your agricultural resources, and it would give the ability to farm families to withstand an excessive estate tax burden and be able to pass that farm down to the next generation.

In addition, the American Farm Protection Act would provide valuable incentive for voluntary conservation easements on rural lands. Our country is losing over 4 square miles of farmland every day. That is over 1,200 acres—or over 2,400 acres, excuse me. This bill would also provide a tool to conserve the land for agricultural purposes without heavyhanded government regulation and without taking the property off the tax rolls.

Mr. Chairman and members, I am not a lobbyist. I am a farmer that simply wants to continue farming my family farm as long as I can. We have done everything under current legislation, in terms of the estate tax and the gift tax laws, that we can to make that happen. Without this legislation we and other farm families across the country will not be able to hold on to the family farm. I urge this committee to include the provisions of the American Farm Protection Act in any tax legislation you approve.

Thank you.

[The prepared statement follows:]

STATEMENT OF ROBERT T. LANGE, FARMER
MALVERN, PENNSYLVANIA
BEFORE THE COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
WEDNESDAY, FEBRUARY 1, 1995

My name is Robert Lange. I am a full-time farmer from just outside Malvern, Pennsylvania, 24 miles west of Philadelphia in Chester County, Pennsylvania. My grandmother, who is 93, currently owns our farm, which has been in our family since 1896. I am here to testify today about a problem that many farm families are facing as the older generation attempts to pass the family farm on to the younger generation who want to continue to farm it, and that is the perverse and I believe unintended impact of the federal estate tax.

Our farm is 226 acres. It is an active, working farm. We grow everything from corn to strawberries and pumpkins. Our proximity to Philadelphia is both a blessing and a curse. Because we sell much of our produce to customers that "pick their own" fruits and vegetables, we need to be relatively close to major population areas. However, our location near an urban area means that the fair market value of our farmland is anywhere from 10 to 20 times higher than typical farmland in Pennsylvania.[1] This is because the fair market value means the value of the land when developed for residential or commercial purposes, not the value at its current farm use. This is crucial because when the owner of the farm dies, the federal estate tax law requires that the fair market value of the farm, that is, its value as developed land rather than farmland, be included in the owner's estate.

Most heirs cannot afford the estate tax bill when the farm is valued in this manner. Even taking full advantage of the limited relief provisions in the tax law, including the unified credit and the deduction for the donation of qualified conservation easements, farm families typically do not have the liquid assets to pay an estate tax of as much as 55 percent of the estate's value. Thus, the heirs are forced to sell some or large portions of the farm just to pay off the federal estate tax. Sale of even a portion of the farm may make the remainder uneconomical as a farming unit.

I believe the problem created by this manner of valuation is a unique problem for farm families. Most closely-held businesses are valued for tax purposes under a formula that at least takes into account the receipts generated by the type of business undertaken. In the case of farms, on the other hand, the farm business is valued by looking at what the property could generate if it were used for a purpose other than farming, such as commercial development.

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[1] Typical farmland in Pennsylvania is valued somewhere between $2000 and $4000 per acre. Farmland close to an urban area, such as mine, is valued between $20,000 and $40,000 per acre.

I do not believe that Congress could have intended the estate tax laws to force the sale of family farms in the United States in this manner. To force the break-up of family farms to pay estate taxes is inconsistent with other relief provisions in the tax laws which attempt to protect family farms. The special valuation rules for farmland contained in Internal Revenue Code section 2032A appear intended to prevent this very result. However, the complexity of the section makes it very difficult for most farm families to understand or use.[2] Moreover, the breakup of family farms to pay estate taxes undermines the goal set forth in U.S. farm policy, the protection of agricultural resources in the United States.

When I realized the difficulties the estate tax laws would create in my own situation, I brought this problem to the attention of my own Congressman at the time, Richard Schulze. He came out to the farm and listened to our problem. The following year he introduced legislation to address our problem and that of other farm families. This legislation was reintroduced with some modifications as H.R.2031 last Congress by Congressman Payne. The solution contained in that bill and the one we seek today is simply to exclude from the estate certain farmland protected by a perpetual easement. Such a provision would achieve the dual goals of protecting the agricultural resources of this country and easing the inequitable tax burden of families who seek to continue farming.

In addition, the American Farm Protection Act would provide a valuable incentive for voluntary conservation of rural land. Our country is losing over 4 square miles of farmland daily to development. This bill would provide a tool to conserve this land for agricultural and other compatible purposes without heavy-handed government regulation, and without taking the property off the local tax rolls.

Mr. Chairman and Members of this Committee, I am not a lobbyist. I am a farmer who wants to go on farming my family's property for as long as I can. My family and I have done everything we can under present estate and gift tax laws to reduce the potential estate tax to a level that will enable us to retain our family farm when the time comes. Even an increase in the unified credit, which I support, as proposed in the Republican Contract, is not enough. Without this legislation, we and other farm families across the country, will not be able to hold on to the family's farm. I urge this Committee to include the provisions of the American Farm Protection Act in any tax legislation you approve.

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[2] Unfortunately, these special rules have not been greatly utilized by farm families primarily because of their complexity, but also because of the cap on the amount by which the value of the estate can be reduced. See, Report of the Comptroller General, Special Estate Tax Provisions for Farmers Should Be Simplified to Achieve Fair Distribution of Benefits, September 30, 1981, PAD-81-68.

Mr. ENSIGN. Thank you, Mr. Lange.
Mr. Thigpen.

STATEMENT OF CHESTER A. THIGPEN, CERTIFIED TREE FARMER, MONTROSE, MISS., ON BEHALF OF THE AMERICAN TREE FARM SYSTEM

Mr. THIGPEN. My name is Chester Thigpen. My wife, Rosett, and I are tree farmers from Montrose, Miss. Mr. Chairman, I appreciate the opportunity to appear before this committee. I have submitted a written statement, and I would like to summarize it for you now.

The issue you are debating is very important to the Nation's 7 million productive landowners. Research tells us that perhaps half of those folks are 62 years old or older, so it should come as no surprise to the committee that when tree farmers get together one of the things we discuss is estate taxes. Estate taxes matter not just to lawyers, doctors and businessmen but to people like Rosett and me.

We were both born on this land that is now a part of our tree farm. I can remember plowing behind a mule for my uncle who owned it before me. My dream then was to own land one day. I bought a small bit in 1940 and inherited some from my family estate in 1946 and then bought some more. Back when I started, the estate tax applied to only 1 estate in 60. Today it applies to 1 in 20, including mine.

Mr. Chairman, you have heard many witnesses talk about the details of estate tax reform. They know more about it than I do, but I know what estate tax reform would mean in places like Montrose, Miss., and to the tree farms like Rosett and I own.

We first got started in forestry in 1960. Much of our land was old cotton and row crop fields, so early on I spent 90 percent of my time trying to keep it from washing away. We have developed a management plan and started growing trees. Today, we manage our property for timber, wildlife habitat, water quality and recreation. We have built ponds for erosion control and for wildlife. Deer and turkey have come.

It took us half a century, but Rosett and I have managed to turn our land into a working tree farm that has been a source of pride and income for my entire family. Our tree farm made it possible to put our five children through college. It made it possible for Rosett and me to share our love of the outdoors and our commitment to good forestry with our neighbors. We want to leave the land in better condition than when we found it here and first started working with it. And we will.

We also want to leave the tree farm in our family. Right now, people tell me that my tree farm could be worth more than $0.5 million—more than $1 million. All that value is tied up in land or trees. We are not rich people. My son and I almost do all the work on this land ourselves. So, under current law, my children might have to break up the tree farm or sell off timber to pay the estate taxes.

I hope the committee will consider a proposal, according to the National Family Enterprise Preservation Act, which would totally exempt over 98 percent of all family enterprises, not just tree

farms, from the Federal estate tax. A copy is attached to my written testimony.

Giving up the tree farm we worked 50 years to create would hurt me and my family. If the tree farm had to be sold or the timber cut before it is time, what would happen to the erosion control program we put in place or the wildlife habitat? Who would make certain that the land stayed open for our neighbors to visit and enjoy? I know my children would.

I mentioned earlier that most of the 7 million landowners in this country are close to retirement age or, like me, way past it. Without estate tax reform, many of their properties will be broken up into smaller tracts or harvested prematurely. Some may no longer be economical to operate as tree farms and will perhaps be converted to other uses or back into marginal agriculture. Other properties may become too small or generate too little cash flow to support the kind of multiple use management we practice on our property.

Healthy, growing forests with abundant wildlife provides benefits to everybody. Without estate tax reform, it will become harder and harder for people like me to remain excellent stewards of our family-owned forests.

Mr. Chairman, a few months ago Rosett and I were named Mississippi's Outstanding Tree Farmers of the Year. It was a great honor to be selected from among the thousands of excellent tree farmers in Mississippi. I am told one reason we were recognized was because Rosett and I have been speaking out on behalf of good forestry for almost four decades. That is why I made this trip to Washington, to remind the committee that estate tax reform is important to preserve family enterprises like ours. Landowners feel the same way about their own tree farms.

We applaud estate tax reform that will make this possible. And thank you.

[The prepared statement and attachment follow:]

STATEMENT OF MR. CHESTER THIGPEN

MONTROSE, MISSISSIPPI

BEFORE THE

COMMITTEE ON WAYS AND MEANS

UNITED STATES HOUSE OF REPRESENTATIVES

FEBRUARY 1, 1995

My name is Chester Thigpen. My wife Rosett and I are Tree Farmers from Montrose, Mississippi.

Mr. Chairman, I appreciate the opportunity to appear before this Committee. You are debating an issue that is very important to more than 7 million people who own most of the nation's productive timberland. Most of us have been at it for a long time. Professor Larry Doolittle of Mississippi State University published a paper in 1992 that suggested half the Tree Farmers in the Mid-South were 62 years old or over. This pattern holds true in other parts of the country as well. So it should come as no surprise to the Committee that, when Tree Farmers gather, one of the things we discuss is estate taxes.

Estate taxes matter not just to lawyers, doctors and businessmen, but to people like Rosett and me. We were both born on land that is now part of our Tree Farm. I can remember plowing behind a mule for my uncle who owned it before me. My dream then was to own land. I bought a little bit in 1940 and inherited some from my family's estate in 1946, and then bought some more. Back when I started, the estate tax applied to only one estate in 60. Today it applies to one in 20 -- including mine. I wonder if I would be able to achieve my dream if I were starting out today.

Mr. Chairman, you have heard many witnesses talk about the technical details of estate tax reform. They know far more about it than I do. With your permission, I'd like to take a few minutes to talk about what I do know: what estate tax reform will mean in places like Montrose, Mississippi and to Tree Farmers like me and Rosette.

We first got started in forestry in 1960. Much of our land was old cotton and row crop fields, so early on I spent 90 percent of my time trying to keep it from washing away. We developed a management plan and started growing trees. Today, we manage our property for timber, wildlife habitat, water quality and recreation. We have built ponds for erosion control and for wildlife. Deer and turkey have come back, so we invite our neighbors to hunt on our land.

It took us half a century, but Rosett and I have managed to turn our land into a working Tree Farm that has been a source of pride and income for my entire family.

Our Tree Farm made it possible to put our five children through college. It made it possible for Rosette and me to share our love of the outdoors and our commitment to good forestry with our neighbors. And finally, it made it possible for us to leave a legacy that makes me very proud: beautiful forests and ponds that can live on for many, many years after my wife and I pass on. We wanted to leave the land in better condition than when we first started working it. And we will.

We also want to leave the Tree Farm in our family. But no matter how hard I work, that depends on you.

Right now, people tell me my Tree Farm could be worth more than a million dollars. All that value is tied up in land or trees. We're not rich people. My son and I do almost all the work on our land ourselves. So, under current law, my children might have to break up the Tree Farm or sell off timber to pay the estate taxes. I am here today to endorse a proposal called the National Family Enterprise Preservation Act which would totally exempt over 98 percent of all family enterprises, not just Tree Farms, from the Federal estate tax. A copy is attached to my written testimony.

Giving up the Tree Farm we worked fifty years to create would hurt me and my family. I don't think it would be good for the public either. If the Tree Farm had to be sold or the timber cut before its time, what would happen to the erosion control programs we put in place, or the wildlife habitat? Who would make certain that the lands stayed open for our neighbors to visit and enjoy? I know my children would. And I hope their children will have an opportunity after them.

I think too often people focus on just the costs of estate tax reform and not the benefits. In forestry, the benefits will be substantial. I mentioned earlier that most of the 7 million landowners in this country are close to retirement age or, like me, way past it. Without estate tax reform, many of their properties will be broken up into smaller tracts or harvested prematurely. Some may no longer be economical to operate as Tree Farms and will perhaps be converted to other uses or back into marginal agriculture. Other properties may become too small or generate too little cash flow to support the kind of multiple use management we practice on our property. Healthy, growing forests with abundant wildlife provide benefits to everybody. Without estate tax reform, it will become harder and harder for people like me to remain excellent stewards of our family-owned forests.

Mr. Chairman, a few months ago, Rosett and I were named Mississippi's Outstanding Tree Farmers of the Year. It was a great honor to be selected from among the thousands of excellent Tree Farmers in Mississippi. I'm told one reason we were recognized was because Rosett and I have been speaking out on behalf of good forestry for almost four decades.

That's why I made this trip to Washington: to remind the Committee that estate tax reform is important to preserve family enterprises like ours. It is also important for good forestry. We just planted some trees on our property a few months ago. I hope my grandchildren and great-grandchildren will be able to watch those trees grow on the Thigpen Tree Farm -- and I know millions of forest landowners feel the same way about their own Tree Farms. We applaud estate tax reforms that will make this possible.

Thank you.

THE NATIONAL FAMILY ENTERPRISE PRESERVATION ACT OF 1995

Something has to be done about laws that force inheritors of a family farm or business to sell that enterprise in order to pay estate taxes on it. A family farm or business is not only an extremely productive component of our economy, it also provides a quality of life which millions of Americans cherish.

Forty or fifty years ago productive agricultural land could be purchased for less than $100 per acre. Today, the national average price per acre is over $750. Inflation has made estate taxes a major burden on family farms and businesses. Independent companies are being forced to merge into large corporations because marketable stock can be acquired tax free and many estate tax problems associated with a family farm or business can be avoided.

In 1942, the estate tax applied to only one estate out of 60. Today, this number has increased to one out of 20, significantly broadening the application of the law. The sad fact is that inflation has pushed family farms and businesses that were too small to pay estate taxes into extremely high tax brackets. The result has been that heirs of these enterprises have been forced out of business because they must pay stiff Federal estate taxes.

Inflation and the increase of economic concentration through conglomerate mergers has seriously imperiled the maintenance of family farms and businesses of all kinds. Our existing tax structure has the effect of subsidizing the growth of big business usually at the expense of small and independent enterprise. What we are witnessing today is a major threat to the very survival of our free and independent enterprise system.

Family owned farms and businesses are an integral and vital component of our economy and society. As a source of entrepreneurial spirit, family owned farms and small businesses must be preserved and protected. These enterprises give the family a personal sense of freedom, accomplishment, and pride in ownership. The perpetuation of the family business in America is of significant importance to the survival of free enterprise that is the foundation of our economy.

We therefore propose to introduce the National Family Enteprise Preservation Act of 1995 (the "NFEP"). This measure will provide estate tax relief to more than 95 percent of our Nation's family owned farms and businesses, allowing them to continue their many contributions to the economy, creating more jobs, advancing technology and innovation, and increasing our productivity. The proposal also recognizes the importance of children and other heirs who work in a family enterprise.

THE NFEP

1. Increase In the Unified Estate and Gift Tax Credit

The current unified credit of $192,800 would be increased to $314,600 in the case of family enterprise property. This would be an increase from $600,000 to $1 million in the amount of property that may pass free of Federal estate and gift taxes.

2. Increase In the Annual Gift Tax Exclusion

The current annual gift tax exclusion of $10,000 would be increased to $20,000 in the case of gifts to qualified family members of family enterprise property. Qualified family members are individuals who are members of the same family within the meaning of section 2032A (e)(2) of the Internal Revenue Code.

3. Special Use Valuation Changes

Currently, special use valuation cannot reduce the gross estate by more than $750,000. This amount would be increased to $1 million.

4. Family Enterprise Interest

The value of the gross estate shall be reduced by 5% for each taxable year in which a qualified family member participates in the active management of the family farm or business following the decedent's death. The estate will be credited with the maximum deduction at the time of the decedent's death. The qualified family member must continue in the active management of the family farm or business for 10 years following the decedent's death, otherwise appropriate recapture provisions would apply. The term active management means the making of the management decisions of a business other than the daily operating decisions. In no event shall the value of the decedent's gross estate be reduced by more than the lesser of 50% or $1 million by reason of family enterprise interests.

Mr. ENSIGN. Thank you, Mr. Thigpen.
Mr. True.

STATEMENT OF DIEMER TRUE, PARTNER AND SHAREHOLDER, TRUE OIL AND AFFILIATED COS., CASPER, WYO., ON BEHALF OF THE U.S. BUSINESS AND INDUSTRIAL COUNCIL

Mr. TRUE. Thank you, Mr. Chairman. What a privilege it is to be here today on behalf of the U.S. Business and Industrial Council and our company, the True Enterprises.

I am Diemer True. I am from Casper, Wyo. I am in business with my two brothers. We operate an oil and gas business principally, but we also operate a regional pipeline company, a regional trucking company and have a cow-calf operation and two small feedlots.

The essential part of the description of my family's businesses is they are all asset-based operations and the businesses were started in 1948 by our father, H.A. "Dave" True, and basically down through the years we have reinvested every dollar of income back into the businesses.

I am sort of an example of what can go right with estate planning and family businesses and also what is wrong with the current situation. Dad passed away in June 1994, and because of planning that he and mother started over 40 years ago, because of some buy-sell agreements that have been grandfathered in the law, my two brothers and I were able to buy the businesses in accordance with those buy-sell agreements.

This is not an academic endeavor from my standpoint, granted that half of the work force in America today is employed by small family businesses and two-thirds of all of the new jobs come from small family businesses. But the problem that I represent is we don't know where to go with the third generation.

The three problems with the current estate tax law as we see it is the extremely high and the steeply graduated tax where, in an asset-based family business, there is not the liquidity to pay that tax, as other witnesses have identified.

The other thing, the other problem is the cumulative effect. In other words, every 20 to 30 years, as another generation is faced with paying 55 percent of the family business to the Federal Government, then the business has to retract 55 percent, and we have another 20 years or another generation of trying to rebuild the business.

Finally, the fatal flaw in the estate tax in my opinion is its complexity. I listened with interest to two earlier witnesses, one an attorney and one a CPA, and they said it was complicated but don't let the complication bother you. As a businessowner, let me tell you, it is a fatal flaw, because we cannot plan. We simply cannot say to our 773 employees what the business will look like 20 years from now when my brothers and I retire.

The options that I am suggesting are options. They ought not to be considered in a package, but ought to be looked at individually, and I would hope that the committee would be aggressive and bold as they look at the estate tax.

First of all, I think any option that you look at ought to be considered in the light of simplification. Let us know what the rules are and then we can play the game.

Second, I would hope the committee, and I think this arguably is revenue-neutral, ought to consider reauthorizing in the statutes intergenerational buy-sell agreements, such as the ones that my brothers and I are the beneficiaries of, if you will, in being able to buy mother and dad out of the business.

In 1984 my sister withdrew from the business, and at that time, rather than it being an acrimonious circumstance, we knew ahead of time not only what we were going to pay her for her share of the business, but she knew what she would receive for her share of the business.

I really do applaud the increase in the unified credit that is embodied in the Contract With America. That is a great step forward, and I hope that will be considered and adopted.

There are a number of other countries which have low estate taxes—Ireland, for example, has only a 2 percent estate tax; Australia, none. Sir John Templeton, you know, has actually renounced his citizenship and moved to the Bahamas because of the estate tax.

I think we ought to seriously consider reducing in its entirety the estate tax to zero or to a very low flat rate.

Mr. Chairman, I am most grateful for the opportunity to be here and to present these options.

[The prepared statement follows:]

Testimony of
Diemer True
Partner and Shareholder
True Oil and Affiliated Companies
on Behalf of the United States Business and Industrial Council

on
Estate Tax Reform and Small Business

Mr. Chairman and members of the Committee, I am Diemer True, a partner and shareholder in True Oil Company and its affiliated companies in Casper, Wyoming. The True Companies is a group of family-owned businesses, most of them partnerships of S corporations, headquartered in Casper.

The companies were started by my father, H. A. "Dave" True, Jr., in 1948. The True Companies have principally been involved in oil and gas exploration and development and have expanded its operation regional pipelines, a regional trucking company, a local bank, and an agricultural business, including a cow-calf operation, two small feedlots, and a farm. The companies now employ 773 hard working Americans in the Rocky Mountain states.

In June, 1994, my father passed away. My two brothers and I purchased the bulk of the businesses from his trust and our mother. The purchase was made possible by the planning done by my parents, beginning forty years ago, principally using but-sell agreements. We, three brothers, manage the businesses.

I am here on behalf of the True Companies and the United States Business and Industrial Council. We appreciate this opportunity to offer our comments on various aspects of the federal estate tax, including proposals for change, from the perspective of a second-generation owner of a family business.

Introduction

The federal estate tax laws are a disaster for closely-held businesses. We believe the estate tax is the single greatest impediment to keeping family businesses functioning as such from one generation to another. The sad truth is that in the United States, the founder of a family business spends thirty or forty years building the business, but faces almost insurmountable barriers to passing it on to his or her children. Most founders must choose between selling the business to outsiders or leaving a life's work to almost certain dismemberment at the hands of the estate tax.

Today's world markets demand that American businesses be creative, productive and flexible. It is too much to ask that closely-held American businesses at the same time fight destruction by a confiscatory estate tax.

The small business firm, whether defined in terms of capitalization or number of employees, is the bedrock of the American free-enterprise economy. Small businesses – which are family-owned for the most part – comprise 99 percent of the private sector, with the large "Fortune 500" companies comprising the remaining 1 percent. Most of the "Fortune 500" companies are multi-national economic empires that also operate in many foreign countries. Much of their activity is outside the American economy. In terms of employees, about one-half of all American workers are employed by small businesses. Small business has been creating about two-thirds of all new American jobs. My comments are not intended to be critical of the

"Fortune 500" companies, only to demonstrate that domestic economic vitality and job creation comes largely from the small business entrepreneurial spirit and that the current estate tax law is counterproductive to small closely-held businesses.

A tax that disproportionately and severely affects family businesses is therefore a threat to American competitiveness and job growth. The existing estate tax structure needlessly penalizes the most important part of the private sector – small business. I am here because the True Companies and the United States Business and Industrial Council hope the new Congress will be looking for ways to sustain the economic viability of this sector of the American economy, and that Congress should specifically look at changing the Federal estate tax.

The Problem of Complexity

One of the principal problems with the estate tax is its complexity. Like the federal income tax, the estate tax has become increasingly complex since the present scheme was adopted in 1932. This increasing complexity has touched every aspect of the tax, but perhaps none so extensively as what property is to be included in that estate for tax purposes and how that property is valued.

Property owned at death is obviously subject to the estate tax. Property need not be owned solely or outright to be included in some way in the gross estate. A large body of law, both statutory and case law, has emerged on the composition of the "gross estate." The gross estate may include, among other items:

- property transferred within three years of death;
- property transferred with retained rights of enjoyment;
- transfers that are in some way revocable;
- property over which the decedent has a general power of appointment;
- jointly-owned property; and
- life insurance policies with respect to which the decedents retain some incidents of ownership.

Valuation of the property in the gross estate is as critical to a determination of liability as a determination of what property is includable in the gross estate. Although property is generally valued at fair market value as of the date of death, the precise method of valuation is generally left to statutes, the judicial decision and administrative regulations and rulings. The lack of statutory rules and the infinite variety of property frequently make valuation the most difficult aspect of determining the estate tax.

Valuation is almost always at issue for interests in closely-held businesses, and under current law constitutes one of the greatest problems under the estate tax. Publicaly-held comparable businesses are usually very difficult, often impossible, to find. Valuing the stock or a partnership interest almost always becomes a matter for extremely expensive litigation requiring the testimony of highly-paid valuation experts – "hired guns." The Internal Revenue Service has typically taken an aggressive position on these valuation issues, as its $600 million loss in the Estate of Newhouse case demonstrates.

The lack of a market for interests in closely-held businesses is sometimes anticipated by the use of a buy-sell agreement. Buy-sell provisions mandate the sale, or offer of sale, of a business interest to another owner of the business at a stated price or at a price determined according to a specified method. In the past, such agreements typically attempted to both create a market

for interests in the business and, perhaps more importantly, provide a method for valuing the business interest for estate purposes using some easily applied formula, such as book value.

A body of law emerged from the courts and the Internal Revenue Service as to when a buy-sell agreement would be respected for purposes of valuation. A buy-sell agreement typically established valuation if the agreement applied to both lifetime and time of death transfers; mandated the sale of the business interest by the estate of a deceased business owner; was supported by bone fide business purposes; and prescribed an ascertainable sale price or methodology for determining price.

My father saw the need for book value buy-sell agreements forty years ago. Such provisions were included in the family's first partnership agreements. When my sister withdrew from the family businesses in 1984, they provided a certain means of computing the sale price of her business interests, which the remaining family members purchased. When my father passed away last year, the buy-sell agreements again provided a method by which his interests could be valued in the sales to other family members. We hope the long history of using book value buy-sell agreements in my family's businesses will help us avoid a challenge to their validity from the Internal Revenue Service.

Most other family businesses do not have this option. The case law allowing book value buy-sell agreements was essentially repealed with the adoption in 1987 of the so-called estate freeze valuation rules in the Internal Revenue Code Section 2036(c). My family's agreements were grandfathered and therefore remain valid. Although Section 2036(c) generated a storm of controversy and was retroactively repealed by the Omnibus Reconciliation Act of 1990, a new chapter was added to the Code covering various valuation issues. The new provisions, although much more detailed and less ambiguous than Section 2036(c), have added an entire new set of complexities to the existing valuation problem. The effect of the new provisions on closely-held businesses is essentially to abandon such businesses to expert witnesses and trial lawyers to litigate the issues of fair market value in the tax courts. The high cost of litigation is an additional financial burden which compounds the difficulty of keeping small businesses intact.

As you may be aware, the Internal Revenue Code also provided for an optional method of valuing limited amount of so-called "qualified property" – generally real property used before and after death for farming purposes or in a closely-held business. Qualified property may be valued according to its actual use, not its highest and best use. While not disparaging the usefulness of this optional valuation method to certain taxpayers, the statute is highly technical and limited in scope. The case law is replete with situations of taxpayers who ran afoul of ambiguities and technicalities in the statute and who paid dearly.

As the experience with this special valuation method demonstrates, the complexities of the estate tax for closely-held businesses are not solved by adding new provisions to the Internal Revenue Code.

The Estate Tax's Confiscatory Rates

In addition to the tax's complexity, closely-held business suffers at the hands of the estate tax's rates. Those rates are both confiscatory and steeply graduated.

The rates begin at 18 percent but reach 41 percent at $1 million; 49 percent at $2 million; and the maximum rate of 55 percent at $3 million. Borrowing a concept employed by the income tax, a 5 percent surtax is imposed that effectively phases out the graduated rates and the unified credit on larger estates.

Because the rates hit confiscatory levels at such a low threshold, the estates of many closely-held business interest owners are subject to the maximum rate.

The Unified Credit

Those not familiar with family businesses might believe that the unified credit avoids these complexities, including valuation problems, as well as the confiscatory rates, for a significant number of business owners. The so-called "unified credit" is a credit equivalent to the tax on a taxable estate of $600,000 for decedents dying after 1986. The unified credit is applied first to lifetime taxable gifts, thus first eliminating any gift tax, with any remaining credit available for transfers at death. The credit has not been adjusted since 1986.

One reason the federal estate tax is such a disaster for closely-held agricultural operations and businesses is that the unified credit amount protects only the smallest of such businesses. Most are exposed to the full effects of the tax. Increasing the credit from $600,000 to $750,000 and indexing it, as proposed in the "Job Creation and Wage Enhancement Act" (H.R. 9), will restore the credit to prior levels in real terms and is a needed first step.

The Effects of the Estate Tax on Closely-Held Businesses

The effects of the tax on the owner of closely-held business are profound. Our family has had to address those effects in order to keep our businesses functioning. From my family's perspective, let me describe how the tax has affected us.

The federal estate tax is hurting family-owned business in two ways. First, its steeply graduated and high marginal rates generate a large tax liability relative to the value of the business. Our businesses, like most family businesses, were built by reinvesting profits. We could not have done it while carrying a debt load. The vast majority of sole proprietorships or other family businesses are therefore not liquid enough to pay a significant amount of tax. Such businesses also many have difficult borrowing the funds. Although life insurance is sometimes available to fund the estate tax liability, the premiums themselves are a significant diversion of necessary cash. Furthermore, as a matter of tax policy, we do not believe that a family business should have to divert cash into passive investments and away from job-creating assets in anticipation of the estate tax.
I am aware that the Internal Revenue Code allows a deferral of payment of the portion of the estate tax attributable to the value of active business assets in a closely-held business, if the value exceeds 35 percent of the value of the estate. If an estate qualifies under this limited provision, the tax may be deferred for five years, after which it may be paid in ten annual installments. This deferral, however, may not save the business, but result only in its slow strangulation.

Thus the founder of a business who wishes that business to survive his death (and what founder doesn't), may be forced to decide between two options. One is selling all or part of the business to an outsider, instead of bringing in his own family. The other is passing the business to his own family members, gambling that the business will survive the crushing debt of the estate tax. Without our grandfathered book value buy-sell agreements, my father would have had to make this choice.

The second damaging effect of the estate tax on our businesses will be its cumulative effect. The estate, gift and generation-skipping tax systems are integrated to ensure that, as much as

possible, the transfer of property is taxed in every generation – typically every twenty years or so. Absent a sale to a group of outsiders, the practical result of the estate tax's cumulative effect – viewed most optimistically – will be an ongoing cycle of business contractions between attempts to restore the businesses to their previous vigor. How is a business to compete in the world economy and offer stable jobs under those conditions?

Let me comment here about a proposal that surfaces occasionally that affects the federal income tax. The current estate tax allows a step-up in tax basis for assets included in an estate. That means that the tax basis is automatically increased from the decedent's tax basis to the date-of-death value. On occasion it has been proposed that the step-up rule be repealed and that a decedent's basis be carried over to his survivors. This change could add a significant income tax burden to the estate tax burden, overwhelming businesses already under siege.

What Congress Should Consider

The Federal estate tax is overwhelming in its complexity, is confiscatory, and in the long term, is counterproductive to economic growth and job creation. If family businesses are to survive as such and continue to generate more jobs and economic growth, Congress needs to take action now to stop the tax's effects on closely-held businesses. Among the options:

- Simplify the estate tax. As Congress examines various proposals for change, simplifications should be among your goals.

- Repeal restrictions on the use of buy-sell agreements and similar devices that attempt to make more certain the value of a closely-held business for both business and estate tax purposes. Establishing a market and a methodology for valuing business interests is critical for both lifetime and at-death transfers of closely-held business interests. Previous law on the validity of buy-sell agreements should be restored, both for business reasons and for relief from the estate tax. This option is not included in H.R. 9 or the proposal of the National Federation of Independent Business (NFIB).

- Eliminate the estate tax on certain business assets, including ownership interests in closely-held farms and business, in which the decedents actively participate. If ownership interests in one or more qualified family-owned business constitute 50% or more of the value of the gross estate and are conveyed to qualified heirs, then these interests should be excluded from the decedent's estate. A qualified family-owned business should include the broadest range of business entities possible, regardless of legal structure. The proposal of the NFIB includes a change along these lines.

- Significantly increase and index the amount of the unified credit so that it effectively protects an interest in the small or medium-sized family business. Indexing the credit or restoring it to its prior real level, while helpful, are insufficient to provide significant relief. An even greater increase would be more appropriate.

  The Job Creation and Wage Enhancement Act (H.R. 9) would raise the estate tax exemption from $600,000 to $750,000, and index the exemption to inflation. The U.S. Business and Industrial Council strongly supports this proposal. This is a very needed first step, but the USBIC proposes further that the value of family or closely-held

business, farm and ranch assets in an estate be exempted altogether from estate taxes.

- Reduce the rates on qualified family-owned businesses that continue to be owned and actively managed by a family member. An alternative to an exemption is a special reduced estate tax rate for family business interests and business assets held by sole proprietors. A recapture provision could require that business interests be held for a period after the death of the decedent, and that the heirs materially participate for that period, in order for business interests to continue to qualify. This option is not included in H.R. 9 or the proposal of the NFIB.

- Apply a flat estate tax rate to interests in closely-held businesses. Instead of the steeply-graduated and confiscatory rates under the current tax, a single low rate could apply to business interests and business assets. This option is not included in H.R. 9 or the proposal of the NFIB.

- Expand the applicability of the deferred payment provisions, including the four percent interest on deferred taxes. These provisions are extremely limited under current law, both in terms of qualifying and the portion of tax to which they apply. The deferred payment provisions should be made more helpful to family businesses and the four percent interest provision should be applicable to all the tax attributable to qualifying business interests. The proposal of the NFIB includes such a proposal.

Conclusion

The federal estate tax is a matter of extreme importance to family businesses in this country. In markets that are now world-wide, the pressures on businesses of competition and providing stable jobs are enormous. The added pressures on family businesses of surviving the federal estate tax are too much more to bear. With small family businesses being such a significant sector of the American economy and providing so many of the new jobs being created, this is a critical issue for the new Congress. If businesses like my family's are to continue in the hands of my children and grandchildren, my nieces and nephews, and in our community, small businesses need relief from this tax.

On behalf of the U.S. Busiiness and Industrial Council, my family and companies, I wish to thank the Committee for the opportunity to present these comments.

Mr. ENSIGN [presiding]. I want to thank the entire panel for their testimony.

Mr. Herger.

Mr. HERGER. Thank you very much, Mr. Chairman.

I want to thank each of our members of our panel. I have a question for you, Mr. Turner.

My background is one of coming from a rural area. I am from a ranching background myself, small business background; I can relate to what you are saying.

Mr. True, it is interesting that one of the stated purposes ironically of this estate tax from those who support it is to break up, purposely—to do just what we are hearing that they are trying to do with your family, Mr. True—is to break up family holdings, even though only 1 percent of the total Federal revenues come from this tax.

I would like to ask a question of you, Mr. Turner. If you could tell me, from your experience, when the Federal estate taxes force a cattle rancher to sell either part or all of his ranch, does the sale really break up the assets, and are those assets then passed down to the "little fellow" to give them a chance? What is your experience in this?

Mr. TURNER. My experience is not just in agriculture, Congressman, but in family-owned businesses generally, that there isn't enough capital out there among other little guys to go purchase these assets from estates to generate the kind of splitups that was perhaps intended when the estate tax was implemented. The only ones with the capital sufficient to do that are large publicly owned corporations or the like, that step in, buy the assets from the families in these estates, generating more concentration rather than less concentration. The census statistics from the Department of Agriculture bear this out.

We feel that estate taxes are one of perhaps several reasons that are causing the number of operations in this country, at least in the cattle business, to substantially decline. The graph is dramatic from 1965. It has just fallen off the table. And we think the estate taxes have been counterproductive indeed, to whatever goal may have initially been there to split up operations, to diffuse concentrations of wealth.

[At the time of printing, the graph had not been received.]

Mr. HERGER. Well, then just a followup question. What are the options then that the rancher would have once the Federal Government "becomes a co-owner of his upon the death of a family member"?

Mr. TURNER. Unfortunately, Congressman, I think the options are limited. You, of course, have the sale options, which is bad for the country, bad for local economies, bad for rural America. You have the debt option. Go to your Federal land bank, go to the section 6166 provision of the code, allow Uncle Sam to be your banker, pay the estate tax off in installments.

But whether you borrow the money to pay estate taxes commercially or avail yourself of section 6166, the estate tax rates are so high that the debt service burden on family ranchers and successive generations is so bad that there is just a slow strangulation of the business. If they can afford to carry the debt for a couple of

years, well, maybe they can do that. But eventually, it just chokes off the incentive of that next generation to continue in the enterprise.

Mr. HERGER. Thank you.

Again, my experience being in an agricultural area, it is not unusual at all to have families that have been working a ranch or a farm for three, four, maybe even five generations, and it becomes progressively more difficult, as you pointed out, Mr. True, to be able to keep that family, and really, we are talking about someone again who grew up on a ranch, really a way of life. The amount of profit is such a small one; you are working on very small, limited returns to begin with, and it just makes it that much more difficult.

Mr. Thigpen, I thank you for your comments. We have so many different examples, not just in ranching, but so many small family enterprises out there that are trying to make the American dream work for themselves and for their children, it is really a tragedy what we see happening. Again, I thank you for your comments and your testimony.

Thank you, Mr. Chairman.

Mr. CRANE [presiding]. Mr. Cardin.

Mr. CARDIN. Thank you, Mr. Chairman, and I appreciate the testimony of all of the witnesses. It seems that, if I understand your testimony correctly, although the increase of the exemption level from $600,000 to $750,000 will have a positive impact, there is a lot more that we need to do in order to be able to preserve family businesses. I see from the nods that there is general agreement from the panel.

I am intrigued about the buyout contracts and why you were able to do it in your circumstance, but no longer would we be able to have those types of arrangements. My family has a family business. We are now in the third or fourth generation and we had severe problems to get to that point. In fact, most families are no longer in the business, but it was not an easy way to work it out, and the tax laws played a part, among other considerations.

So I am curious as to what we can do as far as the potential for buyout arrangements among families that you would recommend as a way of improving the chances of family businesses being able to survive beyond maybe one or two generations?

Mr. TRUE. May I respond to that, Congressman?

The current problem was created with the adoption of section 2036(c) of the code in 1987 which dealt with the estate tax freeze provisions. With the repeal of that in 1990 and the adoption of chapter 14, we grandfathered in the existing buy-sell agreements, but we still had some problems intergenerationally.

Now, you can still enter into buy-sell agreements outside family members, but you can't enter into intergenerational buy-sell agreements. The buy-sell agreements are particularly attractive because it allows you to plan. You have to establish a business purpose; you have to establish a reasonable value, and then it creates particularly a market, you see, for a closely held business. We own all of the stock in our business, the family does.

So when my sister withdrew in 1984, there was no other market. But she knew ahead of time what the price was and we knew what the price would be in order to buy her out.

Mr. CARDIN. My general recollection is that in 1990 that action was taken because we were freezing the value at current value with an appraisal, but then issuing additional equity in the corporation and trying to avoid taxes. Was it——

Mr. TRUE. That was a corollary situation where you would have an equity stock issued to the successive generations and preferred stock retained by the senior generation. That is not the circumstance in our case.

Mr. CARDIN. But I think that the action taken by Congress was to prevent that type of tax avoidance.

Mr. TRUE. That is true, and I am not sure that is a justified public policy reason. In that particular case, they were trying to continue to break up family businesses, which I don't think is the appropriate public policy purpose. In our particular case, we are based in Casper, Wyo.

If we had to liquidate our business as an asset-based business, those assets would probably go to Denver and Houston, frankly.

Mr. CARDIN. I think your point is well taken, and if any other panelist wants to respond, please do. The reaction in 1990 was understandable because of the expansions of these types of avoidance schemes or advice that was being given by just about any tax planner, but we didn't replace it with anything, we didn't take care of the legitimate problems that you are referring to.

Mr. TRUE. That is correct.

Mr. CARDIN. So we really need to take a look at this again. I am not so sure that reinstating the prior rules is reasonable, but we need to take a look at what could replace it.

I guess my concern is that if we pass the provisions that are in this contract, we still have a major problem ahead of us that we have to take a look at if we are going to be able to preserve small family businesses in our community. Anyone else wish to comment? Fine. I have 30 seconds left on my time.

If not, let me again thank you all for your testimony.

Mr. CRANE. Let's see.

Ms. Dunn.

Ms. DUNN. Thank you, Mr. Chairman.

And thank you, gentlemen. I think your testimony has been outstanding, a poignant presentation of some areas where we obviously need to do a lot of work here at the Federal level.

Mr. True, I want to say hello to you. I greeted members of your family on November 3 in Casper, Wyo. It was the day of the snowstorm and I enjoyed getting to know your airport very well.

Mr. TRUE. We were glad you were there.

Ms. DUNN. Thank you. It was delightful. A very successful venture, I am so pleased to say.

Mr. McNutt, Mr. Thigpen, Mr. Lange, all of you did a terrific job of bringing something to our attention, that it is vitally important as we talk about this estate tax relief that we have to push forward and that is the nonliquidity of certain types of products.

As I mentioned earlier when Mr. Barrett was testifying, I represent a very large district in Washington State, some of which is

around Mt. Ranier, and that we have many small timber farms that exist there, and the fact that that is a long turnover sort of product makes the situation almost impossible. So that young families who are taking over after the death of a parent really have great trouble financing the estate tax and often simply have to cut the timber off that property to pay the estate taxes and often sell the property. And, as Mr. Turner said, it becomes houses and it is a great loss, I believe. Certainly I have seen that happen in my own district.

I suspect that in order to compensate for this big problem that we are all facing, you find yourself looking for legal tax loopholes. And I would be curious if you could fill me in on, if there has been some action you have taken to help you solve this problem.

And I welcome any response. Mr. True, perhaps you have some thoughts.

Mr. TRUE. Well, thank you, Congresswoman, and it is good to see you again. Thank you.

We are currently in the process of engaging some very expensive lawyers, accountants and life insurance people. And I have dragged my feet in that exercise, as my father did before me, because it seems to me as a matter of public policy it doesn't make any sense to divert the necessary capital that we reinvest into our business and divert it into large life insurance policies which, yes, indeed at some future date would provide the liquidity necessary for us to pay those estate taxes, but what it does right now is it constrains the economic opportunities that our business would have. So we have been resisting that. But I know that at some future date we will have to pay the piper if we don't plan now.

Ms. DUNN. And that sort of thing of course cuts back on your capital that you have to invest in the company.

Mr. TRUE. Exactly. It is counterproductive.

Mr. MCNUTT. I think a real tragedy in this whole scenario and regrettably it extends throughout the whole tax system of taxation is that it is so complex that it forces the taxpayer to literally play games to try to find where you can penetrate the wall, where can you save a dollar.

You know, it is easy to understand why people without any real knowledge of it love this flat tax idea. You do a little postcard, it is marvelous, it is marvelous. But to have to go out and spend so much money for tax planning, accountants, attorneys, to look for ways to conserve your own money and shield it from the Federal Government is just a basic flaw I think in our tax policy.

Mr. CRANE. Ms. Dunn, are you finished?

Ms. DUNN. Unless any of the other gentlemen have a response.

Mr. LANGE. A quick response. One thing that is semirelated. The capital gains tax of 28 percent, if we had a farm today, we could sell our farm and pay 28 percent capital gains. If we hold on to the farm and the owner dies, then we are assessed up to 55 percent. So there is no—it is hard to have incentive to hang on to the farm when you know that you are going to get hammered twice as hard by holding on to it.

Mr. TURNER. Let me just respond quickly if I might to the complexity issue since I practice somewhat in this area. Looking at 2032(a) itself, and we appreciate Congressman Herger's and others'

efforts to broaden the relief under that, but to take the maximum benefit of it, you need to take advantage of those limits in that code section in both estates.

So typically you have a spouse that dies, because the unlimited marital deduction gives everything to the surviving spouse, then that surviving spouse has to execute a disclaimer to create some tax in the surviving spouse's estate to take advantage of section 2032(a), so that then when the surviving spouse also passes away, he or she can then take advantage of the benefits and limits of section 2032(a) again in their estate, and so forth and so on, and so it goes. Very complex. And to have so much complexity, to plan around a tax that is such bad, counterproductive public policy anyway we think is just nonsensical.

So certainly our organization not only advocates some amendments to current law, but really urges a look at the entire public policy behind the estate tax.

Ms. DUNN. Thank you.

Mr. CRANE. Mr. Payne has a quick question, but first let me counsel the members of the panel. We appreciate your appearance here. Because we have a vote, after Mr. Payne's questions, what I would like to do is recess the committee and let you folks be excused, and thank you again.

Proceed.

Mr. PAYNE. Thank you very much, Mr. Chairman. I will be very brief.

I want to thank all of the panelists for the testimony. I think it has been very helpful. Since I have a very brief amount of time, I will address my comments to Mr. Lange with whom I was working on a piece of legislation in the last Congress. As he mentioned, Mr. Schultz on this committee offered a similar bill two Congresses ago, and shortly Mr. Houghton and I will introduce the American Farm Protection Act of 1995. This essentially will contain a provision that will allow rural landowners within 50 miles of a defined metropolitan area, who voluntarily and permanently provide for the commitment of their land to rural land use through a donation of a qualified conservation easement, to exempt this from the Federal estate tax.

I have a lot of statistics about what is going on in my district alone. We have lost 5,000 farms in the last 20 years. On this panel as we look at all of the members, more than 25,000 farms have been lost in the last 20 years. And this is clearly a situation which we should address and the Contract With America is the right place to address it.

So I encourage the committee to look at the American Farm Protection Act as a part of the Contract With America.

I thank the panelists again, and, Mr. Chairman, I yield back the balance of my time. Thank you.

Mr. CRANE. Again, we thank you. The committee is recessed until 2 p.m.

[Recess.]

Mr. MCCRERY [presiding]. The committee will come to order.

Our next panel can take their seats at the witness table and we will resume testimony. We have with us a Member of the U.S. Senate, former Member of the lower House, Hon. Robert Smith, and

we have with us a most respected member of the majority in the House of Representatives, Robert Walker from Pennsylvania.

Gentlemen, welcome to our committee and we will be pleased to take your testimony. Anything that you have prepared in writing, we will submit for the record, and if you would summarize your testimony orally and if you can stay for questions, we will start with Senator Smith, or if you all had decided on another order.

Mr. WALKER. I will go ahead and start.

Thank you, Mr. Chairman.

Mr. MCCRERY. Mr. Walker.

STATEMENT OF HON. ROBERT S. WALKER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF PENNSYLVANIA

Mr. WALKER. Mr. Chairman, one piece of H.R. 9 title XI is the Taxpayer Debt Buydown Act, and we believe this to be an effective and innovative plan to cut the runaway Federal budget deficit and reduce the $4.6 trillion national debt. It is a revolutionary attempt to bring the American taxpayer directly into the budget process, a plan that will give the taxpayers the power they need to participate in controlling Federal spending.

This legislation would allow each taxpayer to contribute up to 10 percent of his or her tax liability to a public debt reduction fund. The corresponding reduction in funds to the government could result in an across-the-board sequester of all accounts, except Social Security retirement benefits, interest on the debt, deposit insurance, and a few other minor contractual obligations of the Federal Government.

Both OMB and CBO have had an opportunity to examine this measure. It works and would balance the budget in 6 years and zero out the debt by the year 2008 under full participation. If public debt is not reduced in the same time period, it will increase to over $12 trillion. CBO is currently restoring this bill for inclusion in the Job Creation and Wage Enhancement Act.

Changes have been made to accommodate some concerns that have arisen about the bill. The legislation would have locked back all public debt including the public trust fund. I am extending the retirement trust fund to the new version of the bill, which are one of the three of the largest trust funds, so that they would not end up being defunded. They are the Social Security Trust Fund, the Civil Service and the military retirement trust funds.

Due to the imminent passage of the balanced budget amendment, discussions are under way about the simultaneous implementation of the balanced budget amendment and this buydown plan. In new language, the checkoff would count only if the amount is greater than the cuts that Congress have already implemented.

For example, if Congress passes a reconciliation bill this year, which designates cuts at $50 billion in 1998, and the checkoff in 1998 totals $60 billion, only an additional $10 billion would be cut under my legislation, rather than under the legislation—rather than cuts. That would total $110 billion, as some people had said the bill would do. If the checkoff is only $40 billion, then nothing would happen. In other words, it would not be necessary to move forward.

Due to the Treasury Department concerns and the concerns of estimating, I am building a 1-year time lag into the measure. For example, if the American people were to take advantage of the 10 percent this April 15, the IRS would have until October 1995 to estimate the amount. This figure would then be submitted to Congress in February 1996 as part of the President's budget for fiscal year 1997. Congress would then have until October 1996 to make the cuts before a sequester would be mandated.

Originally I had only exempted the Social Security retirement account's interest on the debt and deposit insurance. During consultation with the House Budget Committee, the Ways and Means Committee and CBO, it was pointed out that there were several other accounts where there were contractual obligations of the Federal Government and therefore they had to be fully funded. Examples include judges' salaries, payments resulting from government insurance and guarantees. These accounts are negligible financially and will have little effect on the estimates within the measure.

We are attempting to incorporate all of the various changes that people have told us need to be done in the bill, and I think we have done this.

This measure has broad support. I reintroduced it on the first day of the 104th Congress and we now have 84 cosponsors. On the Senate side, Bob Smith, who is here with me today, is lead sponsor. Norm Ture, president of IRET, Paul Merski of CSE, Tom Schatz from CAGW are all here today. Other long-term supporters include Lawrence Kudlow, the economics editor for the National Review and the National Taxpayers Union.

We have had very, very good polling results. Any time that this has been polled, it has shown heavy acceptance amongst the American people, and I believe that debt buydown takes an intractable issue of spending cuts outside the halls of Congress into the households of the American people and would assure that we would have a combination of getting something done about the debt and doing so with almost a national referendum.

I thank you, Mr. Chairman.

[The prepared statement follows:]

TESTIMONY OF

CONGRESSMAN ROBERT S. WALKER

BEFORE THE HOUSE COMMITTEE ON WAYS AND MEANS

FEBRUARY 1, 1995

THANK YOU VERY MUCH FOR THE OPPORTUNITY TO TESTIFY ON WHAT I BELIEVE IS AN EFFECTIVE, INNOVATIVE PLAN TO CUT THE RUNAWAY FEDERAL BUDGET DEFICIT AND REDUCE THE $4.6 TRILLION NATIONAL DEBT.

THE TAXPAYER DEBT BUY-DOWN ACT IS MORE THAN A DEBT AND DEFICIT REDUCTION PLAN. IT IS A REVOLUTIONARY ATTEMPT TO BRING THE AMERICAN TAXPAYER DIRECTLY INTO THE BUDGET PROCESS; A PLAN THAT WILL GIVE TAXPAYERS THE POWER THEY NEED TO PARTICIPATE IN CONTROLLING FEDERAL SPENDING. IN FACT, IF PASSED, THIS LEGISLATION WOULD BE A REFERENDUM EVERY APRIL 15 ON FEDERAL EXPENDITURES.

THE LEGISLATION WOULD ALLOW EACH TAXPAYER TO CONTRIBUTE UP TO 10% OF HIS OR HER TAX LIABILITY TO A PUBLIC DEBT REDUCTION FUND. THE CORRESPONDING REDUCTION IN FUNDS TO THE GOVERNMENT COULD RESULT IN AN ACROSS-THE-BOARD SEQUESTER OF ALL ACCOUNTS EXCEPT SOCIAL SECURITY RETIREMENT BENEFITS, INTEREST ON THE DEBT, DEPOSIT INSURANCE, AND A FEW OTHER MINOR CONTRACTUAL OBLIGATIONS OF THE FEDERAL GOVERNMENT.

A LOT OF CONTROVERSY AND MISINFORMATION HAS ARISEN ABOUT THIS LAST POINT. DIRE PREDICTIONS HAVE BEEN MADE ABOUT THE COLLAPSE OF GOVERNMENT UNDER THE SEVERITY OF THESE CUTS. THOSE PREDICTIONS ARE NONSENSE! I WOULD LIKE TO POINT OUT THAT, EVEN WITH MAXIMUM TAXPAYER PARTICIPATION, OUTLAYS WOULD CONTINUE TO INCREASE ACCORDING TO THE OMB ESTIMATES. GOVERNMENT SPENDING WOULD CONTINUE TO GROW DURING THE TIME WE ARE COLLAPSING THE DEBT TO ZERO IN 15 YEARS. HOW CAN SOMEONE PREDICT THE COLLAPSE OF THE GOVERNMENT ON FUNDING LEVELS WHICH ARE HIGHER THAN THOSE WE HAVE TODAY? SPENDING PRIORITIES WOULD HAVE TO BE REALLOCATED AND GOVERNMENT NON-ESSENTIALS WOULD HAVE TO BE ELIMINATED, BUT THERE WOULD BE PLENTY OF MONEY TO DO THE NECESSARY WORK OF NATIONAL GOVERNMENT.

BOTH OMB AND CBO HAVE EXAMINED THIS MEASURE. THEY CONCUR THAT THIS IDEA WOULD BALANCE THE BUDGET IN SIX YEARS, AND ZERO OUT THE DEBT BY FISCAL YEAR 2008, UNDER FULL PARTICIPATION. IF THE PUBLIC DEBT IS NOT REDUCED IN THE SAME TIME PERIOD IT WILL INCREASE TO OVER $12 TRILLION!

CBO IS CURRENTLY RESCORING THIS BILL FOR INCLUSION IN THE JOB CREATION AND WAGE ENHANCEMENT ACT.

A FEW CHANGES HAVE BEEN MADE TO ACCOMMODATE CONCERNS THAT HAVE BEEN RAISED. (1)THE LEGISLATION WOULD HAVE BOUGHT-BACK ALL PUBLIC DEBT, INCLUDING ALL THE RETIREMENT TRUST FUNDS. I AM EXEMPTING THE RETIREMENT ACCOUNTS, WHICH ARE THREE OF THE LARGEST TRUST FUNDS, FROM BEING DEFUNDED. THEY ARE: THE SOCIAL SECURITY TRUST FUND, CIVIL SERVICE, AND MILITARY RETIREMENT FUNDS. I AM CONCERNED THAT IF THESE ACCOUNTS ARE DEFUNDED, QUESTIONS MAY ARISE ABOUT THEIR FINANCIAL INTEGRITY, AND THE ENTIRE ACCOUNT COULD BE JEOPARDIZED.

(2)DUE TO THE IMMINENT PASSAGE OF THE BALANCED BUDGET AMENDMENT (BBA), DISCUSSING ARE UNDERWAY ABOUT THE SIMULTANEOUS IMPLEMENTATION OF THE BBA AND THE BUY-DOWN. IN THE NEW LANGUAGE, THE CHECK-OFF WILL COUNT ONLY IF THE AMOUNT IS GREATER THAN THE CUTS THAT CONGRESS HAVE ALREADY IMPLEMENTED. FOR EXAMPLE, IF CONGRESS PASSES A RECONCILIATION BILL THIS YEAR WHICH DESIGNATES CUTS OF $50 BILLION IN 1998 AND THE CHECK-OFF IN 1998 TOTALS $60 BILLION, ONLY AN ADDITIONAL $10

BILLION WILL BE CUT UNDER MY LEGISLATION, RATHER THAN CUTS THAT WOULD TOTAL $110 BILLION. IF THE CHECK-OFF IS ONLY $40 BILLION, THEN NOTHING WILL HAPPEN.

THEREFORE, THE AMERICAN PEOPLE WILL BE TELLING CONGRESS IF THEY ARE ON THE RIGHT BUDGET TRACK, OR IF THEY WANT FURTHER SPENDING REDUCTIONS.

(3)THE TREASURY DEPARTMENT WAS CONCERNED ABOUT THE TIME INVOLVED IN ESTIMATING THE AMOUNT OF THE CHECK-OFF FOR CONGRESS. THEREFORE, I AM BUILDING A ONE-YEAR LAG TIME INTO THE MEASURE. FOR EXAMPLE, IF THE AMERICAN PEOPLE WERE ABLE TO TAKE ADVANTAGE OF THE **10%** THIS APRIL 15TH, THE IRS WOULD HAVE UNTIL OCTOBER, 1995 TO ESTIMATE THE AMOUNT. THIS FIGURE WOULD THEN BE SUBMITTED TO CONGRESS IN FEBRUARY, 1996 AS PART OF THE PRESIDENT'S BUDGET FOR FISCAL YEAR 1997. CONGRESS WOULD THEN HAVE UNTIL OCTOBER, 1996 TO MAKE THE CUTS BEFORE A SEQUESTER WOULD BE MANDATED.

THIS ALSO GIVES CONGRESS MORE OPPORTUNITY TO FORESEE THE CUTS AND MAKE INFORMED DECISIONS.

(4)THIS LAST CHANGE IS ONE TO WHICH I ALLUDED EARLIER. ORIGINALLY, I HAD ONLY EXEMPTED THE SOCIAL SECURITY RETIREMENT ACCOUNTS, INTEREST ON THE DEBT AND DEPOSIT INSURANCE FROM THE SEQUESTRATION WHICH WOULD OCCUR IF CONGRESS DID NOT MAKE THE NECESSARY CUTS THEMSELVES. DURING CONSULTATIONS WITH THE HOUSE BUDGET COMMITTEE, WAYS AND MEANS, AND CBO, IT WAS POINTED OUT TO ME THAT THERE WERE SEVERAL OTHER ACCOUNTS WHICH WERE CONTRACTUAL OBLIGATIONS OF THE FEDERAL GOVERNMENT, AND THEREFORE, HAD TO BE FULLY FUNDED. EXAMPLES INCLUDE JUDGES SALARIES AND PAYMENTS RESULTING FROM GOVERNMENT INSURANCE AND GUARANTEES. THESE ACCOUNTS ARE NEGLIGIBLE FINANCIALLY, AND WILL HAVE LITTLE EFFECT ON THE ESTIMATES OF THE MEASURE.

ONE AND THREE HAVE ALREADY BEEN INCORPORATED IN THE BILL. NUMBERS TWO AND FOUR WILL HAVE TO BE ADDED LATER.

THIS MEASURE HAS BROAD SUPPORT. I REINTRODUCED IT ON THE FIRST DAY OF THE 104TH CONGRESS AND NOW HAVE 84 COSPONSORS. SENATOR BOB SMITH WHO IS ALSO TESTIFYING TODAY IS THE LEAD SPONSOR ON THE SENATE SIDE.

I AM THANKFUL TO THE GROWING NUMBER OF ORGANIZATIONS AND INDIVIDUALS WHO HAVE ENDORSED THE TAXPAYER DEBT BUY-DOWN. NORM TURE, PRESIDENT OF THE INSTITUTE FOR THE RESEARCH ON THE ECONOMICS OF TAXATION, PAUL MERSKI OF THE CITIZENS FOR A SOUND ECONOMY, AND TOM SCHATZ FROM THE CITIZENS AGAINST GOVERNMENT WASTE ARE ALL HERE TODAY ON THIS BILLS' BEHALF. OTHERS LONG-TERM SUPPORTERS INCLUDE, LAWRENCE KUDLOW, ECONOMICS EDITOR FOR THE NATIONAL REVIEW, AND THE NATIONAL TAXPAYERS UNION.

PRESIDENT CLINTON INCHED TOWARD THE CONCEPT OF DEBT BUY-DOWN WITH HIS DEFICIT TRUST FUND PROPOSAL. BY ESTABLISHING A PARKING PLACE FOR DEBT REDUCTION AT THE U.S. TREASURY, THE PRESIDENT ACKNOWLEDGED THE NEED FOR AN ACCOUNTING TOOL TO ASSURE THE PUBLIC THAT DEFICIT REDUCTION MONEY WAS TRULY GOING TO DEFICIT REDUCTION.

BUT THE PRESIDENT'S FUND HAS NO LEGS BEYOND ITS ACCOUNTING CLEVERNESS. FOR DEBT AND DEFICITS TO BE REDUCED, THE SPENDING CUT AND SEQUESTRATION MECHANISM OF THE TAXPAYER DEBT BUY-DOWN ARE NEEDED. ONLY THEN CAN CBO AND OMB SCORE REAL SAVINGS.

SEVERAL OTHER POINTS SHOULD BE NOTED FOR A FULL UNDERSTANDING OF THIS PROPOSAL. TAX INCREASES CANNOT BE USED TO OFFSET THE SPENDING CUT DEMANDS MADE BY TAXPAYERS EACH YEAR. WHILE CONGRESS WOULD STILL BE PERMITTED TO RAISE TAXES FOR OTHER REASONS, TAX REVENUES WOULD NOT COUNT AGAINST THE BASELINE REDUCTIONS REQUIRED BY THE BUY-DOWN PLAN. AND, ANY TAX INCREASES ON PERSONAL INCOME WOULD HAVE THE EFFECT OF GIVING TAXPAYERS MORE OF A LIABILITY AGAINST

WHICH TO REQUIRE SPENDING CUTS.

THERE HAS BEEN SOME PUBLIC REACTION TO THE DEBT BUY-DOWN CONCEPT AND THAT REACTION HAS BEEN HIGHLY POSITIVE. PRESIDENT BUSH'S ENDORSEMENT OF THIS IDEA AT THE 1992 REPUBLICAN NATIONAL CONVENTION LED POLLSTERS TO GAUGE PUBLIC OPINION. A POLL DONE FOR THE BUSH CAMPAIGN SHOWED 66% OF AMERICANS SUPPORTING THIS NEW IDEA IN THE SUMMER OF 1992. PUBLIC SUPPORT INCREASED TO 75% IN A NATIONAL OPINION BALLOT DONE IN DECEMBER 1992. IN JUNE, 1993, THE NATIONAL FEDERATION OF INDEPENDENT BUSINESS FOUND 77% OF THEIR MEMBERSHIP FAVORED THE PLAN.

DEBT BUY-DOWN TAKES THE INTRACTABLE ISSUE OF SPENDING CUTS OUTSIDE THE HALLS OF CONGRESS AND INTO THE HOUSEHOLDS OF THE AMERICAN PEOPLE. THEY WOULD HAVE AN OPPORTUNITY NOT ONLY TO HELP DECIDE HOW MUCH CUTTING WOULD BE DONE, BUT THEY WOULD HAVE AN OPPORTUNITY TO HOLD THEIR REPRESENTATIVES ACCOUNTABLE FOR ACTING OR FAILING TO ACT ON THEIR WISHES. AND AT ANY TIME THE AMERICAN PEOPLE BEGAN TO BELIEVE THE SPENDING CUTS HAD GONE TOO DEEP, THEY WOULD HAVE AN ANNUAL OPTION OF NOT ASKING FOR ADDITIONAL REDUCTIONS.

DEBT BUY-DOWN IS A REVOLUTIONARY APPROACH TO A GROWING PROBLEM. THE NATIONAL DEBT PROBLEM HAS GROWN SO LARGE THAT IT DEFIES TINKERING AROUND THE MARGINS. REAL SOLUTIONS ARE GOING TO DEMAND BREAK-THROUGH IDEAS. THE DEBT BUY-DOWN BREAKS THROUGH MANY OF THE PROBLEMS CONNECTED WITH THE DEBT AND DEFICIT BY BYPASSING SPECIAL INTEREST PLEADINGS FOR EVER-LARGER BUDGETS AND GIVING A BROAD SEGMENT OF THE POPULATION A CHANCE TO REGISTER AN ANTI-SPENDING MANDATE EACH AND EVERY YEAR.

EMPTY PROMISES OF FISCAL RESPONSIBILITY ARE NO LONGER ADEQUATE. PUBLIC DISCOURSE WILL DEMAND REAL SOLUTIONS. ONLY BOLD ACTION WILL CONVINCE OUR CONSTITUENTS THAT WE ARE FINALLY PUTTING OUR FISCAL HOUSE IN ORDER. YOU CAN BEGIN THAT ACTION BY APPROVING THE TAXPAYER DEBT BUY-DOWN.

BEFORE I CLOSE, I WOULD LIKE TO BRIEFLY DISCUSS WITH YOU ANOTHER PART OF THE JOB CREATION AND WAGE ENHANCEMENT ACT, WHICH CHAIRMAN ARCHER HAS INTRODUCED AND HAS BEEN REFERRED TO THE COMMITTEE ON SCIENCE, WHICH I CHAIR. THE LEGISLATION IS THE RISK ASSESSMENT AND COST/BENEFIT ANALYSIS FOR NEW REGULATIONS, WHICH IS TITLE III OF H.R. 9.

THE COST OF COMPLIANCE WITH FEDERAL REGULATIONS IS ASTOUNDING - AS LEAST $130 BILLION ANNUALLY FOR ENVIRONMENTAL REGULATIONS ALONE. PRIVATE SECTOR COMPLIANCE COSTS FOR ALL FEDERAL REGULATIONS EXCEED $430 BILLION PER YEAR - 9 PERCENT OF OUR GROSS DOMESTIC PRODUCT, ACCORDING TO THE CLINTON ADMINISTRATION'S OWN NATIONAL PERFORMANCE REVIEW (PAGE 32). IN AN ERA OF TOUGH BUDGET REALITIES, POLICY-MAKERS NEED TO MAKE CHOICES AND SET PRIORITIES -- TO CONCENTRATE SCARCE DOLLARS WHERE THEY WILL DO THE MOST GOOD, AND ANALYZE ALTERNATIVES TO ACHIEVE THE GOAL OF PUBLIC SAFETY AT THE LOWEST POSSIBLE COST.

WITH A STANDARDIZED, UNDERSTANDABLE CALCULATION OF RISKS AND COMPLIANCE COSTS, CONGRESS AND THE PUBLIC WILL KNOW THAT THEIR DOLLARS ARE BEING WELL SPENT - WITHOUT LOWER STANDARDS OF PROTECTION.

THE PURPOSE OF TITLE III IS TO GIVE US THE GREATEST PROTECTION OF PERSONAL HEALTH AND SAFETY FOR OUR EFFORTS, ALLOWING US TO DIRECT OUR RESOURCES TO THOSE PROBLEMS THAT WILL SAVE MORE LIVES. TITLE III IS A SMARTER APPROACH TO FEDERAL REGULATION AIMED AT GETTING OUR MONEY'S WORTH FROM RISK ANALYSIS. IT AIMS AT IMPROVING AND STANDARDIZING THE METHODS FEDERAL REGULATORS USE FOR RISK ASSESSMENT. RISK ANALYSIS SHOULD BE BASED ON UNBIASED SCIENCE, TO ASSURE THEY ARE AS ACCURATE AND OBJECTIVE AS POSSIBLE. THE LEGISLATION ALSO ESTABLISHES RELATIVE RISK REDUCTION AS A PRINCIPAL TOOL FOR SETTING PRIORITIES FOR FEDERAL REGULATIONS.

THANK YOU FOR YOUR TIME AND CONSIDERATION.

Mr. McCRERY. Thank you, Mr. Walker.
Senator Smith.

STATEMENT OF HON. ROBERT SMITH, A U.S. SENATOR FROM THE STATE OF NEW HAMPSHIRE

Senator SMITH. Thank you very much, Mr. Chairman.

I might just say, with no disrespect to my colleagues on the Democratic side, it is nice to say "Mr. Chairman" to a Republican colleague. This is exciting for me.

I want to compliment my colleague, Bob Walker, for getting this in the Contract With America, because it is moving along now in a big package, and that is very exciting. Bob has explained pretty much how it works. I do have a full statement regarding that that I would like to insert for the record and just make a few summary comments.

The midterm elections I think represented a mandate for change; there isn't any question about that. The American people want to be more directly involved in their government. You are seeing a great popularity now in town meetings, in citizen referendum, talk radio, all of these things, and I think the 104th Congress is listening to the people. This is an example of that listening.

We have seen the Congressional Accountability Act, the unfunded mandates bill already passed one body or the other, and the Congressional Accountability Act, both bodies; the balanced budget amendment already passed the House, now on the floor. We have been talking about giving welfare back to the States. This is all very exciting.

Now, the Taxpayer Debt Buydown Act is the same thing, it is the same spirit. It gives people the right to participate. It prevents politicians, whoever they may be in the future, from mortgaging their kids' future. It is a safety valve.

We let taxpayers finance the debt—this is a very interesting point—we let taxpayers finance the debt by purchasing Treasury securities. So why not let them finance deficit reduction by designating a certain percentage of their tax dollars up to 10 percent. The American people deserve that chance. They deserve to show that they are willing to sacrifice. It is their money.

Most Americans feel it is immoral to pass on this debt to future generations, as we do, and this bill will give us a referendum on spending. Congress gets its marching orders from the people. And it is more and more important also if the amendment passes the Senate, which I hope it will do in the very near future and be ratified by the States, that will balance the budget when Congress decides to implement the amendment. But then we have to reduce the debt. It is not enough just to keep the budget balanced.

We will have well over a $5 trillion debt by the time the balanced budget amendment takes effect, and this is a safety valve. This will say that the taxpayers can say, Up to 10 percent of our dollars will be used on reducing the national debt, and of course if it is implemented before that, it would reduce the deficit. But until that time, this is a safety valve, and no matter what the taxpayers, whatever the Congress does, if they say we are going to reduce it by $100 billion and the taxpayers pick $50 billion, so be it. But if the tax-

payers pick more than that kicks in, the taxpayers then would dictate how much it should be reduced.

So it is all very exciting, and I am pleased to be a part of it.

Certainly I would be happy to answer any questions, and thank you, Mr. Chairman, for having a hearing on this, what I consider to be a very important piece of legislation.

[The prepared statement follows:]

TESTIMONY ON THE TAXPAYER DEBT BUY DOWN ACT
HOUSE COMMITTEE ON WAYS AND MEANS
SENATOR ROBERT SMITH
FEBRUARY 1, 1995

MR. CHAIRMAN, MR. GIBBONS, MEMBERS OF THE COMMITTEE: THANK YOU FOR GIVING ME THE OPPORTUNITY TO TESTIFY IN SUPPORT OF THE TAXPAYER DEBT BUY DOWN ACT. I AM THE SENATE SPONSOR OF THE BILL AND I AM PROUD TO JOIN BOB WALKER IN THIS EFFORT TO INVOLVE THE AMERICAN PEOPLE IN THE FIGHT TO REDUCE DEFICITS AND PAY DOWN THE DEBT. CONGRESSMAN WALKER HAS ALREADY EXPLAINED IN GREAT DETAIL HOW THE BILL WOULD WORK SO I WOULD LIKE TO FOCUS ON WHY I THINK IT IS SUCH A GOOD IDEA.

MR. CHAIRMAN, THE MIDTERM ELECTIONS REPRESENTED A MANDATE NOT JUST FOR LESS GOVERNMENT BUT ALSO FOR MORE RESPONSIVE GOVERNMENT. THE AMERICAN PEOPLE ARE DEMANDING AN END TO BUSINESS AS USUAL IN WASHINGTON. AS ANYONE WHO HAS HELD A TOWN MEETING RECENTLY, OR WATCHED THE POPULARITY OF CITIZEN REFERENDA SPREAD ACROSS THE STATES, OR TUNED IN TO TALK RADIO KNOWS, THE AMERICAN PEOPLE WANT TO BE MORE DIRECTLY INVOLVED IN THEIR GOVERNMENT. THEY DON'T WANT EVERY DECISION BEING MADE IN A FAR AWAY CAPITOL.

I AM PLEASED TO SAY THAT, THUS FAR, THE 104TH CONGRESS IS LISTENING TO THE AMERICAN PEOPLE. WE ARE LISTENING AND WE ARE GETTING THINGS DONE. WE PASSED THE CONGRESSIONAL ACCOUNTABILITY ACT IN RECORD TIME. AT LONG LAST, CONGRESS WILL BE UNABLE TO EXEMPT ITSELF FROM THE LAWS IT PASSES ON THE PRIVATE SECTOR. IN ADDITION, WE OVERWHELMINGLY PASSED THE BILL MAKING IT HARDER FOR WASHINGTON TO PUT UNFUNDED MANDATES ON STATES AND LOCALITIES.

THESE BIPARTISAN SUCCESS STORIES ARE JUST THE BEGINNING. THAT IS WHY WE ARE LOOKING AT WAYS TO SEND FEDERAL PROGRAMS SUCH AS WELFARE BACK TO THE STATES. THAT IS WHY WE ARE GOING TO HAVE THE FIRST-EVER FLOOR VOTE ON TERM LIMITS THIS YEAR. THE TAXPAYER DEBT BUY DOWN ACT IS IN THAT SAME SPIRIT.

CONGRESSMAN WALKER AND I DEVELOPED THIS LEGISLATION SO THAT WE COULD CREATE AN ACTIVE ROLE FOR "WE THE PEOPLE" IN FISCAL MATTERS OF THE FEDERAL GOVERNMENT. THE TAXPAYER DEBT BUY-DOWN ACT WOULD ALLOW TAXPAYERS TO DIRECTLY PARTICIPATE IN SOLVING THE MOST CRITICAL FISCAL PROBLEMS FACING OUR NATION: THE ANNUAL BUDGET DEFICITS AND THE EVER-INCREASING NATIONAL DEBT.

THIS BOLD LEGISLATION WOULD ALLOW TAXPAYERS TO DESIGNATE UP TO TEN PERCENT OF THEIR INCOME TAX LIABILITY FOR THE SOLE PURPOSE OF DEFICIT REDUCTION. CONGRESS WOULD THEN HAVE TO ENACT THE SPENDING CUTS NEEDED TO EQUAL THE TOTAL AMOUNT DESIGNATED IN ANY GIVEN YEAR BY THE TAXPAYERS. IF CONGRESS FAILED TO ACT, AN AUTOMATIC ACROSS-THE-BOARD SEQUESTER OF ALL GOVERNMENT ACCOUNTS EXCEPT SOCIAL SECURITY, DEPOSIT INSURANCE, CERTAIN CONTRACTUAL OBLIGATIONS, AND NET INTEREST ON THE DEBT WOULD BE TRIGGERED. AGAIN, THERE IS AN ACROSS-THE-BOARD SEQUESTER ONLY IF THE CONGRESS REFUSES TO TAKE ACTION.

I KNOW THAT SOME MEMBERS FEEL THAT ACROSS-THE-BOARD CUTS ARE UNFAIR. HOWEVER, SEQUESTERS ARE NOT NEARLY AS UNFAIR AS

BURDENING FUTURE GENERATIONS WITH MOUNTAINS OF DEBT. AND WE DO NOT HAVE TO HAVE ACROSS-THE-BOARD CUTS. THE ONLY REASON A SEQUESTER WILL OCCUR IS IF CONGRESS DOES NOT HAVE THE GUTS TO STEP UP TO THE PLATE AND PRIORITIZE FEDERAL SPENDING.

UNLIKE MANY PREVIOUS ATTEMPTS TO REDUCE THE DEFICIT, OUR BILL WOULD RESULT IN REAL SPENDING CUTS. THE BUDGET BASELINE WILL BE REDUCED BY THE AMOUNT OF THE CUT; THUS, LASTING DEFICIT REDUCTION IS ASSURED. IT IS THIS PROVISION THAT MAKES THE 10% CHECK-OFF VIABLE BECAUSE FEDERAL SPENDING WILL BE PUT ON A STEADILY DECLINING PATH. MOREOVER, WHILE NOTHING IN THIS BILL PREVENTS CONGRESS FROM RAISING TAXES, TAX HIKES COULD NOT BE USED TO SUBSTITUTE FOR THE SPENDING CUTS DESIGNATED BY THE TAXPAYERS.

THE FEDERAL GOVERNMENT HAS NOT HAD A BALANCED BUDGET SINCE 1969 AND CURRENT PROJECTIONS SHOW HUGE DEFICITS FOR YEARS TO COME. WE HAVE NO CHOICE BUT TO STOP THE SPENDING, STOP THE BORROWING AND PAY DOWN THE DEBT.

TWENTY FIVE YEARS OF DEFICIT SPENDING HAVE LEFT US WITH A NATIONAL DEBT IN EXCESS OF $4.7 TRILLION. EVERY AMERICAN'S SHARE OF THAT DEBT IS AN ASTOUNDING $17,700. AND, DESPITE CLAIMS OF PROGRESS ON THE DEFICIT, WHEN PRESIDENT CLINTON'S SO-CALLED DEFICIT REDUCTION PLAN HAS RUN ITS COURSE, THE NATIONAL DEBT WILL APPROACH $6 TRILLION.

THE AMERICAN PEOPLE KNOW OUR NATION IS IN A FINANCIAL CRISIS THAT CALLS FOR DECISIVE ACTION. THE 10% CHECKOFF WILL GIVE THE AMERICAN PEOPLE THE RIGHT TO DEMAND THAT POLITICIANS IN WASHINGTON STOP MORTGAGING THE FUTURE FOR THEIR OWN POLITICAL BENEFIT.

POLLS SHOW THAT THIS IDEA IS VERY POPULAR WITH THE AMERICAN PEOPLE. HOWEVER, IT IS NOT NEARLY SO POPULAR INSIDE THE BELTWAY. MANY IN WASHINGTON ARE HORRIFIED BY THE NOTION OF GIVING TAXPAYERS MORE SAY IN HOW THEIR MONEY IS SPENT.

WELL, WE ALLOW TAXPAYERS TO DIRECTLY FINANCE DEFICIT SPENDING BY GIVING THEM THE OPTION OF PURCHASING TREASURY SECURITIES. WHY CAN'T WE ALLOW THEM TO DIRECTLY FINANCE DEFICIT REDUCTION BY LETTING THEM DEVOTE A SMALL PORTION OF THEIR TAX LIABILITY TO THE DEFICIT REDUCTION TRUST FUND?

MR. CHAIRMAN, IT HAS BECOME CONVENTIONAL POLITICAL WISDOM THAT THE AMERICAN PEOPLE SUPPORT DEFICIT REDUCTION IN THEORY BUT NOT IN PRACTICE. BUT I AM NOT SURE THAT'S TRUE. I THINK MOST AMERICANS FEEL IT IS IMMORAL TO PASS ON MOUNTAINS OF DEBT TO FUTURE GENERATIONS. I THINK MOST AMERICANS WANT TO PASS ON TO THEIR CHILDREN A NATION OF WHICH THEY CAN BE PROUD. I KNOW THE CITIZENS OF NEW HAMPSHIRE ARE INTENSELY CONCERNED ABOUT THE NATIONAL DEBT.

THE TEN-PERCENT CHECKOFF WILL GIVE US A NATIONAL REFERENDUM ON SPENDING AND THE DEFICIT EVERY APRIL 15TH. WE WILL KNOW HOW THE AMERICAN PEOPLE REALLY FEEL ABOUT IT. THEY WILL GIVE CONGRESS ITS MARCHING ORDERS AND CONGRESS WILL FINALLY CONTROL SPENDING BECAUSE THEY WILL HAVE NO CHOICE.

I THINK THE AMERICAN PEOPLE DESERVE A CHANCE TO SHOW THEY ARE WILLING TO MAKE THE SACRIFICES NEEDED TO SAVE THE COUNTRY.

THAT IS ALL WE ARE ASKING IN THIS LEGISLATION. GIVE THE AMERICAN PEOPLE A CHANCE.

MR. CHAIRMAN, ANOTHER REASON THE DEBT BUY DOWN ACT IS SO APPEALING IS BECAUSE IT IS A GREAT COMPLIMENT TO THE BALANCED BUDGET AMENDMENT. BY THE WAY, I'D LIKE TO CONGRATULATE THE HOUSE FOR PASSING THE BALANCED BUDGET AMENDMENT. THROUGHOUT MY SERVICE IN CONGRESS I HAVE ADVOCATED A CONSTITUTIONAL REQUIREMENT THAT WE BALANCE THE FEDERAL BUDGET. I AM HOPEFUL WE CAN GET IT THROUGH THE SENATE AND SEND IT OFF TO THE STATES FOR RATIFICATION.

IF THE BALANCED BUDGET AMENDMENT IS RATIFIED HARD CHOICES WILL HAVE TO BE MADE TO BRING THE BUDGET INTO BALANCE BY 2002. CONGRESS IS GOING TO HAVE TO SQUARE WITH THE AMERICAN PEOPLE. WE WILL HAVE TO DECIDE WHETHER WE WANT TO SLOW THE GROWTH OF SPENDING, RAISE TAXES OR SOME COMBINATION OF BOTH. I THINK THE NOVEMBER ELECTIONS PROVED THE AMERICAN PEOPLE WANT TO BALANCE THE BUDGET BY HOLDING THE LINE ON SPENDING. THE TAXPAYER DEBT BUY DOWN ACT WILL LET THEM SAY SO LOUD AND CLEAR EVERY APRIL.

IT IS ALSO IMPORTANT TO REMEMBER THAT THE BALANCED BUDGET AMENDMENT DOES NOT GUARANTEE WE WILL BALANCE THE BUDGET EVERY YEAR. IT WILL BE MUCH HARDER TO RUN A DEFICIT BECAUSE MEMBERS OF CONGRESS WOULD HAVE TO SPECIFICALLY VOTE FOR DEFICIT SPENDING. STILL, WITH A SUPER MAJORITY VOTE CONGRESS CAN WAIVE THE BALANCED BUDGET REQUIREMENT AND ADD TO THE NATIONAL DEBT.

THAT DEBT IS A MILLSTONE AROUND THE NECK OF FUTURE GENERATIONS. THAT DEBT IS THE REASON MORE YOUNG PEOPLE BELIEVE IN UFOs THAN BELIEVE THAT SOCIAL SECURITY WILL BE THERE FOR THEM. BY GIVING THE TAXPAYERS THE POWER TO MANDATE SPENDING CUTS THE TAXPAYER DEBT BUY DOWN ACT WILL MAKE IT MUCH LESS ATTRACTIVE FOR CONGRESS TO WAIVE THE BALANCED BUDGET REQUIREMENT. IF CONGRESS IS FORCED BY THE AMERICAN PEOPLE TO SPEND LESS, THERE IS LITTLE CHANCE CONGRESS WILL BE ABLE TO RUN A DEFICIT EVEN IF IT WANTS TO.

THE TAXPAYER DEBT BUY DOWN ACT ALSO PUTS IN PLACE A MECHANISM BY WHICH WE CAN PAY DOWN THE NATIONAL DEBT. THIS IS IMPORTANT BECAUSE THE NATIONAL DEBT WILL NOT DISAPPEAR JUST BECAUSE WE HAVE A BALANCED BUDGET AMENDMENT. IF WE BALANCE THE BUDGET IN 2002, THE NATIONAL DEBT WILL BE IN THE NEIGHBORHOOD OF $6 TRILLION. I THINK THE AMERICAN PEOPLE SHOULD BE GIVEN THE OPTION TO TELL CONGRESS TO START PAYING DOWN THAT $6 TRILLION DEBT.

SO IT'S A PERFECT COMPLIMENT TO THE BALANCED BUDGET AMENDMENT: IT WILL ALLOW THE TAXPAYERS TO MANDATE THAT THE BUDGET BE BALANCED BY SPENDING CUTS; IT WILL MAKE CONGRESS LESS LIKELY TO WAIVE THE BALANCED BUDGET REQUIREMENT; AND, IT WILL HELP US PAY DOWN THE DEBT.

MR. CHAIRMAN, IN CLOSING, I KNOW THIS BILL IS CONTROVERSIAL. BUT, IT IS ALSO REAL, POSITIVE CHANGE. IT IS DEFINITELY NOT BUSINESS AS USUAL. THIS LEGISLATION WILL DIRECTLY INVOLVE THE AMERICAN PEOPLE IN THE FIGHT TO MAKE THE GOVERNMENT LIVE WITHIN ITS MEANS.

AND, IT HAS THE POTENTIAL TO FORCE MEMBERS OF CONGRESS--OF BOTH PARTIES--TO DO WHAT WE SHOULD HAVE BEEN DOING FOR 25 YEARS: NAMELY, REDUCE SPENDING AND BUY DOWN THE DEBT. I URGE THE COMMITTEE TO SUPPORT IT. AGAIN, I THANK THE COMMITTEE FOR LETTING ME TESTIFY AND I'D BE HAPPY TO ANSWER ANY QUESTIONS.

Mr. MCCRERY. Thank you, Senator and Representative Walker. We appreciate very much your taking time out to visit with us and explain your legislation.

Mr. Herger, do you have questions of the witnesses?

Mr. HERGER. I just might ask quickly, briefly, how do you see the debt buydown proposal working with the balanced budget amendment? Would the debt buydown proposal assist the budget balancing process as required by the constitutional amendment? And if so, how would the two be coordinated?

Mr. WALKER. Well, I think they work very well together. First of all, this is an implementation tool for the balanced budget amendment. Insofar as we are trying to go from deficit budgets to a balanced budget, for a period of time here you have a mechanism that is helpful to reconciliation.

If in fact we decide in the reconciliation process to get rid of the deficit faster than what the American people have designated, this would have no effect. However, let's say Congress is finding it tougher and tougher to do reconciliation and the American people decide that we ought to be moving faster. They can, through their taxes, tell us that they want us to go faster, and force us to do even quicker implementation of the balanced budget amendment, simply by checking off on their tax forms that they want more to be subtracted from the spending.

I think that sends an important political signal to the Congress, and I think it sends an important economic signal to the country; that the people maybe will be more willing to go faster than the politicians. And then it gives the politicians some cover because we are simply doing that which the American people have told us they want done.

Senator SMITH. If I could give a quick response, I think it is very much an implementing tool as well. I agree with what Congressman Walker says.

If you just use one example, let's say that the taxpayers decide that they want to pay off $20 billion a year and the Congress doesn't want to pay any. Well, even if the taxpayers so decide that, it would take 50 years at $20 billion a year to get—retire $1 trillion of what will probably be a $5 or $6 trillion debt, if we are lucky, by the time we get to the balanced budget amendment and get this thing implemented.

So it is a safety valve. It is very important. It gives the taxpayers the opportunity to set the pace of retirement with, you know, with some restrictions. If Congress goes more or less—but they can't go less. That is the point. They can go more, but they can't go less. I think that is why it is exciting.

I think the taxpayers are going to be very excited about this, especially after the balanced budget amendment becomes law, becomes part of the Constitution. I think they are going to be very excited about being a part of it. Everywhere I have gone in the meetings I have had on this, as I am sure Congressman Walker has found out, there is a lot of excitement about it. Some say, Wow, I can see this; I donate $2,000 and I know it is going right to the debt, it can't go anywhere else. It is empowering.

Mr. HERGER. I thank you very much. That is indeed my experience, as I go around the townhall meetings, people feel a sense of

responsibility that we have this huge debt which is on their children and grandchildren, and the excitement of being able to at least do their part, whatever amount that is toward doing away with this debt, again, is very popular, I have found.

So thank you very much. I appreciate it.

Mr. MCCRERY. Mr. Hancock.

Mr. HANCOCK. Thank you, Mr. Chairman.

I have had a little bit of problem explaining this, even though I support it. I think Bob especially knows that I have supported it. In fact, you spoke, I think it was last year, to one of the Ways and Means meetings on this subject.

Actually, aren't we in a situation where we are saying what a lot of us who support the balanced budget amendment wanted, and that is a balanced budget amendment with a spending limit slightly under the taxing limit. In other words, aren't we saying here that we are going to balance the budget, but we are going to start reducing the debt; therefore, we are going to actually spend less money than we have coming in, but we are going to leave it up to the people to designate how much money they want to spend of their taxes toward reducing the debt.

Isn't that what you end up with?

Mr. WALKER. Well, I am not certain that it is exactly that. Remember, as long as there is a deficit, what people are doing is they are designating their money to debt buydown, and so we are in fact, spending that money to buy down a debt which presently exists. But the mandate is as long as there is a deficit, that you have to subtract an equal amount of spending.

Now, Congress can either decide to do the job of finding those spending cuts through a reconciliation process or whatever else they want to do, but if they don't do it, then there is an across-the-board sequester to assure that the spending is cut. So, therefore, what you get during the period you have deficits is you have both debt and deficit coming down at the same time.

Now, once you balance the budget, then you get to the situation where any money that people designate to debt buydown is specifically going to buy down the debt instrument of the Federal Government.

Senator SMITH. That is what I like about it. I mean, assuming we are going to get to the balanced budget, because the amendment will force us to do that, it is the ideal follow on technology, if you will. If you want to use an example that Science and Space Committee Congressman Walker chairs, it is "follow on."

We will get there with a balanced budget, but the balanced budget amendment doesn't say how or if or whatever way we are going to reduce the debt. It just gets us to a balanced budget, which theoretically could leave us at a $5.2 trillion debt forever. This says you can reduce it and here is how much you have to reduce it minimally.

Mr. HANCOCK. Well, and this is the point that I wanted to make, I wanted to get on the record, that in effect what this would do is what I mentioned: It would establish a balanced budget, but a spending limit slightly under the amount of the money that we take in. In other words, you would have to spend less money than you are taking in, if, in fact, you are ever going to reduce the debt.

Mr. WALKER. Yes. After you have wiped out the deficit, you are absolutely right, you are absolutely correct. What you have done is you have prioritized the debt buydown at that point and assured that that would always be the first thing that was done. And so you would end up spending less in order to cover whatever obligation the American people have put on you to get rid of the debt.

Mr. HANCOCK. I guess what I am having a little bit of a problem getting into my own head is, quite frankly, how you can actually start reducing the debt before you get the budget balanced. I don't know how you actually start reducing the debt without a balanced budget.

Senator SMITH. You don't. The amendment would deal with the deficit first until the deficit goes away. When the deficit goes away, then the dollars would go toward the buydown of the debt.

Mr. WALKER. But you actually have to have something that the money is going toward. When people designate the money, you actually have to do something with the money that has been designated, the revenue coming in.

What we are doing is using that revenue to buy down debt instruments. That gives you the actual transaction that is taking place. At the same time we are telling the government that it must eliminate spending at that same amount, so that anything that you are doing in terms of buying down debt is offset with spending, and you are not simply pushing up the spending to perhaps levels higher than the debt that you have eliminated.

Senator SMITH. Congressman Hancock, one other point which needs to be mentioned here. A lot of people don't realize it, but when you pay off $1 billion of the national debt, you are reducing the interest payment about $80 million, depending on roughly what you borrow, 8 or 9 percent, 8 percent, $80 billion for every billion we retire we are saving in interest. So it has a tremendous ripple effect on the whole issue.

Mr. HANCOCK. It is too bad that the Congress didn't recognize when it started borrowing this money in the first place, when they borrow $1 billion that they are paying off $80 million interest expense every year or thereabouts.

So thank you very much.

Mr. MCCRERY. Mr. Collins.

Mr. COLLINS. Mr. Chairman, I have no questions. But I do appreciate the two gentlemen coming and sharing their views with us. I think you have a good idea.

Mr. WALKER. Thank you, Mr. Collins.

I had a note here from you about a question that you have that we need to discuss a little bit because I don't know the exact implications, but I will be happy to work with you.

Mr. COLLINS. Thank you very much.

Mr. MCCRERY. Mr. Christensen.

Mr. CHRISTENSEN. Just a brief comment and a question and I would also echo my fellow colleagues' sentiments for you coming by. I have seen this plan, I campaigned on this idea, Congressman, and when I met with you and you explained it to me I thought it made a lot of common sense.

In his comments earlier this morning, our colleague, Mr. Kleczka, pretty much attacked this proposal. One of his statements

was the fact that this empowers those above-average earners and gives them more say in how their tax dollars are spent in reducing the deficit and eliminating the debt.

Would you care to comment on that, either one of you?

Mr. WALKER. Well, in my view, what it does is assures that we can prioritize some of the spending cuts. If, in fact, it is relatively high-income people who are designating the money, it does tell you maybe some programs that you ought to look at in terms of eliminating spending. If those people are making it very clear that they want the debt to come down, maybe the subsidy programs that go toward them ought to be some of the ones that we look at for elimination.

On the other side of this is, it is taxpayers who are carrying this burden. I mean, we can point to everybody else in society and suggest that they have an equal right to participate, but the bottom line is that when we place these burdens on society, it is the taxpayers who are being required to carry the interest burden and the debt burden and the deficit burden. And all this says is, since we are giving them that obligation, let's give them some say in how we work our way out of it so that they don't have to carry that burden any longer.

I don't see that as a big threat to the Republic. As a matter of fact, I think that ends up strengthening the Republic.

Senator SMITH. Just as an additional comment, I think this is the old class warfare arguments that our friends on the other side like to use, in classifying people in the haves and the have-nots. I think that really is not the issue. It is the debt, it is the debt that is being reduced by the dollars.

We are not—there is no—those taxpayers have no say in what is being reduced. They cannot choose and say, OK, here is $3,000 that I am going to designate for debt retirement, but you got to take it out of, you know, whatever, Medicaid. That is up to the men and women who are elected by American people to do that.

So I think it is a very weak argument. They use it, but I don't think it really holds water.

Mr. WALKER. The other day our colleague from Massachusetts, Joe Kennedy, made a very eloquent argument on the House floor in favor of the balanced budget amendment saying that the people who have suffered the most as a result of the debt and deficit that we have accumulated have been the poorest in our society. If, in fact, we have an implementation strategy here that allows the American people to become directly involved in solving that problem, it is in fact all Americans, including the poorest Americans, who will benefit from that, and it seems to me a pretty good reason for doing that.

Mr. CHRISTENSEN. Thank you very much.

Thank you, Mr. Chairman.

Mr. MCCRERY. Just a quick question, and I apologize for not having researched this myself. But is there a sunset on this legislation?

Mr. WALKER. Well, there is not a specific sunset. I mean, ultimately at the time that you have wiped out the entire debt, there is no longer a need for the program. But the reality is that it prob-

ably should stay in place until you have eliminated the debt, because that is the purpose behind it.

First of all, it eliminates the deficit and then it eliminates the debt. The sunset year is 2008.

Mr. MCCRERY. So 6 years following the balanced budget——

Mr. WALKER. If everybody participated and if everything works optimally, you can get there by the year 2008.

Senator SMITH. That is optimal. It is not reasonable to assume that every single taxpayer is going to put 10 percent in. But if I live to see the debt retired as a result of this or any other plan, I will have lived a full life, no matter what year it is. Hopefully that won't be next year.

Mr. WALKER. In fact, I am told, I am looking at the language of the bill here just put in front of me and we say the "amendments made by this section shall cease to have any effect after the first fiscal year during which there is no public debt."

Mr. MCCRERY. Very good.

Mr. WALKER. So that is the——

Mr. MCCRERY. Well, if we had a war and we had to finance some extra expenditures and create a debt, this bill wouldn't still be on the books and force us to extinguish that debt the next year.

Mr. WALKER. Yes. As a part—this bill is written into the Gramm-Rudman bill, and as I understand it, it allows for this to be set aside in a declared emergency or in the case of war.

Mr. MCCRERY. OK. Well, thank you both for your testimony. It is a great idea. I am supposed to be a cosponsor. If I am not, please put me down.

Mr. WALKER. You are a cosponsor. In fact, I have your name as well as several other members of the panel, and I am very grateful for that.

Mr. MCCRERY. Thank you very much, gentlemen.

Mr. WALKER. Thank you.

Senator SMITH. Thank you.

Mr. MCCRERY. Our next panel is Mr. Ture, from the Institute for Research on the Economics of Taxation; Mr. Merski, Citizens for a Sound Economy; and Mr. Schatz, Citizens Against Government Waste.

Welcome, gentlemen. We appreciate your coming today to share your views with us. Your written testimony will be admitted to the record, and we would like for you to take about 5 minutes each and summarize, if you would, your written testimony.

We will begin with you, Mr. Ture.

STATEMENT OF NORMAN B. TURE, PH.D., PRESIDENT, INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

Mr. TURE. Thank you, Mr. Chairman.

Please accept my commendations for the committee for providing this opportunity to address title XI of H.R. 9. I think the enactment and implementation of title XI would very likely result in a material slowdown in the growth of Federal spending, and in reduction of the Federal budget deficits, as the two previous witnesses have suggested to you. By tying budget policy more closely to the expressed preferences of individual taxpayers, title XI would substan-

tially improve the Federal budget process and increase the efficiency of the fiscal system.

Most Members of the Congress and their constituents alike deplore Federal budget deficits and the resulting requirement for the Federal Government to borrow some of the savings of households and businesses. Notwithstanding, Federal budget deficits are the rule rather than the exception.

In large part, this anomaly results from the fact that the public as a whole can't tell policymakers how much government they are willing to pay for. On the other hand, individuals with a community of interest in obtaining a particular objective for their benefit often organize to persuade policymakers to authorize government programs on behalf of these individuals. This rent seeking has led to proliferation of government programs and activities and expansion of government spending in the aggregate.

Title XI would go a long way toward resolving this problem. It would impose on policymakers the need for much more careful assignment of priorities among government activities and programs. The result would be pressure to curtail programs for particular interest groups in favor of expenditures on behalf of the public as a whole.

Policymaking for any given fiscal year is also very much the prisoner of spending decisions in the past and of the aversion to cutting back on future spending for programs with established beneficiary constituencies. Baseline projections of existing budget program outlays, not the worthiness of those programs, have for the most part dominated budget decisionmaking.

Title XI provides the equivalent of an annual taxpayer referendum concerning the extent to which Federal Government spending should be reduced below the baseline levels for each fiscal year. It would moreover alter the role of baseline spending projections. These projections would be the base from which taxpayer-mandated spending cuts are to be made rather than the base to which outlays are to be added.

Congressman Walker and Senator Smith have suggested the possible size of the spending cuts that title XI would lead to. Whether taxpayers chose to take little or maximum advantage of this opportunity, the aggregate results would be far more accurate than any other poll conveyed to policymakers of the public's views about the level and growth of total Federal spending.

One objection raised to title XI is that it would allow taxpayers to choose only spending cuts, not spending increases. I believe this objection is without substance.

Many people may believe that the government spends too little on this, that, or the other program, but it strains credulity to think that any significant number of people believe that the Federal Government spends too little in the aggregate. Even if the proposed buydown checkoff were to allow taxpayers to indicate that they want an increase in total spending, and are willing to pay more taxes for it, it is most unlikely that any significant number of people would call for a noticeable increase in aggregate Federal outlays.

Another complaint about title XI is that because they pay so much more income taxes, high-income individuals would exert a

disproportionately large influence on total spending. Unless it can be shown, however, that there is a positive correlation between income level and preference regarding total Federal outlays, this complaint is without merit.

Title XI would make an important contribution in improving the content of Federal programs and activities and in reducing the government's use and direction of the economy's production capabilities. Its enactment would significantly enhance fiscal efficiency.

I urge the committee's favorable consideration of title XI.

Thank you.

[The prepared statement follows:]

H.R. 9, Title XI: ENHANCING FISCAL EFFICIENCY

Statement by
Norman B. Ture, President
Institute for Research on the Economics of Taxation (IRET)
to
Committee on Ways and Means
U.S. House of Representatives

February 1, 1995

I am Norman B. Ture, president of the Institute for Research on the Economics of Taxation (IRET). My testimony presents my views, not necessarily those of IRET, about Title XI of H.R. 9, the Taxpayer Debt Buy-Down.

I want to commend the Chairman and the Committee for providing this opportunity to address Title XI. These provisions of H.R. 9, I believe, represent a highly constructive effort to improve the existing federal budget process. Their enactment and implementation would very likely result in a material slowdown in the growth of federal spending and in more constructive federal programs.

By tying budget policy making more closely to the expressed preferences of individual taxpayers, Title XI would substantially improve the federal budget process and increase the efficiency of the fiscal system.

Most members of the Congress and their constituents alike deplore federal budget deficits and the resulting requirement for the federal government to borrow some of the saving of households and businesses. Notwithstanding, federal budget deficits are the rule, rather than the exception. In large part, this anomaly results from the fact that budget policy making for any given fiscal year is very much the prisoner of spending decisions in the past and of the aversion to cutting back on future spending for programs with established beneficiary constituencies. Baseline projections of existing budget program outlays, not the worthiness of those programs, have for the most part dominated budget decisions making, not only impelling excessive expansion of federal spending but also impeding adjustment of spending priorities to the changes in demands for government services that necessarily occur in a dynamic society.

Something must be done to overcome these impairments of the fiscal system. Title XI would meet the requirements for a more efficient fiscal system.

Fiscal Efficiency

In a free society, government budget deficits reflect a fundamental failure of the fiscal system. An efficient fiscal system would provide a volume and composition of government spending programs and activities that conform closely with the public's preferences for the services it wants from its government and the cost it is willing to bear to obtain those services.

Achieving an efficient fiscal system, one that confines government spending to the amount the public is willing to pay for in taxes, requires effective communication between taxpayers and public policy makers. The existing fiscal system suffers from communication breakdown. It operates, therefore, contrary to the preferences of policy makers and the body politic as a whole for getting from rapidly expanding budget outlays and deficits to slower growth, if not actual reduction, in the amount of government spending and much smaller deficits. What is needed is a system that (1) allows policy makers to hear the demands of the constituency as a whole for less government spending and smaller deficits, and (2) effectively satisfies these demands.

Title XI enables every individual income taxpayer to communicate explicit instructions to the executive branch and to the Congress to reduce aggregate budget outlays by as much as 10 percent of individual income tax liabilities. Title XI provides the equivalent of an annual

taxpayer referendum concerning the extent to which federal government spending should be reduced below the baseline levels for each fiscal year. Moreover, the referendum would mandate the Congress to enact these reductions.

Title XI would not impose on taxpayers the impossible task of specifying which government programs are to be cut back by how much from the spending levels they would otherwise reach. Instead, the Congress would have to order the priorities of existing and new spending programs subject to the overall outlay constraint specified by individual income taxpayers. Only if the Congress failed to bring aggregate spending authorizations within the limits set by the buy-down would an across-the-board sequestration take effect.

One of the great virtues of Title XI is that it would alter the influence of baseline spending projections on budget policy making. The projections would serve as the base from which the taxpayer-mandated reductions are to be made, rather than as that to which outlays are to be added.

Expected Results of Implementing Title XI

The enactment of Title XI would very effectively open the lines of communication between taxpayers and policy makers, informing budget makers by how much taxpayers want spending for the coming fiscal year to be reduced from the projected baseline amount. Whether taxpayers chose to take little or maximum advantage of this opportunity, the aggregate results would far more accurately than any other poll convey to policy makers the public's views about the level and growth of total federal spending.

Congressman Walker and Senator Smith have spoken to the subject of the possible budget effects of Title XI, and I have little to add to their statements on this matter. The specific magnitudes of the budget results, in one sense, would be less consequential than what the results would reflect — a measure of what taxpayers generally wish in terms of aggregate levels of government services. As such, these results would also depict a major achievement in enhancing fiscal efficiency.

Criticisms of Title XI

I want to examine two of the objections that have been raised to Title XI. One of these is that the proposed buy-down check-off is one-sided — it would allow individual taxpayers to opt only for less total spending and deny them the opportunity to choose more total federal outlays. The other objection is that upper-income individuals who pay the most taxes, not the public as a whole, would dictate by how much federal spending as a whole must be reduced.

"The Debt Buy-Down Is a One-Way Street" Objection

The objection that the proposed debt buy-down is asymmetrical — that it offers taxpayers the opportunity to call for a cut in federal spending but no chance to ask for increases in federal outlays — is without real substance. It strains credulity to believe that any significant number of people believe that total federal spending is too low or that total federal spending should be greater.

There are to be sure, many individuals who very much want the federal government to undertake programs or activities on their behalf. Very often, individuals with a community of interest in obtaining a particular objective for their benefit form organizations dedicated to persuading policy makers of the worthiness of the organization's objectives and of the desirability of authorizing government programs and activities to achieve them. What these groups are seeking, of course, are benefits that they are unwilling or unable to obtain by their own efforts or for which they are unwilling themselves to pay.

All public policy makers are familiar with this "rent seeking" which has become the hallmark of our times. It is responsible for the enormous proliferation of government programs and activities aimed at benefitting specific groups in the population rather than the population as

a whole. This same proliferation accounts in significant measure for the expansion of aggregate federal spending.

These rent-seeking groups have no concern about the implications of the success of their efforts for the total size of the government, nor do they want expansion of government as a whole. They want, instead, initiation and expansion of activities and programs to serve their particular interests. Even if the proposed debt buy-down check-off were to allow taxpayers to indicate that they want an increase in total government spending, it is highly unlikely that any significant number of people would call for any significant increase in the aggregate amount of federal outlays.

There is, accordingly, no reason to provide any such symmetry in the proposed check-off. The problem that the nation confronts is certainly not that people have no way to get government to hear and to address their demands for government services or benefits. The problem is precisely the reverse — that policy makers are continuously exposed to intensive pressures to add new programs and activities and to expand existing ones on behalf of one or another organized rent-seeking group. And except on rare occasions, policy makers confront no broad-based, organized efforts by the public as a whole to reduce total government outlays, to cut back government programs and activities in general.

The proposed debt buy-down affords individual income taxpayers as a whole the opportunity they do not now have to direct and require policy makers to reduce aggregate government spending. The debt buy-down, moreover, allows the taxpaying public to avoid the maneuver that some policy makers fall back on to finesse calls for less government spending, to wit, "Tell us what specific spending programs you want us to cut."

Individuals can't be expected to name specific spending programs that should be cut. Few, if any of us, are able to identify specific spending programs now in the federal budget. There are probably many individuals who are convinced that the federal government's spending on education, for example, is nonproductive if not, indeed, counterproductive, but it is doubtful that any but a handful of those individuals could identify any specific education program and the amount of its outlays. There is probably a vastly larger number of individuals who are convinced that the federal government is much too large and who do not really much care what programs are curtailed in the interests of greatly reducing the government's presence in our daily lives.

It is not reasonable to ask the public to specify which activities and which programs are to be cut back if aggregate federal outlays are to be reduced. Fortunately, Title XI doesn't make this demand on the public but on the policy makers who are elected with the specific responsibility of making decisions about how much of what government should do.

There is a broadly-based consensus, reflected in the support for a balanced budget amendment, in favor of limiting total federal spending to the amount of taxes people are prepared to pay for government activities. This is a wholly appropriate but nonetheless elusive goal of budget policy. Achieving that goal will require imposing severe limits on initiating or continuing government programs and activities for the benefit of particular groups and particular interests in our society. Government spending, instead, must be concentrated on activities and programs that can be shown to provide benefits for the public as a whole and that exceed the costs they impose.

Title XI will make an important contribution in this respect. By imposing substantial constraints on total spending growth, it will exert continuing, significant pressure on policy makers as a group to set priorities among all the contending program and activity claims that each of them advances. The result is likely to be not only slower growth of government and its reduced presence in people's daily lives but government programs and activities that better meet the demands of the public as a whole.

"The Rich Would Have Too Large a Say in Spending Cut Backs" Objection

Under Title XI, the larger is the amount of an individual's income tax liability, the greater is the amount that the individual can check off for buying down the federal debt and reducing federal spending. The objection that has been raised, not unexpectedly, to this is that it would be unfair to allow people paying substantial amounts of income taxes, i.e., rich people, to exert undue, disproportionate influence over total federal spending — to outvote the poor who pay little in income taxes. But one should ask why it is unfair for those who pay a large amount of income taxes to defray the costs of government to have a larger voice concerning how much the government spends than those who pay little or no income taxes? Indeed, isn't it, instead, unfair for people who pay very little or nothing for the services of government on their behalf to insist that the voices of those who pay for those services should be muted?

The implication, clearly, is that people paying a lot of federal income taxes want the government to do less while people who pay little income tax want the government to spend more. It's difficult to identify any basis for this difference in viewpoint, in the abstract, and it's highly doubtful that there is, in fact, any such income-based difference in preference.

This does not gainsay that people at any taxable income level are likely to oppose cutbacks in government programs of which they are the beneficiaries. As noted above, however, this desire for the government to maintain or enlarge programs on one's behalf doesn't mean one prefers higher amounts of government activities and spending.

Title XI's Contribution to Long-Term Improvement in Budget Policy

The Bipartisan Commission on Entitlements and Tax Reform has performed an invaluable service in alerting the nation to the looming fiscal catastrophe that will overtake us if entitlement spending growth is not materially slowed or tax revenues enormously increased. Reasonable projections of existing law entitlement outlays and tax revenues show that within a generation's time entitlement spending alone will take up every dime of federal revenues. The resulting budget deficits will be in the range of 15 to 20 percent of GDP, and federal borrowing will preempt all of the nation's saving, leaving no saving to finance capital formation. These results foretell a shrinking economy, one in which the living standards of the growing American population will fall at a significant rate.

Even if one substantially discounts these projections of fiscal crisis, prudence dictates that budget policy must very soon turn to putting the brakes on federal spending growth, particularly of entitlement programs. Title XI has the great virtue of giving the public at large the opportunity to fortify policy makers' resolve to address these budgetary difficulties. I urge this Committee's favorable consideration of Title XI of H.R. 9.

Mr. HERGER [presiding]. Thank you very much, Mr. Ture.
Mr. Merski.

STATEMENT OF PAUL G. MERSKI, DIRECTOR, TAX AND BUDGET POLICY, CITIZENS FOR A SOUND ECONOMY

Mr MERSKI. Thank you, Mr. Chairman and members of this committee.

My name is Paul Merski. I am here on behalf of the 250,000 members of Citizens for a Sound Economy. Our members throughout the country have fought long and hard to reduce deficit spending and to bring down our national debt burden.

We give full support to the Taxpayer Debt Buydown Act, a proposal that would empower taxpayers directly to help reduce the national deficit and bring down the debt. Our 250,000 members were instrumental in helping to pass the balanced budget amendment in the House last week.

We believe that the passage of the balanced budget amendment would give even greater urgency to passing sensible proposals like the Taxpayer Debt Buydown Act to help ensure that a balanced Federal budget will become a reality.

Understandably, the American taxpayer has become increasingly frustrated at the inability of policymakers to halt the trend of Federal spending and higher taxes. I believe we clearly witnessed voters venting this frustration this past November 8. Most previous attempts to reduce the deficit and bring the budget into balance has met with little success. So, in order to bring fiscal sanity to the budget process and to lower our national debt, new thinking and new ideas are needed.

Including the 1993 Budget Act signed into law by President Clinton, there have been no less than six major budget deals enacted over the past decade that promised taxpayers a reversal in the trend of deficit spending and a path to a balanced Federal budget.

While it may be too early to see the full results of President Clinton's budget deal that included a record $248 billion tax hike, the failure of similar attempts to reduce the deficit are quite clear.

Under the guise of deficit reduction, combinations of major tax hikes and promised spending cuts were agreed to by Congress in 1982, 1984, 1985, 1987, 1989, 1990, and 1993. Each and every time the results were the same: Greater tax burdens, increased spending and persistent deficits.

Congress' own frustration with persistent budget deficits was vented with the passage of the original Gramm-Rudman-Hollings act in 1985. Unfortunately, even GRH was subverted by Congress and has since been superseded by other legislations. Taxpayers were left with higher taxes, and little deficit reduction to show for it.

While taxpayers may feel betrayed and helpless in their attempt to reduce deficit spending, the Taxpayer Debt Buydown Act—or the 10 percent checkoff—on their tax form would provide them with a unique opportunity to become directly involved in reducing deficit spending if Congress cannot. All taxpayers by the means of a simple checkoff on their tax return could dedicate up to 10 percent of their tax liability specifically toward the payment of the Federal budget deficit and to bring down the debt.

The uniqueness of the 10 percent checkoff approach to deficit reduction is that it breaks from the traditional call of more tax revenues that have in the past actually fostered spending increases rather than reductions. The taxpayer 10 percent checkoff would not represent any new tax liability or burden; it is simply a matter of voluntarily choosing anywhere between 1 and 10 percent of your existing tax liability to reduce the deficit and debt.

I think taxpayers could at last directly enforce the discipline on Washington that it hasn't seen in quite a while.

In the current budget situation, tax revenues intended to go toward deficit reduction can simply be spent. But under provisions in the Debt Buydown Act, the revenues taxpayers designate to reduce the debt cannot lead to increased spending. It would be placed in a debt retirement trust fund and, most importantly, would mandate an equivalent amount of real spending reductions.

Let me just say that I think there is plenty of room for additional spending cuts in our $1.6 trillion budget. Despite the claims by many lawmakers that there will be draconian cuts, because of deceptive baseline budgeting, we will be spending more each year over the next several years than we are in the current fiscal year.

In addition to the balanced budget amendment, we also support a Presidential line-item veto. Those two proposals, with the Taxpayer Buydown Act, provide simple and reasonable solutions that would allow taxpayers the ability to get our fiscal house in order.

Thank you.

[The prepared statement follows:]

Testimony of

Paul G. Merski
Director of Tax and Budget Policy

Citizens for a Sound Economy

before the

Committee on Ways and Means
United States House of Representatives

on

The Taxpayer Debt Buy-Down Act

February 1, 1995

Mr. Chairman and Members of this Committee, thank you for the opportunity to speak before you today. My name is Paul Merski, and I am here on behalf of the 250,000 members of Citizens for a Sound Economy (CSE), a non-profit, citizens group formed in 1984 to develop market-based solutions to public policy problems.

Our members throughout the country have fought long and hard to help reduce federal deficit spending and to bring down our national debt burden. We give full support to the Taxpayer Debt Buy-Down Act, a proposal that would empower taxpayers directly to help reduce the national deficit and debt by reducing federal spending instead of increasing taxes. Our 250,000 members were instrumental in helping pass the Balanced Budget Amendment in the House just last week. We believe that the passage of a Balanced Budget Amendment gives greater urgency to passing sensible proposals like the Taxpayer Debt Buy-Down Act to help ensure that a balanced federal budget will become a reality.

Introduction

Understandably, the American taxpayer has become increasingly frustrated at the inability of policymakers to halt the trend of federal deficit spending and higher taxes. I believe we clearly witnessed voters venting this frustrations this past November 8th. Previous attempts to reduce deficit spending and balance the budget have met will little success.

To bring fiscal sanity to the budget process and to lower our nation's debt, new thinking and new ideas are needed. Including the Omnibus Budget Reconciliation Act of 1993 signed into law by President Clinton), there have been no less than six major budget deals enacted over the past decade that promised taxpayers a reversal in the trend of deficit spending and a path to a balanced federal budget. While it may be too early to see the full results of President Clinton's recent budget deal that included a record $248 billion tax hike, the failures of similar attempts to reduce the deficit are quite clear.

Under the guise of deficit reduction, combinations of major tax hikes and promised spending cuts were agreed to by Congress in 1982, 1984, 1985, 1987, 1989, 1990, and 1993. Each and every time the results were the same: greater tax burdens, increased spending, and persistent deficits. Congress' own frustration with persistent budget deficits was vented with the passage of the original Gramm-Rudman-Hollings Act (GRH) in 1985. GRH contained an automatic sequester mechanism that was intended to cut spending even when Congress could not.

Unfortunately, even this seemingly fool-proof mechanism was subverted by policymakers when an actual $16 billion sequester would have been triggered in 1989. The sequester was simply replaced by a new budget deal that allowed Congress to avoid any tough spending cuts, raise taxes, and stretch out the balanced budget target date further into the future. The budget controls in GRH were further weakened and eventually eliminated by subsequent budget deals that left taxpayers with higher tax burdens and little if any deficit reduction to show for it.

The history lesson of the "budget deal" approach to deficit reduction is clear. Tax increases matched with promised spending cuts have not reduced the deficit over the long term. Inevitably, the promised spending cuts either never materialize or are offset by new spending increases in the budget. Unfortunately, President Clinton's 1993 budget deal once again paired immediate tax hikes (even retroactive tax hikes) with the promise of major spending cuts in the future. However, as history has proven, the only spending cuts that can be counted on are reductions in the budget authority of the current fiscal year, not promised future reductions from increased spending baselines four or five years down the road.

Taxpayers' Recourse

While taxpayers may feel betrayed and helpless in their attempt to reduce deficit spending, the Taxpayer Debt Buy-Down Act (the 10-percent checkoff) would provide them with a unique opportunity to become directly involved in reducing deficit spending if Congress cannot. All taxpayers, by means of a simple checkoff on their tax return, could dedicate up to 10 percent of their tax liability specifically toward the payment of the federal budget deficit.

When the deficit is paid down and the budget is balanced, the funds would then go to reducing the national debt, which is now well over $4.5 trillion and growing. It's a simple fact, until deficit spending is completely eliminated, the national debt will only continue to grow. Currently, one of every seven dollars taxpayers send to Washington must be spent just to pay the interest on our national debt.

The uniqueness of the 10-percent checkoff approach to deficit reduction is that it breaks from the traditional call for more tax revenues that have in the past actually fostered spending increases rather than reductions. The taxpayers' 10-percent checkoff would not represent a new tax liability or burden. It is simply a matter of voluntarily choosing anywhere between 1 and 10 percent of your existing tax liability to help reduce the deficit and debt.

For example, a taxpayer with a $5,000 income tax liability could designate up to 10 percent (or $500) of his taxes to go directly to deficit reduction. The key is that it is a voluntary proposal that lets taxpayers decide themselves the importance of deficit reduction. It is an empowerment issue on the part of the taxpayer. Nothing is mandated until taxpayers designate it by exercising their checkoff option. No lawmaker could be accused of cutting spending against the will of the taxpayer.

Spending Control With Teeth

Taxpayers have repeatedly endured tax increases paired with the promise of future spending cuts that never materialize. That's because there is nothing to stop the new revenues from simply being spent on new or existing federal programs. However, the 10 percent checkoff proposal also provides the means to achieve real spending reduction. By checking off an amount to go toward debt reduction, each individual taxpayer would simultaneously authorize a corresponding dollar-for-dollar reduction in federal spending, except for spending on Social Security, mandatory interest payments on the debt, federal deposit insurance, and other contractual obligations of the federal government.

After the April 15 tax return deadline, the Treasury Department would be required to provide Congress with an estimate of the total amount of money taxpayers have designated to go towards debt reduction. Congress would have more than a year to make any needed spending reductions before a sequester would be mandated. This would enforce taxpayers' wishes that Congress uses the money to both reduce government indebtedness as well as federal spending growth.

If Congress fails to make the designated amount of spending cuts called for by taxpayers, the automatic across-the-board cut (sequester) would kick in. Social Security, net interest, and deposit insurance spending would be exempt. Tax increases would not be allowed to substitute for the required sequestration.

Taxpayers could at last directly force fiscal discipline on Washington. In the current budget situation, tax revenues intended to go toward deficit reduction can simply be spent. But, under the provisions in the Debt Buy-Down Act, the revenue taxpayers designate to reduce the debt cannot lead to increased spending. It would be placed into a debt retirement trust fund and, most importantly, would mandate an equivalent amount of real spending reduction.

This process would repeat each year, further reducing the deficit as well as the spending baseline. The legislation is intended to make spending reductions permanent. A program would be prevented from returning to its previous spending level after a sequestration.

The exact amount of debt reduction that taxpayers would check off cannot be easily estimated since there is insufficient information on how many taxpayers would participate, at what level between zero and ten percent would they choose, and for how long they would participate. However, the Congressional Budget Office has calculated the full deficit reduction potential of the plan illustrating a budget surplus in five years. For example, income tax revenues for 1994 are estimated to be $531 billion. Therefore, the maximum amount that can be dedicated to deficit reduction and matching spending cuts would be $53.1 billion (10% of $531). Additionally, this single year's spending reduction would generate savings in all future years, as programs are barred from returning to previous spending plans. Therefore, even a relatively modest level of participation in the checkoff plan can generate significant future savings as the baseline spending level is reduced.

Plenty Of Room For Savings

Clearly, there is plenty of room for additional spending cuts in a $1.52 trillion per year federal budget. Despite the claim by many lawmakers that draconian spending cuts would be needed, deceptive baseline budgeting currently allows policy makers to spend more, not less, each year while claiming spending has been cut. In the current fiscal year the federal government will spend an estimated $1.52 trillion (which most Americans believe is too high) but, by the year 2000, federal spending will have risen to $1.93 trillion.

While many policymakers are pressured to preserve and increase spending by the multitude of well-organized, well-funded, special-interest groups, the spending cuts demanded by taxpayers themselves under the 10-percent checkoff plan may provide the pressure needed to make a real dent in deficit spending.

Even with a Constitutional Balanced Budget Amendment, additional controls on the federal budget process are needed to ensure taxpayers that the chronic deficit spending situation will improve. In addition to the Balanced Budget Amendment and the 10-percent checkoff plan, CSE's members also support granting line-item veto authority to the President as viable means to control deficit spending.

Taxpayers who just experienced two major federal tax hikes in 1990 and 1993 should at least be granted the ability to help make sure that the deficit reduction promised them is achieved. For Americans to be able to continue increasing their standard of living, government taxing and spending cannot continue to consume a larger and larger portion of their economic efforts. It is devastating to allow the growth rate of the federal debt to outpace our economic growth rate. Many Americans know the effects of running up credit cards and struggling just to pay the interest cost and balance. Taxpayers must balance their checkbooks and they demand now more than ever that elected representatives balance the federal budget books as well. The Taxpayer Debt Buy-Down Act provides a simple and reasonable solution that would allow taxpayers the ability to help get our nation's fiscal house in order.

I thank the Committee for allowing me to testify and would be glad to answer any questions you may have.

Mr. HERGER [presiding]. Thank you very much, Mr. Merski.
Mr. Schatz.

STATEMENT OF THOMAS A. SCHATZ, PRESIDENT, CITIZENS AGAINST GOVERNMENT WASTE

Mr. SCHATZ. Thank you very much, Mr. Chairman.

I appreciate the opportunity to appear before this committee today. My name is Tom Schatz, and I represent the 600,000 members of Citizens Against Government Waste.

In 1993, I testified before the Ways and Means Subcommittee on Select Revenue Measures concerning the Taxpayer Debt Buydown Act, and we greatly appreciate its inclusion in the Contract With America and the legislation that you are considering today.

CAGW supported Representative Walker's and Senator Smith's legislation then, and we continue to believe it represents a real change in the power base in this country. Since Congress has not done its job, it is time for those most directly affected to have their say.

In 1993, I commented to the Subcommittee on Select Revenue Measures that taxpayer agitation and anger is extremely high, but it has not peaked. It may have peaked on November 8, 1994. The message was sent and it must be heeded.

Taxpayers are looking for a plan from the 104th Congress to reduce the deficit, pay down the debt, avoid higher taxes, and regain some control over how Washington spends their money. The Taxpayer Debt Buydown Act allows individual taxpayers to check off a box on their tax return and designate up to 10 percent of their tax liability to a public debt reduction fund to buy down the public debt.

To ensure the contributions to the fund are not offset by higher outlays, the buydown would be matched by equivalent across-the-board spending cuts in all programs except Social Security retirement benefits, interest on the debt, deposit insurance, and a few other minor contractual obligations of the Federal Government.

The true test for the new Congress is to pass meaningful legislation that will once again connect American workers with the government they elect and give them greater control over what is spent. After all, it is their money.

As Mr. Walker noted, both OMB and CBO agree that full participation in the checkoff would balance the budget in 6 years and zero out the debt by fiscal year 2008.

The consequences of failing to eliminate deficits and the debt are devastating. Under current projections, there would be a $12 trillion national debt in 2008; in fiscal year 2012, interest payments and entitlements will eat up all government revenues.

Why is CAGW committed to the Taxpayer Debt Buydown Act? Mr. Chairman, the unchecked growth of public debt and deficits is slowly smothering America's economic strength. This is America's 26th year of unbalanced budgets and recordbreaking deficits. This should not be par for the course.

First, the total debt for liabilities, contingencies and financial obligations for government at all levels may be as high as $17 trillion. This is a number that boggles the mind. It is almost incomprehensible. It is also a number that will continue to grow over the

next 5 years no matter what we do to balance spending or balance the budget.

At the Federal level, the national debt of $4.7 trillion today will be more than $6 trillion at the end of fiscal year 1998. Gross interest on the debt, $320 billion in fiscal year 1994, will also continue to rise, reaching, according to CBO calculations, $407 billion in 1998. And if the projections are wrong, and deficits and interest rates are greater, we may be looking at interest payments far greater than that amount.

Mr. Chairman, under any scenario, in the next 15 years or so this country is facing near bankruptcy if we do not address our massive debt and interest payments.

What happens when you cannot repay your debt? For example, if you had four Argentine pesos in 1946, and you had put one in your pocket, do you know how many pesos it would equal today for that single piece of currency? Two point three trillion pesos. In Brazil, you would get 800 to 900 billion pieces of currency for a 1946 coin. People may say this is the United States and we cannot suffer hyperinflation. Argentina was the flagship of South America in 1946 and now the country lies in financial ruins.

This legislation deserves a chance to succeed. The House of Representatives took a major step forward last week by overwhelmingly passing the balanced budget amendment. This week the Senate will begin to debate the balanced budget amendment. Americans know that trimming here and there does not work anymore. The stakes are too high.

When I testified on this bill several years ago some members of the Select Revenue Measures Subcommittee called it irresponsible. We think it is irresponsible to fail to balance the budget and pay down the debt. It is irresponsible to tell the American people that government will collapse, when even with maximum taxpayer participation in the buydown plan, outlays would continue to increase. And it is irresponsible to fail to reorder spending priorities and eliminate nonessential programs in order to eliminate deficits and the debt.

Mr. Chairman, we need to trust the American people to make decisions that have not been made inside the beltway. It is immoral to pass on a massive debt to the next generation and ruin their standard of living. That is why we support the Taxpayer Debt Buydown Act, which would, for the first time, place into the hands of those people who bear the burden of the national debt the power to pay it back. It is time to get it done.

Thank you.

[The prepared statement follows:]

Testimony of
Thomas A. Schatz
President of Citizens Against Government Waste
before the
House Ways and Means Committee
February 1, 1995

Good Afternoon, Mr. Chairman. Thank you for the opportunity to appear before this committee today. I would ask that my written statement be entered into the record.

My name is Tom Schatz and I represent the 600,000 members of Citizens Against Government Waste (CCAGW). In 1993, I testified before the Ways and Means Subcommittee on Select Revenue Measures concerning the Taxpayer Debt Buy-Down Act. CAGW supported Rep. Walker's (R-PA) and Senator Bob Smith's (R-NH) legislation then and we continue to believe it represents a real change in the power base in this country. The Taxpayer Debt Buy-Down Act would shift from legislators to taxpayers the ability to reduce the deficit and debt. Since Congress has not done the job, it's time for those most directly affected to take over.

CAGW was created 11 years ago after Peter Grace presented to President Ronald Reagan 2,478 findings and recommendations of the Grace Commission (formally known as the President's Private Sector Survey on Cost Control). These recommendations provided a blueprint for a more efficient, effective, less wasteful, and smaller government.

Since 1986, the implementation of Grace Commission recommendations has helped save taxpayers more than $250 billion. Other CAGW cost-cutting proposals enacted in 1993 and 1994 will save more than $100 billion over the next five years. CAGW has been working tirelessly to carry out the Grace Commission's mission to eliminate government waste.

In 1993, I commented to the Ways and Means Subcommittee on Select Revenue Measures that "taxpayer agitation and anger is extremely high, but it has not peaked." On November 8, 1994, the people's frustration reached a new level. A message was sent, and must be heeded.

Every year, working Americans see the first five months of their hard- earned dollars given to local, state, and federal taxes. For many, taxes at all levels eat up 40 percent or more of their gross income. That's more than enough. They do not want the deficit reduced with increased taxes.

Taxpayers also feel disconnected to Washington. They are not in charge and they are not truly empowered. The true test for the new Congress is to pass meaningful legislation that will once again connect American workers with the government they elect and give them greater control over what is, after all, their money.

The purpose of today's hearing is to discuss the Taxpayer Debt Buy-Down Act (Title XI of H.R. 9, "The Job Creation and Wage Enhancement Act"), to establish a debt reduction trust fund in the Department of the Treasury, into which up to 10% of an individual's income tax liability would be deposited to help pay off the national debt through a check-off on tax returns. This is a simple, revolutionary, and essential idea with huge consequences.

Both OMB and CBO agree that full participation in the check-off would balance the budget in six years, and zero out the debt by fiscal year 2008. The consequences of failing to eliminate deficits and the debt are devastating: under current projections, in fiscal year 2012, interest payments and entitlements will eat up all government revenues.

President Clinton told the American people last week that many courageous members of Congress who voted for his deficit reduction package in 1993 were voted out of office. What the president failed to tell us is that the 105th and 106th Congresses will have to vote to implement over 80% of those cuts -- so much for courage. Politicians so far have just not been up to the challenge. The cradle-to-grave mentality of big brother government has penetrated deeply into Washington's psyche -- there needs to be another check and balance from the taxpayer.

Why is CAGW committed to the Taxpayer Debt Buy-Down Act? This is America's 26th year of unbalanced budgets and record-breaking deficits. First, the total debt for liabilities, contingencies, and financial obligations for the U.S. government is $17 trillion. This is a number that boggles the mind; it's almost incomprehensible. It's also a number that will continue to grow over the next five years. At the federal level, the national debt of $4.7 trillion today will be more than $6 trillion at the end of fiscal year 1998.

Gross interest on the national debt, $320 billion in FY 1994, will continue to rise, reaching, according to CBO calculations, $407 billion in 1998. If the projections are wrong, and deficits and interest rates are

greater, we may be looking at interest payments twice that amount, or more than $800 billion.

Mr. Walker testified earlier that on our current path, the debt will exceed $12 trillion in FY 2008; at 6% interest -- a modest historic average -- that's a payment of $780 billion. Could it happen 10 years earlier? Why not? Did anyone think interest rates would be more than 18% in the late 1970s? Just as a point of information, 18% of $6 trillion is nearly $1.1 trillion.

Mr. Chairman, under any scenario in the next 15 or so years, this country is facing bankruptcy without addressing our massive debt and interest payments.

What happens when you can't repay your debt? For example, if you had four Argentine pesos in 1946, and you had put one in your pocket, do you know how many you would get today for that single piece of currency? 2.3 trillion pesos. In Brazil, you would get 800-900 billion pieces of currency for a 1946 coin. People may say, "this is the United States, we can't suffer hyperinflation." Argentina was the flagship of South America in 1946 and now the country lies in financial ruins.

This legislation deserves a chance to succeed. The House of Representatives took a major step forward last week by overwhelmingly passing the Balanced Budget Amendment (BBA). This week the Senate will begin to debate the BBA. If we are serious about balancing America's budget, we need all ideas of reform and spending cuts out on the table and moved forward quickly by Congress. Americans are savvy enough to recognize we are in a fiscal time-bomb. Trimming here and there does not work anymore. The stakes are too high.

The last time I testified on this bill, some members of the House Ways and Means Subcommittee on Select Revenue Measures called the Walker-Smith bill "irresponsible." I object. It's the height of irresponsibility to fail to balance the budget and pay down the debt. It's irresponsible to have failed to balance the budget since 1969 while running up a $4.7 trillion national debt. It's irresponsible to tell the American people that government will collapse when even with maximum taxpayer participation in the Buy-Down plan, outlays would continue to increase. It is irresponsible to predict the collapse of government on funding levels which are higher that those that we have today. And it is irresponsible to

fail to reorder spending priorities and eliminate non-essential programs in order to eliminate deficits and the debt.

Is Congress really more responsible than the American people? Do we not trust them to make decisions that have not been made inside the Beltway? What about the morality of passing on a massive debt to the next generation and ruining their standard of living? Do opponents of the Buy-Down Act plan to balance the budget with massive tax increases, which have not proven effective in the past?

Mr. Chairman, the Taxpayer Debt Buy-Down Act would, for the first time, place into the hands of those people who will bear the burden of the national debt the power to pay it back. It's time to get it done.

Some have raised the question of how reduced participation in the presidential taxpayer check-off program would affect interest in the debt buy-down check-off. Very simply, Mr. Chairman, taxpayers would be far more likely to check a box that saves them money rather than one that costs them money.

It is time to clean up Washington. It is time to stand up to the special interests that will claim their programs can't be cut. It is time to recognize that the only way to help our children and grandchildren is to enact a plan to eliminate the massive debt that will ruin their futures.

The Taxpayer Buy-Down Act will let the real owners of this country, the taxpayers, do just that. I would be happy to answer any questions.

Mr. HERGER [presiding]. Thank you very much for your testimony, Mr. Schatz.

Mr. Ture, if you could maybe comment, with the public expecting Congress to balance the budget with the passage of the constitutional amendment, would you expect any change in the checkoff participation rate?

Mr. TURE. You know, I suspect that the effect on the checkoff rate would probably be positive if a balanced budget amendment passes the Senate as well as the House.

I think that people would see that there really is some determination on the part of the Congress, and one would hope on the part of the States, to bring the Federal Government's fiscal affairs in order. And I think it would focus their attention on their ability to communicate to you and your colleagues, Here is what we would like to see happen.

They do not have that—there is no way in which they can provide that communication today. You can have some of your constituents come in and tell you about how delightful this, that, or the other program would be on their behalf, and they may or may not persuade you. But you cannot get your constituency as a whole to come in and say, We think you are spending too much. They do not have a vehicle for expressing that to you, except perhaps as they did last November.

Give them an opportunity to, in effect, write it down on that single most important document they confront during the course of a calendar year, their tax returns. That is a message you cannot ignore, and I think they would be energized to provide you that message if they really thought, as attested to by a balanced budget amendment, that you guys meant it; that you were serious about it.

Mr. HERGER. Thank you again for your testimony.

Mr. Kleczka will inquire.

Mr. KLECZKA. Thank you, Mr. Chairman.

I do not know if you gentlemen were here for my opening statement on this issue this morning, but I might indicate that I have my misgivings about it. There were those in years past who called it irresponsible. I would go as far as calling it misguided.

I see that in the Walker testimony that the program has been changed somewhat, wherein if in fact Congress were to pass a reconciliation bill of $50 billion, the deficit checkoff would total $40 billion, at that point no action would need to be taken.

I am saying at that point, if that is the new change in the legislation we will be considering, then you have really made it a sham. Because all those folks who checked the box thinking this was really going to do something above and beyond what has already been done, have just been not lied to but have not been honest with, OK?

So, now maybe I have to amend my remarks by saying it is misguided and now it is going to the point of being phony also.

But if in fact we want to give taxpayers of this country the right to help us budget on form 1040, my idea this morning, and it is still a high priority of mine, would be to give them two options.

Number one, one box for deficit reduction. If in fact you check that box, we will provide a series of boxes in the next column with

broad categories of Federal spending, like defense, like welfare, like veterans benefits. And let us ask those same taxpayers to further help Congress out and check one or more of the other boxes. Because what will happen is, once we add this option, if this ever goes through, God forbid, we are going to be faced with not only all the cuts we have to activate because of the tax cuts that are coming before this committee, but other portions of the Contract will have more spending cuts. The balanced budget will entail more spending cuts, and at that point I think there comes a time where if we are to be told in one year, late in that year, that you need to do another $50 billion, we will have serious problems around here.

So I am saying let us ask the taxpayers to identify their least-liked program and have another column and check a box there.

Would you gentlemen support that amendment?

Mr. TURE. No, sir, I would not. In my testimony, the full statement, you will find that I have a discussion of that very point. And let me see if I can very briefly——

Mr. KLECZKA. I do have 5 minutes and I want the other panelists to also respond.

Mr. TURE. I will very briefly address it. I think you will have a great deal of difficulty selecting at random any 100 taxpayers and ask them to identify 5 explicit line items in the budget.

Mr. KLECZKA. I said broad categories.

Mr. TURE. Broad categories.

Mr. KLECZKA. Defense, welfare.

Mr. TURE. No, I think that is an unfair demand to make of the taxpayer. Taxpayers know or have a feeling that they are being asked to finance too much government. I think you have gotten that message very loudly and clearly last November. If you ask them specific programs or even specific categories of programs——

Mr. KLECZKA. Broad, not specific. Broad.

Mr. TURE. Broad programs. I think you are asking them to do something they are not capable of doing.

Mr. KLECZKA. Would the other gentlemen like to respond also?

Mr. SCHATZ. We did a survey of our members in December, and I can assure you that there is very little they would wish to exempt, other than Social Security, which I think really addresses everything that everyone has been saying here. Everything should be on the table.

Mr. KLECZKA. Including defense?

Mr. SCHATZ. Including defense.

Mr. KLECZKA. So your group is not too enamored with us increasing defense spending?

Mr. SCHATZ. I did not say that. I think there is plenty of room to make cuts in defense. I think everyone has agreed, including the President, that there is a need to increase spending on defense. But there are reductions, there is still procurement reform and management changes you can make. You can do a lot of things without affecting readiness, which, again, I think everybody agrees upon.

Mr. MERSKI. I think I would have a problem of asking taxpayers to do Congress' job of identifying where the waste, fraud and abuse and spending could be cut. I do not think anyone is losing any sleep at night that spending would be cut too fast or too much.

What I would say is that identifying broad categories of spending cuts is part of the political process up here right now, and I do not see putting a broad category on a tax return helping that effort in any significant way. And, in fact, the legislation has an across-the-board sequester if the spending cuts are not made. So it would cover all programs if cuts were not identified by policymakers who are supposed to be making those cuts in the first place.

Mr. KLECZKA. Let me, in closing, cite an article that was in The Hill, a newspaper that circulates around here. It indicates that Jim Kolbe and another Member, Joe Knollenberg, introduced a welfare proposal today that would allow citizens to direct up to 10 percent of their income tax bill to private charity.

So now we have the taxpayers checking off 10 percent for deficit reduction, here is another 10 percent for charity. I am assuming there will be some other ideas. We will get to the point where all 100 percent is already earmarked, and at that point you do not need the Congress: Government will have to run without it.

So this proposal, I restate, is misguided, and I know full well it will be followed by others, like the Kolbe proposal, where they have a pet program and they want 10 percent of the pie, and all of a sudden, my friends, we will run out of the pie.

Thank you.

Mr. HERGER. Thank you, Mr. Kleczka.

The gentleman from Missouri, Mr. Hancock.

Mr. HANCOCK. Thank you very much.

I would like to say to this particular panel that I hope you will continue to send me the reports and the information that you periodically send out. I have used it extensively over the last 6 years that I have been in the Congress and before. In fact, I supported your organizations before I came into the Congress.

I would like to make just this one comment. After what has gone on here just in the past couple of days, I have a little reservation about a public debt reduction trust fund, after I see what has happened over there in the White House having to do with the Currency Stabilization Trust Fund. I might just throw that out for you to think about.

Thank you.

Mr. HERGER. Thank you.

The gentleman from Maryland, Mr. Cardin.

Mr. CARDIN. Thank you, Mr. Chairman.

Let me thank our three panelists for their testimony here. I agree that we need to take responsible action to reduce the Federal deficit, and I would suggest that perhaps the most important thing we could do is to make sure we do the spending cuts that are necessary to get us on the glidepath to reduce the Federal deficit, before we take up the tax cut bill that is before this committee.

The tax cut bill would reduce revenues by $720 billion, according to Treasury. Congress has never been able to cut that much out of spending. It is interesting that we do not have any specific proposals to reduce spending by the leadership, but we do have a specific proposal to reduce revenues.

So I would hope, if we are at all serious about deficit reduction, we will start talking about slowing down the tax cut bill until we

know we have the revenues in order to pay for it and continue deficit reduction.

And I would assume that my colleagues would agree with that, and the witnesses, who are serious about deficit reduction, will be equally articulate about making sure the tax bill is paid for and we are on deficit reduction.

I think Mr. Walker is correct in trying to find a way to get the average person involved in deficit reduction, and I thank Mr. Walker for being here today and staying through the hearing and presenting a proposal. I am glad to see that there have been changes made in his proposal. I think those changes were needed. I think additional changes are still needed.

One thing that I would urge is that we do not put this proposal on a fast track. Let us work together, as Democrats and Republicans, and see if we cannot find a way to get the taxpayer involved in deficit reduction without any unintended consequences, which I think this legislation still would have.

I am still not clear as to whether the checkoff is 1 year or cumulative. At least in one version of the bill there was a cumulative checkoff, so that if in one year you had $10 billion, that became the base for year two; then in year two if you had another $10 billion, it became $20 billion for that year. And I assume eventually 100 percent of our tax collections would go for deficit reduction if you followed that logic. And I assume that was not the intent of the sponsors, but I want to be sure we do not have unintended consequences.

I would also suggest that, as presently constituted, I am not sure we will accomplish the objective that you have brought out in your testimony. I am not sure the public will have confidence that it is participating in deficit reduction if their action in year one does not really become reality for a couple years later.

If I understand, it would be 1994 taxes that would actually go to reduce deficits in 1997. And that seems a little bit far removed for us to be able to make a case to our taxpayers that, in fact, they are directly participating in deficit reduction.

I am also concerned by the perception that will be out there that you may be voting for deficit reduction, but if reconciliation—which my taxpayers have absolutely no knowledge at all of what reconciliation means—is higher, then your vote for deficit reduction has no impact. They are not going to understand that. They will not understand what that means. I also think we will lose a little bit of credibility there.

And I would point out, and I appreciate the response that has already been made on the class issue, that only people who have large tax liabilities have a chance to vote here. But, remember, we are not talking about dollar-for-dollar reduction. If I understand it, we are talking about the potential for some across-the-board reduction in Federal spending, which is a policy decision being made by people who have more wealth than people who do not have wealth, because they do not have a chance to vote. That is a policy determination. And we are doing that by dollars.

So I guess my question—and you only have 10 seconds to respond, unfortunately—is that understanding this is not going to be today's dollars paying off today's debt, but today's dollars paying off

tomorrow's debt, and that the unpredictability of whether it will mean anything at all, whether we will gain any credibility with the public at all with this proposal, that they are in fact participating in deficit reduction.

Mr. SCHATZ. I would just say very quickly that it is a little bit, maybe, like a savings account. People are giving money now, and if you explain to them what the situation is, I think they would be perfectly willing to do that. I know I would. Maybe because we are so involved as an organization in this, and I am sure many of our members would.

Say a contribution from an individual that comes into this organization may or may not get spent in the same year, but the fact is that they are looking at getting rid of the debt. And if it takes 2, 3, 4, or 5 years, they know it is being set aside for that purpose. That is critical.

Mr. CARDIN. Of course, you know people can add to their tax liability today and pay off the debt, and very few people do. We will take a check from you right now to help pay off the debt.

Mr. SCHATZ. I am afraid I don't have $17,000. I am sorry.

Mr. HERGER. Let's see, Mr. Christensen does not have any questions.

Anyone else for any followup?

I thank our panelists. It has been very helpful. And with that, this Committee of Ways and Means will stand adjourned.

Thank you.

[Whereupon, at 2:55 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

Statement of the
American Automobile Manufacturers Association
Submitted for the Record

Committee on Ways and Means
U.S. House of Representatives

Hearings on H.R. 9
The Job Creation and Wage Enhancement Bill of 1995

The American Automobile Manufacturers Association (AAMA) appreciates the opportunity to submit this statement for the record on section 12002 of H.R. 9, a provision that has important economic implications for countless small firms that purchase motor vehicles for use in their businesses, as well as for the domestic automobile industry. The issue is first-year expensing, which is currently available for all business assets except motor vehicles. It is proposed in H.R. 9 that the current expensing limit be raised from $17,500 to $25,000.

AAMA is the trade association for the domestic automobile manufacturing industry. Our members are Chrysler Corporation, Ford Motor Company, and General Motors Corporation. Together, our members employ more than 600,000 workers directly and account for another 1,500,000 jobs through their dealers and suppliers.

Internal Revenue Code section 179 allows small businesses to expense up to $17,500 of the cost of most depreciable assets. However, section 280F of the Code limits to $3,060 the amount a small business can deduct for a business-use passenger car or light-duty truck in the first year through either depreciation or expensing. Thus, small businesses that purchase a car or light-duty truck during a year are unfairly denied the benefits of section 179. The proposal to raise the section 179 limit to $25,000 would not alleviate this disparity. AAMA urges extending the applicability of Code section 179 to purchases of business-use automobiles and light-duty trucks by amending the cap imposed by section 280F of the Code.

The businesses directly affected by this limitation are those small businesses whose only asset purchase for a tax year is a motor vehicle. They are the truly small businesses in America -- the local carpenters, plumbers, grocers, florists -- businesses so small that they often are not well represented before Congress. If the only significant asset purchased by such a business in a year is a motor vehicle, the business receives no benefit from section 179 expensing. This increases the after-tax cost of the purchase of a motor vehicle relative to other business assets.

For example, a business asset costing $20,000 and not subject to the section 280F limits would be allowed $17,500 first-year expensing under section 179, plus full first-year depreciation on the remaining cost of $2,500. In contrast, a business-use motor vehicle costing $20,000 would be limited to first-year depreciation of $3,060 with no section 179 expensing. Thus, section 280F not only limits ordinary depreciation deductions for so-called "luxury" vehicles", but also effectively disallows section 179 expensing of the "non-luxury" cost (i.e. $15,300, the amount of non-luxury depreciation allowable under section 280F over a vehicle's five year recovery period). No other business asset is subject to a so-called "luxury" cap. Moreover, to call $15,300 a "luxury" cap is a misnomer.

The current rules, thus, discriminate against small firms who invest in business-use vehicles as compared to small firms who make non-automotive investments. A simple and more equitable solution would be to allow for expensing of motor vehicles, at least up to the five year "luxury" depreciation limit, currently $15,300. This would reduce the discrimination against the small firms that invest only in business-use vehicles during a tax year, without changing the "luxury" depreciation limits. In other words, small businesses purchasing cars or light-duty trucks should be allowed to benefit from enhanced expensing rules, at least to the extent of the "non-luxury" content of the purchased vehicles. This would place all small businesses on a more equitable footing, whether they invest in motor vehicles or in non-automotive business assets. We believe such improved neutrality is essential to effective, efficient and equitable tax law.

Whether or not a motor vehicle qualifies for additional first-year expensing has important cash flow implications for small firms. This is because qualifying for expense treatment would lower the present value of a vehicle's after-tax purchase cost by varying amounts, depending on the price of the vehicle and the purchaser's marginal tax rate. For example, the after-tax cost of a vehicle costing $20,000 could be reduced by more than 7% (assuming a 35% marginal tax rate for the purchaser).

The purchasers of motor vehicles, especially small businesses, are very responsive to price changes. It is estimated that a 7% price decrease could bring about a 7% increase in vehicle purchases by affected small businesses. Thus, current law not only adversely impacts the cash flow of small businesses, it is also harmful to the interests of the automobile industry. The lower sales level resulting from this discriminatory provision costs automobile industry jobs. Industry economists estimate allowing additional first-year expensing for motor vehicles could increase industry sales by 15,000 to 20,000 units per year, supporting an additional 2,500 to 3,500 jobs in auto and auto related industries.

The limitation on small business expensing is only one of a number of provisions in the Code that discriminate against purchasers of automobiles. The so-called "luxury" depreciation cap cited above is an example, as is the five year class life, when three years more appropriately reflects economic life for business-use automobiles according to a 1991 Treasury study. We hope that Congress will address these inequities in the future, but, above all, we hope future legislation does not exacerbate the existing discrimination. It should be noted that, as drafted, the proposal to increase the section 179 expensing limit, as well as the Neutral Cost Recovery proposal, would improve cost recovery rules for business assets generally, but would not benefit businesses that purchase motor vehicles. Thus, Congress is currently considering proposals that would worsen the cost recovery rules for motor vehicles relative to other business assets. We respectively request that any bills reported out of the Committee treat purchasers of business-use motor vehicles equitably vis-a-vis purchasers of other business assets.

In summary, AAMA urges the Committee to allow purchasers of business-use passenger cars and light-duty trucks the benefits of the section 179 additional first-year expensing, at least up to the luxury depreciation cap of section 280F. In testimony before the House Committee on Small Business, January 17, 1995, The Small Business Survival Committee and the National Association of Manufacturers both supported making section 179 expensing available to purchasers of motor vehicles.

STATEMENT OF THE AMERICAN BANKERS ASSOCIATION

The American Bankers Association ("ABA") appreciates the opportunity to comment on the tax provisions contained within the "Contract with America" which were, among other things, designed to encourage people to enhance their financial security by increasing their savings and investment. Another way for hundreds of thousands of small business owners and farmers to enhance their financial security is by assuring them that the businesses and farms that they have worked so hard to sustain can be passed down intact to other family members when the business owner or farmer dies.

The tax provisions of the "Contract with America" which are contained in H.R. 9 that was introduced by Chairman Bill Archer on January 9, includes several important small business incentives. The one that the American Bankers Association ("ABA") would like to address is the provision that would phase in an increase in the estate and gift tax exemption from $600,000 to $750,000.

The federal government's system of transfer taxation imposes a combined tax on the value of estates at death, gifts during life, and generation-skipping transfers. It was the Revenue Act of 1916 that began the process of estate taxes becoming a permanent source of federal revenue. The gross value of a decedent's estate at the time of death was determined and a number of allowable deductions were made to arrive at the net value of the estate. A general exemption was taken and the amount of tax due was then calculated using a schedule of progressive rates. The 1916 Act granted a $50,000 exemption to exclude relatively small estates from taxation.

Over the years the estate and gift tax systems ebbed and flowed as the United States engaged in two World Wars, struggled during the Great Depression and experienced a surge of economic prosperity. It was not until the Tax Reform Act of 1976 that a complete overhaul of the transfer taxation system occurred which unified portions of the separate estate and gift tax systems.

In 1976 the separate estate and gift tax exemptions were replaced with a single unified tax credit. Over the five year period from 1977 to 1981, legislative provisions gradually increased the value of this credit from $30,000 to $47,500, which are equal in value to exemptions of $120,667 and $175,625, respectively.

One of the concerns that had been raised in regards to the transfer tax system is the effect the taxes had on small business and farm activity. Upon the death of the proprietor of the business or farm, the assets of the business become subject to estate taxation. Such taxation creates a heavy financial burden at a sensitive and critical time which may compel these small and even medium-sized businesses and farms to close their doors and sell off the farm or business even though these enterprises would otherwise be productive and profitable.

The 1976 Act attempted to mitigate these problems by providing favorable valuation rules for small businesses and farms and by deferring the payment of taxes on estates composed largely of such small businesses and farms.

The Economic Recovery Tax Act of 1981 built on many of the provisions of the 1976 legislation by raising the unified credit and by providing additional relief to small businesses and farms. The Joint Committee gave the following as the reason for the changes:

> Inflation has been increasing the estate and gift tax burdens by eroding the value of the credit and pushing estates and gifts into higher transfer tax brackets. In addition, the Congress determined that the amount of the prior credit, established in 1976 and fully effective in 1981, was inadequate to provide relief for estates containing farms, ranches, and small businesses which often were forced to dispose of family businesses to pay the estate or gift tax.

The 1981 Act gradually increased the amount of the unified credit from $47,000 to the now current amount of $192,800 over a six-year period. With the unified credit at $192,800 there will be no estate or gift tax payment on transfers of property which total $600,000 or less. The 1981 Act not only continued the liberal rules relating to small businesses and farms in connection with valuation and extension of time for payment but made it easier for businesses and farms to qualify.

The increase in the unified credit that was contained in the "Contract with America" and in H.R. 9 will go a long way towards continuing the protection of small businesses and farms that have been the special concern of Congress for many years. Section 12001 of H.R. 9 increases the unified estate and gift tax credit from $600,000 to $750,000 in 1998 with a cost of living adjustment for decedents dying and gifts made in a calendar year after 1998.

The very nature of entrepreneurial activity results in the accumulation of a certain amount of wealth. During his or her working life, the proprietor of a relatively small manufacturing operation or family farm may accumulate millions of dollars worth of land, plant and equipment. It is a valid goal of Congress to continue to protect these enterprises as family owned businesses generate about 60 percent of our gross domestic product. During the 1980s, family owned businesses accounted for an increase of more than 20 million private sector jobs.

The ABA supports the increase in the unified credit as it will help our many customers by allowing them the opportunity to continue to operate their businesses and farms. Continuation of these enterprises will provide job security for employees. Unexpected unemployment can cause tremendous disruption in people's lives; providing job security should be one of Congress' highest priorities. It will reduce the burden to the Internal Revenue Service as the Service will no longer need to process as many estate tax returns. Many of these returns do not generate revenue to the federal government due to the many credits (such as the unified credit) that an estate may claim against estate tax owed. It would not be an undue assumption that the costs of administering the returns of these small estates may not be justified in light of the fact that these small estate generate little tax. The fewer returns that have to be processed the lower the costs to the Service.

In addition to all the benefits, such a change in the unified credit will not cause a huge decrease in federal revenue. Increasing the unified credit would actually have a minimal effect on total revenue. The amount of revenue generated from estates between $600,000 and $1 million represents only 5% of the total revenue received from estate and gift taxes and totals only .03% of total revenues of the federal government.

Change In Income Tax Rates for Trusts and Estates

While supporting the increase in the unified credit, the ABA feels that there is another area which will provide protection to not only individual farmers and businessmen but also thousands of other middle class Americans.

How can Congress simplify the tax laws, empower people to establish vehicles that will provide for family members who may have medical or other challenges, empower people to establish vehicles that will pay for the educational of grandchildren and other family members, and last, but not least, correct an inequity in the tax system that has existed since 1986?

Congress can do all this by changing the income tax rates for trusts and estates. The Revenue Reconciliation Act of 1993 exacerbated an inequitable practice that started with the Tax Reform Act of 1986. What happened in 1993 is that the income tax rates for estates and trusts were again increased and even more importantly the tax brackets were again sharply compressed.

The result is that funds which are income for an estate or trust are subject to more tax than if those same funds were passed through the trust or estate and were in the hands of individuals who would also have to pay income tax on these same funds. It is only the fact that these monies are income for an estate or trust rather than an individual which subjects them to a much higher rate of tax.

Unlike the starting point of $19,500 for taxing income under the married filing separately category (which bears the highest tax rates applicable to individual taxpayers), trust and estates must begin to pay tax on their income at just $1,550. The highest rate of tax at 36% affects individuals who are married filing separately who have income over $71,800. The same high rate of tax of 36% applies to estates and trusts that have income over $5,600.

It has not always been this way. Before the enactment of the Tax Reform Act of 1986, estates and trusts were taxed at the married filing separately rates.

The trust department of banks are concerned about this issue because it affects our many bank clients who utilize trust services offered by the bank to carry out their wishes in regards to how they want their estate or their assets which are held in trust to be handled. These bank clients are certainly not multi-millionaires but their assets are held in trust for long range planning of the families' needs and many just want the assets that they have accumulated over their lifetimes to go to whomever they choose at their death rather than whom their wives may choose. A recent article that appeared in the January 9, 1996 edition of the Wall Street Journal entitled "Trust Funds Are Just for the Rich? Think Again" stated that:

> Once the province of the very rich, trusts have found their way into the lives of many families who never thought of themselves as wealthy. The escalation in housing prices since the 1970s and the boom in the stock and bond markets during the 1980s and early 1990s have helped push more estates above the federal estate-tax exemption (which is currently $600,000). At the same time, longer life spans, second marriages and lawsuits have more people looking for ways to protect and to manage family assets.

In a more recent article dated January 29, 1995 an article in the Washington Post entitled "QTIP Trusts Help Clean Up Many Estate Planning Messes" stated that:

> Today, the interaction of economic and social change has complicated things immensely, and thousands of families each year confront the vexing question of how to see that a surviving spouse, usually a wife, is provided for while making sure that the husband's assets go to the children after the widow's death.

There are indeed many reasons to set up trusts such as the QTIP trust for estate planning purposes. The Washington Post article continues its estate planning analysis by stating:

> Trusts are the vehicles of choice both to defer estate taxes until the surviving spouse dies and also to guarantee, especially in the context of second marriages, that your assets will be transferred to the beneficiaries of your choice rather than to your second spouse's choice.

There is nothing sinister about trusts or estates that should subject them to such onerous tax burdens. This is especially true for an estate which automatically comes into existence upon the death of a decedent. It contains the property of the person who has died. An executor is appointed who collects income that the decedent was entitled to, pays expenses and makes disbursements. The taxable income of an estate is taxed to the estate unless it is distributed to beneficiaries before the end of the estate's tax year.

There are many non-tax reasons for accumulation in estates and trusts. For example, estates may accumulate income because of the liquidity needs to pay bequests and debts (including taxes); unavoidable recognition of income (IRA and other qualified plan distributions); state law requirements that distributions cannot be made until the claims period for debts expires (personal liability of executor); litigation; and will contests, etc. Trusts may need to build up the trust assets to establish a fund for the future education of minor children, for the care of surviving spouses, orphans, elderly parents, the mentally or physically disabled, or children with special needs. A trustee may make a choice not to distribute assets in certain situations, not for the accumulation of assets, but to protect beneficiaries in certain situations, such as problems with creditors or a beneficiary who is a drug addict.

Is it possible to use these vehicles to avoid the payment of income taxes? Anything is possible, however, an individual does not go to the extreme of dying simply to use an estate as a vehicle to avoid the payment of income tax. There is also nothing sinister or subversive about the use of a trust. A trust is a commonly used estate planning vehicle that allows individuals to provide for their families' needs and/or to achieve certain goals while those individuals are alive or after they have passed away. For example, trusts are set up to save for college or to provide a living allowance for people with disabilities or mental illnesses.

The highly compressed rates which were part of the 1993 Act have had a harsh effect on many trusts and estates. The greatest areas of difficulty arise in instances where there is a need to accumulate income for non-tax reasons. The grantors intentions for the best interests of the beneficiaries are frustrated by the trustees' unenviable position of having to choose to use the assets of the trust or estate to either pay the tax (at a much higher rate than would be taxed in the hands of the individual receiving it) or make unwise distributions to avoid the additional tax.

Let's go over the current rate structure again. Unlike the starting point of $19,500 for taxing income under the married filing separately category (which bears the highest tax rates applicable to individual taxpayers), trust and estates must begin to pay tax on their income at just $1,550. The highest rate of tax at 36% affects individuals who are married filing separately who have income over $71,800. The same high rate of tax of 36% applies to estates and trusts that have income over $5,600.

There was a period of time, a long time ago, when the income tax rates for individuals were higher than those of trusts or estates and therefore there was an incentive for people to set up "multiple trusts" in order to avoid the payment of income taxes. In the unlikely scenario that sometime in the future the individual income tax rate at the highest level will be higher than the top estate and trust income tax rate level, Congress has given the IRS the necessary weapons to combat this "multiple trust evil" by the ability to issue regulations which would treat as one trust, two or more trusts having substantially the same person establishing the trusts and the same beneficiaries, where the principal purpose of the establishment of such trusts was the avoidance of tax. With this device already established in the tax code, an individual cannot hold money inside a trust or estate to enjoy lower income tax rates.

How to Make the Needed Changes

Several members of Congress have already been compelled to try to change this inequitable situation by introducing legislation in both the 103rd Congress and also in these early days of the 104th Congress.

S. 1729 was introduced by Pete Domenici on November 19, 1993. The bill would have established a special income tax rate for disability and higher education trusts.

H.R. 5070 was introduced on September 21, 1994 by L.F. Payne (D-Virginia). The bill would have established a special income tax rate for disability trusts.

H.R. 5169 was introduced on October 4, 1994 by Jim McCrery (R-LA). The bill would have changed the income tax rate on estates and trusts back to the married filing separately rate. Again, the married filing separately rate bears the highest tax rates applicable to individual taxpayers.

The McCrery bill was re-introduced in the 104th session of Congress as H.R. 329 on January 4, 1995. The bill, which is supported by the American Bankers Association would change the income tax rates on estates and trusts back to the married filing separately rate.

Conclusion

The McCrery bill presents the best solution to this inequitable situation. It simplifies the Internal Revenue Code by including estates and trusts in the married filing separately tax brackets. This eliminates one rate table. It will more importantly, help to provide protection to middle class Americans at their death to continue their wishes in regards to supporting their children and other family members through estates or trusts without confiscatory income tax rates eating away at assets which took a lifetime for those middle class Americans to collect. There is no "evil" that trusts or estates represent which should make them the subject of such high rates and compressed brackets. Congress can make sure that individuals can never use these trusts or estates to avoid the payment of income taxes by putting income tax rates for trusts and estates at the highest level an individual's income tax rate could be.

STATEMENT OF LYNNE Z. GOLD-BIKEN
AMERICAN BAR ASSOCIATION

Mr. Chairman and Members of the Committee:

I am Lynne Z. Gold-Bikin of Norristown, Pennsylvania. During my career as a lawyer, my practice has been limited to family law. I am presently Chair of the Section of Family Law of the American Bar Association. I am submitting this statement on behalf of the American Bar Association, as the designee of its President, George E. Bushnell, Jr.

The ABA strongly supports enactment of a tax credit for qualified adoption expenses, such as that found in the Family Reinforcement Act, H.R. 11. We believe its enactment is important for several reasons. First, it will encourage more families to adopt children, by reducing the financial burden of one-time costs which are currently estimated to average $10,000. Second, adoption incentives are less costly to society than institutional alternatives. By making adoption more affordable for thousands of families, fewer children will stay in more costly institutional settings. Most importantly, encouraging adoption is important because adoption is the vastly preferable outcome for adoption-eligible children, providing permanency and a loving environment for children who otherwise may languish in foster care, shelter care or group-care settings. We urge the Committee to support this provision as this much-needed legislation moves forward.

In addition, we urge the Committee to consider the additional step of exempting from taxation employee adoption assistance benefits provided by employers.

The American Bar Association has long supported improvements in the law related to the adoption of children. In 1972 it endorsed a Revised Uniform Adoption Act. In 1980, it endorsed reforms in the federal Adoption Assistance and Child Welfare Act of 1980 (P.L. 96-272) to facilitate adoption of children with special needs. Currently, Association representatives are working with the National Conference of Commissioners on Uniform state Laws on

the development of a new version of the Uniform Adoption Act. Most recently, in February 1993, the ABA House of Delegates approved a Family Law Section-sponsored resolution calling for the federal government and Congress to take a number of further steps to encourage adoption. This most recent resolution forms the basis for this testimony. A copy of the resolution is attached.

In all of its work on adoption, the ABA, primarily through its Family Law Section's Adoption Committee and the ABA Center on Children and the Law of the Young Lawyers Division, has been concerned about legislative improvements designed to build and nurture strong families, including legislation to encourage families to adopt children in need of a nurturing environment. Leaders within the ABA involved with adoption issues have worked with such organizations as the North American Council on Adoptable Children, the National Adoption Information Clearinghouse, the National Resource Center for the Adoption of Children with Special Needs, Adoptive Families of America, and the American Academy of Adoption Attorneys to identify needed enhancements in adoption laws.

The ABA believes that, in establishing public policy to encourage people to adopt children, the federal government (and its state counterparts) must enact policies which will help compensate adoptive parents for the extraordinary costs which are required in the process. While the single largest cost of "newborn" adoption is generally medical expenses of prenatal care and delivery as well as care of the baby, there are a myriad of costs in any given adoptive placement. These include counselling, agency fees, living expenses of the birth mother during pregnancy, health care costs of the child pending adoption, legal fees, and a variety of court costs and document charges in one or more states or countries.

In addition, travel expenses are often unpredictable and cannot be preplanned. Where extended travel is required, there are hidden costs such as lost earnings or child care for other members of the family. It must be noted that in many instances all of these costs are incurred for potential adoptive placements which do not materialize.

Apart from the direct costs, these situations in some instances entail a need for counselling or therapy for the child and even for the entire family. From time to time, unexpected medical conditions will be uninsurable.

If a child's physical or mental health problems are known at the time of the adoption, a child may qualify as having "special needs" under applicable state laws and policies, and the adoptive parents may be able to obtain financial support to meet these needs through an existing government entitlement program. However, not all such problems are known at the time of an adoptive placement, and not all conditions which require special care fall within the varied standards for the "special needs" designation. Therefore, adopting parents assume a substantial risk of significant unanticipated expenses when adopting older children (i.e., those no longer in the "newborn" category).

The 1993 ABA policy resolution on adoption is based on a recognition by those who practice family law, particularly with a specialization in adoption, as well as by those who have adopted children, that the expense incurred in connection with an adoption can be phenomenal. Our position is also based on the recognition that federal law has failed to provide reasonable financial incentives that would help offset these costs for low and middle-income households.

The ABA recognizes the importance of public policy that specially promotes the adoption of "special needs" children

with disabilities; older children in the foster care system; children with special health problems (e.g., drug-exposed babies and children with HIV or AIDS); and children who are otherwise designated by public child welfare agencies as difficult to adopt.

In addition, we support enactment of legislation to provide incentives to employers who provide special employee assistance benefits specifically related to adoption. There are now only a small number of employers that provide such benefits, even though employee assistance benefit programs generally have expanded considerably in recent years. Small employers might only be able to provide very limited assistance in the adoption area (such as limited counselling, legal information for those considering adopting, and assistance with some legal expenses), while large employers may -- with appropriate tax incentives -- be able to provide a much wider array of employee benefits related to adoption.

The federal government itself is a large employer, and federal agencies can develop models of employee assistance related to adoption. Large numbers of federal workers in the U.S. and throughout the world (including members of the military services) are potential adoptive parents. Pilot or demonstration projects focusing on a variety of employee assistance in adoption can furnish state governments and private employers with much useful information about how to structure and operate a successful employee adoption assistance program.

RESOLUTION APPROVED BY HOUSE OF DELEGATES OF THE AMERICAN BAR ASSOCIATION

FEBRUARY 1993

RESOLVED, that the American Bar Association urges the United States Congress to enact legislation providing incentives to encourage individuals throughout the country to adopt juveniles. Such incentives should include:

(a) The allowance of reasonable tax deductions or tax credits for qualified adoption expenses incurred for the adoption of juveniles designated by state or local child welfare agencies as having "special needs."

(b) The provision of tax incentives for employers that provide employees with adoption assistance benefits.

(c) The creation of Federal agency demonstration projects in which federal employees are provided with an adoption assistance benefit program.

(d) The creation of a Federal interagency work group on adoption.

(e) The establishment of a Federal "blue-ribbon" advisory board on adoption.

(f) The provision of Federal support for the development of activities designed to increase understanding of adoption and its impact.

(g) The enactment of Federal legislation or regulations that encourage full disclosure to prospective adoptive parents of information related to the physical and mental health history of all children being placed for adoption, and the inclusion in any new Federal health care legislation of provisions that prevent the denial of dependent coverage to adoptive parents on the basis that the adopted child has a health condition that was pre-existing the date of the adoption.

AMERICAN COUNCIL ON EDUCATION

Office of Vice President and General Counsel

February 2, 1995

The Honorable William Archer
Chairman
House Committee on Ways & Means
United States House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Mr. Chairman:

On behalf of the higher education associations listed below, we wish to express our support for the establishment of American Dream Savings Account (ADS Account), and other pending proposals which would expand the concept of Individual Retirement Accounts.

In view of the significant decline in personal savings and resulting detrimental impact on trade and international competitiveness, we welcome the initiative to encourage saving not only for retirement, but also for either the purchase of a first home or paying for the costs of college.

By enabling penalty-free withdrawal of ADS funds, parents have an additional resource to call upon in meeting the cost of their children's education. In addition, students of all ages as well as spouses and grandparents will be able to significantly participate in saving for anticipated education expenses.

We further support the concept incorporated in HR 682, the Super IRA bill. In particular, we appreciate the understanding that colleges, universities, independent schools and research organizations rely upon Section 403(b) of the Internal Revenue Code to provide both their primary employer-sponsored pension plans and an opportunity for their employees to voluntarily save for retirement with their own pre-tax dollars. The extension of penalty-free withdrawal treatment to distributions of voluntary employee 403(b) contributions for the purchase of a home or for higher education expenses is a potentially valuable benefit for the higher education community.

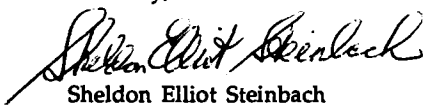
HR 682 would also stop the unfairness that results when a 10 percent penalty is charged because health costs require IRA funds to be withdrawn. The bill addresses another case of unfairness when taxpayers lose their jobs, and have to unexpectedly fall back on their IRA savings. For taxpayers who have exhausted 12 weeks or more of unemployment compensation, they will be allowed to make a penalty-free withdrawal as well.

Lastly, the bill addresses an issue relating to families that are trying to make a better future for themselves by enabling families to save for their education without violating the AFDC eligibility rules.

We hope that this initiative would be supplemental to and not in lieu of extension of full employee educational benefits under Section 127 of the Internal Revenue Code and other provisions that would expand educational opportunity in our country.

We stand ready to aid you and your staff in pursuit of this valuable proposal.

Sincerely,



Sheldon Elliot Steinbach
Vice President & General Counsel

SES:ggl

cc: Jim Clark, Chief Tax Counsel, House Ways & Means Committee
Sam Gibbons, Ranking Minority Member, House Ways & Means Committee
Phil Moseley, Chief of Staff, House Ways & Means Committee

On behalf of the following associations:
American Council on Education
American Association of Community Colleges
American Association of State Colleges and Universities
Association of Community College Trustees
Association of Governing Boards of Universities and Colleges
Association of Jesuit Colleges and Universities
College University Personnel Association
Council of Graduate Schools
Council of Independent Colleges
Hispanic Association of Colleges and Universities
National Association for Equal Opportunity in Higher Education
National Association of College and University Business Officers
National Association of Independent Colleges and Universities
National Association of Student Financial Aid Administrators
National Association of State Universities and Land-Grant Colleges
Teacher's Insurance Annuity Association - College Retirement Equity Fund
United Negro College Fund

STATEMENT OF THE AMERICAN FARM BUREAU FEDERATION TO THE HOUSE WAYS AND MEANS COMMITTEE ON ESTATE TAXES

FEBRUARY 1, 1995

The American Farm Bureau Federation is the nation's largest general farm organization with a membership of 4.4 million member families in 50 states and Puerto Rico. Farm Bureau members produce virtually every commodity grown commercially in this country. Policy is developed by producer members at the county, state and national levels of organization.

Farm Bureau applauds the efforts of this committee to hold hearings focusing on changes needed in estate tax law. Reform of our nation's estate taxes has been at the top of Farm Bureau's agenda for many years.

Farmers and ranchers have a vital interest in estate taxes because production agriculture remains a family enterprise based industry. According to the 1992 Census of Agriculture, 85.9 percent of the farms and ranches are individual or family proprietorships and 9.7 percent are partnerships. Of the 3.4 percent that are family corporations, most have 10 stockholders or less. Only 0.4 percent of the farms and ranches are corporations that are not family held. Farms and ranches that have incorporated have done so for tax and financial planning reasons, not because they are large business enterprises.

While some farms and ranches stay in the family for generations, the actual operators of farm and ranch enterprises are constantly changing. The U.S. Department of Agriculture estimates that between 1992 and 2002 about 500,000 older farmers will leave production agriculture to be replaced by about 250,000 new, young farmers. This is partly happening because the average age of farmers in 1992, according to the census, was 53.3 years. For these retiring farmers and ranchers and the new ones who would like to take their place, now is an important time to make changes in the federal estate tax laws.

Without estate tax law changes the next generation of farmers will find it more difficult to begin farming. According to a USDA analysis of census data collected in 1988, roughly 45 percent of the young farmers who had obtained land had either purchased it from a relative (29 percent) or had received it as an inheritance or gift (15 percent). What those numbers would be without estate taxes and capital gains taxes, we will never know. What we do know is that multi-generation farms and ranches are a fact of life. How viable they will remain will be partly determined by the estate tax load they must carry.

Even though land prices declined in many areas of the country during the 1980's, in both real and nominal terms, they have recovered in recent years in most areas. As a result many farmers and ranchers are facing far higher land prices today than when they purchased the land 30 or 40 years ago. Much of this gain is due to nothing more than inflation. For example, the average price of farmland in Illinois was $234 per acre in 1965; now it is close to $1,500 per acre, over six times what it was in 1965. All portions of the country face the same problems.

Farm Bureau has advocated for many years that the estate tax be abolished. Elimination of the estate tax should not be a major budget issue. Last year, total estate and gift tax revenue came to about $13 billion. While $13 billion is still a considerable amount of money even by today's standards, it is not such a large amount to prevent its phase-out over a number of years.

The unified credit which effectively exempts from taxes the first $600,000 of value of an estate was last increased in 1981. Due to gradual inflation and pressure from land

development, the current $192,800 unified tax credit and allowance for farm use valuation are not sufficient to allow many family farm businesses to pass from one generation to the next.

Farm Bureau supports increasing the estate tax exemption from $600,000 to $2 million and indexing the exemption for inflation. Exact numbers are not available, but this level would likely exempt many farms and ranches from estate taxes and allow them to be passed from one generation to another, unencumbered by federal taxes. If the exemption is not increased and a large portion of farm business assets must be sold to pay the tax, the economic viability of the operation can be destroyed and family members would be forced to abandon the farm.

The impact of an increase in the exemption to $2 million would be significant. For example, the current exemption would exclude 400 acres of average priced Illinois farmland from the estate tax. Again using Illinois as an example, family farms are now more than 400 acres and at least half the land is valued at more than $1,500 per acre. This means the total value of the farming enterprise would be more than $600,000 when the value of equipment, livestock and other assets are considered. Increasing the exemption would allow many farms to be passed tax-free to the next generation of farmers.

Another estate tax issue of importance to farmers and ranchers is the $750,000 ceiling allowed under Internal Revenue Code 2032A for valuing land at its agricultural productive value. Farm Bureau supports elimination of the $750,000 limit to the adjustment in value that can be made when farmland is valued at its actual use rather than its highest and best use under Section 2032A.

This change is especially important in areas faced with urban growth. Land values for development in these areas are much higher than for agricultural use, rendering the $750,000 cap ineffective in preserving farmland. If this cap cannot be eliminated it should, at the very least, be increased and indexed for inflation.

Farm Bureau also supports increasing the annual gift tax exemption per donee from the current $10,000 to $20,000. This would provide another tool to ease the estate tax burden and help keep farms and ranches in the family.

Keeping farms and ranches in the family has never been an easy task. The tax changes we have proposed today are a significant part of making that task just a little bit easier. We urge the committee to work for swift implementation of these measures.

TESTIMONY ON BEHALF OF THE
AMERICAN HORSE COUNCIL
BEFORE THE
COMMITTEE ON WAYS AND MEANS
U. S. HOUSE OF REPRESENTATIVES
FEBRUARY 3, 1995

The American Horse Council is the national representative for the horse industry and includes nearly 200 equine organizations representing over one million horse owners and breeders who are involved in every facet of the horse industry.

The U.S. horse industry is a very diverse $15.2 billion industry that employs and supports hundreds of thousands of workers. Horse owners and breeders spend $13 billion in annual investment and maintenance costs. $200 million worth of horses are exported each year, far more than are imported. Horse farms and training facilities provide green space, often in areas that are being threatened by encroaching urban growth.

Pari-mutuel horse racing is legal in 43 states and involves the racing of Thoroughbreds, Standardbreds, Quarter Horses, Arabians, Appaloosas and Paints. Off-track and inter-track wagering is legal in 41 states. There are over 200 racetracks in the U.S. In 1993, over 64 million people attended the races, generating over $493 million in direct revenue to states from pari-mutuel taxes, track licenses, occupational licenses, admission taxes and miscellaneous fees.

Another 40 million people view equine sports each year at horse shows and rodeos. There are 14,000 sanctioned horse shows a year with thousands of local, unsanctioned additional shows. These shows contribute $223 million annually to our economy with rodeos contributing over $100 million. 27 million people over twelve ride each year, more than half on a regular basis.

On the state level, California's horse industry generates the most dollars with a total GNP of $2 billion annually, followed by New York's $1.3 billion and Texas' $1 billion. Many other states have very substantial breeding, racing and showing industries.

The equine industry is very labor-intensive. Hundreds of thousands of individuals breed, own, train, use and care for horses. These people, who work full-time in the horse industry, include owners, trainers, grooms, jockeys, drivers and riders, veterinarians, instructors, van operators, racetrack employees and the countless others who do not work directly with the horse but whose livelihood depends on it.

According to the American Veterinary Medical Association's 1988 research study, there are 6.6 million equine in the United States. Previously, the AHC's economic impact study stated there were 5.25 million economically productive equine.

Several of the tax provisions of H.R. 9 would be, if enacted, beneficial to our industry by way of promoting both investment and job growth.

Our membership strongly supports a reduction of the capital gains rate as proposed in H.R. 9, as well as permitting a taxpayer to increase the basis in certain assets to reflect the impact of inflation during the taxpayer's holding period.

AHC and its membership are also in favor of the increase in the expense deduction from $17,500 to $25,000.

Other proposals which would be beneficial to the horse industry include:

1. The proposed neutral cost recovery system permitting the taxpayer to increase annual depreciation deductions by an inflation factor;

2. Broadening of the deduction for home office expenses; and

3. Reform of the estate and gift tax laws increasing the $600,000 exemption to $750,000.

In connection with estate tax reform, we would also favor changes which would permit family owned businesses to continue to operate rather than have to be liquidated to pay as much as 55% of the value of the estate in federal estate taxes.

We appreciate the Committee's consideration of these comments. If you have any questions, please contact the American Horse Council.

1201 New York Avenue, NW
Washington, DC 20005-3931
Tel. 202/289-3120
Fax 202/289-3185

February 3, 1995

The Honorable Bill Archer
Chairman, Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

Dear Chairman Archer:

The American Hotel and Motel Association (AH&MA) is a federation of state and local lodging associations representing over 10,000 properties. The lodging industry employs over 1.5 million people and has annual sales exceeding $60 billion. Our association represents all of the major lodging chains and also contains a significant number of smaller properties. On behalf of our member properties we offer the following comments and request they be made a part of the record of the hearings on capital gains tax reform held January 24, 1995, through January 26, 1995.

AH&MA supports the provisions in the Contract with America to reduce the capital gains tax and index the value of assets to eliminate taxing "illusory gains" and applauds this committee's efforts in focusing on the advantages to the business community of a capital gains reduction. We believe that many hotels, including our smaller properties, may benefit from this change in several ways.

Firstly, it is likely that some investors already in the industry are holding hotels out of a reluctance to face the current level of taxation upon their sale. This reluctance to sell can artificially reduce normal turnover of property ownership and can act as a drag on our industry which is just beginning to recover from one of its worst downturns. A capital gains reduction would encourage investors to turn over appropriate properties and may even have a salutary effect on the sale price. At the same time, a capital gains tax reduction would encourage those investors to make upgrades to their properties prior to sale, knowing that their return on that additional investment would not be unduly penalized.

For those investors outside the lodging industry who are able to have capital freed by sales or dispositions of other assets, we believe investment in the lodging industry will be an increasingly attractive consideration. As our industry continues its recovery and experiences modest expansion, a change in capital gain rates along with indexing of asset value should help ensure solid growth for hotel and motel owners. The freeing up of capital both inside and outside our industry should help to stimulate the market for hotel properties.

We believe these benefits are not limited to the lodging industry and that many other industries could likely experience similar favorable results from the capital gains tax change under consideration. We look forward to final action by the Congress on this tax change.

Sincerely,

James E. Gaffigan

James E. Gaffigan
Vice President, Governmental Affairs

STATEMENT OF ASSOCIATED BUILDERS AND CONTRACTORS

Mr. Chairman, On behalf of the over 17,500 contractors, subcontractors, suppliers and related companies of the Associated Builders and Contractors (ABC), we greatly appreciate this opportunity to submit our comments on H.R. 9, the Job Creation and Wage Enhancement Act. This Act, based on the tax provisions in the Contract With America, will encourage greater savings and investment. ABC supports the entrepreneurial incentives in the Act.

ABC is a national trade association representing approximately 17,500 contractors, subcontractors, material suppliers, and related firms from across the country and from all specialties in the construction industry. Our diverse membership is bound by a shared commitment to the merit shop philosophy of awarding construction contracts to the lowest responsible bidder, regardless of labor affiliation, through open and competitive bidding. With 80% of the nation's construction workers choosing not to be represented by a union, ABC is proud to be their voice.

The construction industry accounts for 7-15% of our nation's gross national product each year and employs close to 5 million workers. It is easy to see why the improvements in the tax laws that affect the construction industry will create jobs and enhance wages. ABC is especially supportive of four proposals that will particularly affect the construction industry -- implementing neutral cost recovery, raising the limit on expensing, increasing the estate tax exemption, and the capital gains incentives. Additionally, ABC supports the notion in the Contract that there should be a tax credit for education. However, rather than credit for college, ABC believes that a tax credit for those who provide job training is more economically sound and provides realistic benefits for more of America.

Neutral Cost Recovery

The proposal to implement a system of neutral cost recovery would allow firms to deduct the full real present value of their investments. This represents a significant improvement over current depreciation allowances. The current system falls woefully short -- failing to take into account both inflation and the time value of money.

ABC believes that neutral cost recovery is a step in the right direction toward a system of taxation that encourages, rather than inhibits, growth. This step was undoubtedly arrived at by taking a realistic look at the tax provisions affecting businesses. Why should businesses lose the value of their investments to arbitrary depreciation schedules? ABC further believes that there are other arbitrary provisions in the tax code that adversely affect businesses.

For example, the Lookback Rule, an integral part of the Percentage of Completion Method of accounting, requires taxpayers engaged in the production of property under a long-term contract to engage in costly and excessive calculations. Under the Percentage of Completion Method, gross income for taxation purposes is calculated by multiplying the gross contract price by the percentage of the contract completed in the year in question. The percentage of the contract completed is determined by comparing actual costs incurred during the year with the estimated total contract costs.

Because the Percentage of Completion Method uses estimated, rather than actual, contract price and costs to figure gross income for any taxable year, the Lookback Rule is applied in the year the contract is completed. The taxpayer is then compensated for the acceleration or deferral of taxes paid over the contract term.

Application of the Lookback Rule requires a three-step process. First the taxpayer must recalculate the percentage of contract completed using actual, rather than estimated prices and

costs. This first step allows any under or over reported taxable amount to be calculated. Second, the taxpayer must compare his tax liability for each year based on the income reallocated under the first step with the tax liability previously reported. In the final step, the taxpayer must apply the Lookback Method interest rate to the under or over payment and pay the interest or receive the refund accordingly.

Under the 10% de minimis rule, the contractor may complete only the first step of the Lookback Rule. If the estimated contract price and costs are within 10% of the actual contract price and costs, the contractor can elect not to proceed further in application of the Lookback Rule. Although the 10% de minimis rule provides some relief for larger contractors from the burdensome computations and excessive administrative costs, complex calculations must still be performed to determine if each contract meets the 10% rule. Small contractors typically lack the necessary resources it takes to perform these complex calculations.

Additionally, all construction contractors must make the percentage of completion and look-back calculations for purposes of the Alternative Minimum Tax. This is true despite the fact that in the 1986 Act, Congress provided an exemption for contractors with average annual revenues under $10 million dollars from the Percentage of Completion Method and the Lookback Method for regular tax purposes.

Members of the construction industry, along with other businesses requiring ongoing capital investment, are often forced into the Alternative Minimum Tax, and, therefore, into calculations under the Lookback method despite Congress' intent to exempt them. As an additional burden, the Alternative Minimum Tax subjects these companies to the worst capital cost recovery system in the industrialized world. The Alternative Minimum Tax can result in

capital costs that are 20% higher than for foreign companies or those not subject to the Alternative Minimum Tax. Under the Alternative Minimum Tax, cash flow that could otherwise be used to fund new jobs or more investment is, instead, flowing into the Treasury as a punishment for investment in capital. The problem of the Alternative Minimum Tax should be addressed when Congress addresses the problems with the current system of depreciation.

Additionally, small contractors should be granted a full exemption from the Lookback Method. According to the IRS, Lookback is revenue neutral. This means that it provides no great benefit to either the Treasury, in the form of interest, or to the taxpayer, in the form of a refund. What Lookback does do is pull funds away from job creation and investment and expend them on paperwork and calculations. In fact, contractors typically spend much more in administrative compliance costs than the amount of any interest either owed or received after Lookback is calculated.

Expensing

Currently, businesses are permitted to expense, or fully deduct, the first $17,500 they invest in equipment in the year it is purchased. The Contract With America proposes raising that limit to $25,000. Expensing helps construction firms who make considerable investments in equipment by freeing up money far faster than depreciation schedules allow. This freedom encourages further investments and, therefore, speeds growth and spurs further hiring.

For these reasons, ABC supports an increase in the amount permitted to be expensed. While the proposed increase would be helpful, especially to smaller businesses, ABC supports an even higher level to encourage that much more investment.

Additionally, ABC believes that expensing should be reformed to the extent that

expensing is reduced dollar for dollar when capital expenditures exceed $200,000. Also, cars and trucks, not currently permitted to be expensed should be included in the reformed provision. Often light trucks are the most critical piece of machinery purchased by a construction firm.

Capital Gains

The Job Creation and Wage Enhancement Act proposes excluding 50% of capital gains from taxation and indexing the capital gains tax rate to inflation. This proposal makes good economic sense. In fact, capital gains rarely keep up with inflation. As inflation increases over time, it becomes necessary to sell your property for much more than you paid for it to realize any actual gain. If property is sold for less than its inflation adjusted purchase price, the owner effectively takes a loss. Then, at the current rate, the government takes another 28% off what the owner did manage to recapture. It is easy to see why individuals are often reluctant to sell property and realize illusory "gains" on which they are then taxed.

Excluding 50% of capital gains from taxation and indexing the rate to inflation does not amount to a tax break for the rich. These proposed changes to capital gains taxation will free individuals to sell property and reinvest. This reinvestment is good for business and good for the economy. It will create growth, more jobs, and higher wages. Additionally, the Treasury will likely benefit from the increased realizations and resulting tax dollars.

Estate Tax

Many of ABC's members are small or family-owned businesses. The proposal in the Contract With America to raise the estate tax exemption from $600,000 to $750,000 would do much to ensure the continued existence of these businesses even after the death of an owner. Because all assets are included in estate tax calculations, many small businesses must be sold to

outsiders upon the death of the owner. A construction firm with modest assets in equipment may be forced to sell to outsiders simply because it lacks the liquid assets to pay the estate tax.

Education Tax Credits – Job Training

Tax cuts, designed to stimulate economic growth and increase the number of good jobs available to Americans must be at the forefront of Congress' agenda. These pro-growth tax cuts will go far further toward accomplishing improvements in the economy than will budget reductions. Yes, it is important to get the budget in line, but this will be even easier once productivity rises and the returns start rolling in.

ABC is fully supportive of all aspects of the Contract, including tax cuts and credits for individuals in certain circumstances. For example, the tax credit for college tuition will doubtless go far to help those students actually headed for college. But what of that vast number of students for whom college is not the best answer? ABC believes that it is important to acknowledge that, while college is a great option for some, skill based training in an industry like construction may be an even better alternative for many.

There is a lot of talk in Congress about overhauling the federal job training system. ABC would like its job training program, the Wheels of Learning, to be recognized as a valuable private resource -- a model for those in the construction industry and other industries to follow. The key to job training consolidation is that resources must be pooled and first-quality training must be provided in fields in which it will be possible to obtain employment.

ABC's private training program, the Wheels of Learning, provides state of the art, Department of Labor approved, skill based training in 17 crafts. The training received under the Wheels of Learning is standardized and portable. It provides workers in the construction

industry with high level, practical skills.

Unfortunately, profit margins in the construction industry are extremely slim -- often only one penny on the dollar. When money is tight, the practicality is that training is often the first cost cut. ABC believes that private training programs are a valuable asset that should be exploited by a new federal job training system. Assurance of their continued quality can be accomplished through a proven response mechanism -- the tax credit.

Obviously, the particulars of integrating private training programs like the Wheels of Learning into the federal system need to be further explored. However, one thing is clear. A tax credit to the provider of private, practical job training programs would go far to ensure the continued success of the program. A tax credit directly to the trainer would ensure that the money goes toward improving the programs available. It additionally insures that federal money goes to programs that meet national standards and specific state and local needs.

A tax credit to the trainer makes good economic sense. One centralized trainer can allocate the available money within its program to provide superior training. Its incentive is the worker shortage. By the year 2000 there will be a serious shortage of workers in the construction industry. Construction firms have every incentive to provide their workers with high quality training that will be of benefit to both employer and employee.

Congress' willingness to help Americans become better educated is admirable. ABC offers the suggestion that Congress look to the most economical method of providing that education. ABC also suggests that Congress focus on the strong, well-paying jobs available in the construction industry for which specific craft training, but not necessarily college, is a requirement.

Beyond the Contract – S Corporation Reform

The Subchapter S Corporation, which is a pass-through entity taxing its owners directly on corporate profits, was originally introduced by Congress in 1958. One of the major objectives in establishing S Corporations was to allow business owners, particularly those of small businesses to obtain the single-tier level of taxation afforded members of partnerships. The S Corporation structure recognizes that a business whose owners are generally the same as its managers should not be taxed as if the two were separate groups, earning two different sets of income. S Corporations also benefit by maintaining the limited liability of a regular C Corporation. Regretfully, however, Subchapter S, as originally enacted in 1958, was very limiting and contained a number of pitfalls.

Unfortunately, changes in the tax rules for S Corporations have not kept pace with the economic and financial changes in the business world. In fact, the 1993 Budget Reconciliation Act affected a dramatic change in S Corporation tax policy. Subchapter S Corporations now pay the highest tax rates in the country regardless of whether shareholders distribute profits or reinvest them in their business. Considering the fact that S Corporation status is the rule of thumb for small and family owned businesses, reform of Subchapter S is critical.

The guiding principle behind S Corporation reform is the elimination of barriers to growth and capital formation for these often small and family-owned businesses. S Corporations should be given access to capital sources now unavailable to them such as new kinds of debt and equity and new types of shareholders. S Corporations should have the opportunity to grow. They should be permitted to own other companies and have better ownership structures themselves. Estate planning for S Corporations should be improved to recognize realities in

generational succession. Finally, obsolete tax rules that exist simply to trap unwary companies and endanger subchapter S status should be eliminated.

Beyond the Contract -- the Targeted Jobs Tax Credit

Another area ripe for reform is the targeted jobs tax credit. Reform in this area is particularly critical to small businesses. In the past, this tax credit has provided employers with an incentive to hire the structurally unemployed. It has helped approximately 500,000 disadvantaged Americans enter the workforce each year since the original bill was passed in 1978. Because the tax credit makes it easier for these individuals to obtain private sector employment, everyone benefits from reduced government costs.

The old Targeted Jobs Tax Credit expired on December 31, 1994. While the old system had its difficulties, the idea of giving a tax credit to employers who hire individuals who want to work but may be less attractive as job candidates is a good one. This is especially true considering how hard Congress is working to minimize the number of people on the welfare rolls.

The key to this type of tax credit is that the credit be the incentive for the hiring. For a small business, a couple of thousand dollars is, indeed, a great incentive. However, under the old law, the complexities associated with obtaining the credit often necessitated many hours of administrative costs and sometimes even paying to hire a consultant -- effectively eliminating the incentive for the small business owner.

The new program should incorporate objective eligibility criteria that would replace the current, local, case by case decision making. Under the old system, decision making was a burdensome and often lengthy process. In the construction industry, people are often hired for

short term projects and the point is often moot by the time the certification process has been completed. Simplified administration would save money for the government and for the contractor who would no longer have to rely on the expertise of a consultant. Additionally, objective eligibility criteria would enable an immediate hiring decision to be made with the knowledge of whether or not the tax credit makes the candidate more attractive. It is a good idea to set the system up so that employers cannot get a windfall by having a candidate they would have hired anyway turn out to qualify the employer for the credit. On the other hand, multiple rejections when the contractor believed he was hiring a qualified individual create a disincentive to participate in the program.

Beyond the Contract -- Independent Contractor Status

Under current law, taxpayers must use a 20 factor common law test to determine whether a worker is an employee or an independent contractor. Whatever changes are made in the tax laws that affect independent contractors must strengthen the 20 factor test by preserving its support of independent contractor status while simplifying its application.

The same common law, 20 factor test is used by the IRS to determine compliance. The IRS generally examines the classification of workers some time after the taxpayer has made its determination of the workers' classification and after the taxpayer has filed its returns. Thus, reclassification by the IRS can result in severe penalties in the form of back taxes and interest. ABC believes that Congress and not the IRS should define independent contractor status. By clearly setting out rules that encompass the 20 factor test, Congress can protect those in the construction industry and other industries who find it mutually beneficial to utilize independent contractors.

When considering the independent contractor issue, it is critical to distinguish between wrongful classification and misclassification. In construction, wrongful classification can result in a competitive edge. Those companies not paying employee taxes or workmans' compensation can undercut the competition by offering lower bids. ABC in no way condones intentional misclassification by businesses who shirk their duties to society and their workers.

The "safe harbor" provisions in Section 530 protect taxpayers from reclassification if there is a reasonable basis for treating workers other than as employees. This reasonable basis may come from published rulings, a prior audit, or industry practice. Section 530 recognizes that taxpayers must be able to rely on reasonable methods of classification without risking bankruptcy. The protection found in Section 530 are invaluable, especially to the construction industry with its long history of industry practice.

In addition to protecting past classifications, ABC believes that the time may be ripe to clear up the fog surrounding the 20 factor test for future classifications once and for all. A clean and simple test that recognizes the valuable role of independent contractors in the small business world would ease the way of the contractor struggling with a classification and make it easier to identify wrongfully classified workers. ABC would support such clarification as long as it preserves the current, mutually beneficial industry practice of properly utilizing independent contractors.

Conclusion

ABC supports this Committee in its examination of the tax proposals in the Contract with America. ABC believes that these proposals are pro-growth and pro-economy. ABC supports the additional proposals mentioned here as further building and enhancing the Contract's foundation.

TESTIMONY OF BUILDING OWNERS AND MANAGERS ASSOCIATION INTERNATIONAL

Office Buildings Create Jobs

The Building Owners and Managers Association (BOMA) International is pleased to present our perspective on two significant issues of concern to commercial real estate: the tax treatment of capital gains and the depreciation of leasehold improvements. These issues are addressed in the Job Creation and Wage Enhancement Act (H.R. 9).

BOMA is the oldest and largest association uniquely representing the office building industry. Our members collectively control over 6 billion square feet of office space -- more than half the total nationwide. After a prolonged and dismal downturn in our industry, we are encouraged that Congress is considering approaches to encourage savings, investment, and economic reinvigoration. Nowhere are such changes more welcome than in commercial real estate.

Unlock Resources

On capital gains, we strongly support the greatly lowered tax rate proposed in H.R. 9, as well as the indexation of *original capital cost* -- an appropriate approach for real estate -- to ensure that "fictional" gains from inflation are eliminated.

The high rate of tax now in place on capital gains discourages a range of activities that are economically desirable: the acquisition and development of commercial properties; lending to finance or refinance investment in those properties; and the employment of skilled workers involved in carrying out construction, renovation and remodeling work. Owners who wish to sell or dispose of a building may choose, for tax reasons rather than sound business reasons, to hold onto the property. For example, the sale of a building may result in a significant "paper gain" without sufficient cash actually being on hand to pay the tax. In such a case, a reduced capital gains rate would make the building's transfer more tenable. The approach put forward in H.R. 9 would unlock a good deal of capital in the private sector, making resources available for improving the infrastructure of America's downtowns.

BOMA also supports two provisions in this legislation that would guarantee fairness in capital gains treatment: that currently held assets should benefit from a reduced rate in the same way as newly acquired assets; and that the tax changes should apply to individually held as well as corporately held assets. Further, we are pleased that H.R. 9 would maintain the current depreciation recapture rules, which recognize that real estate assets do, in fact, depreciate.

Spur Employment

Overall, the capital gains plan contained in H.R. 9 would do a great deal to stimulate prudent investment and reasonable expansion of activity in the office building industry -- an industry that has learned its lesson from the rampant overbuilding that occurred during the 1980s. A significant tax barrier to the sale and redevelopment of commercial properties will be removed, spurring employment for the construction and modernization trades and boosting the nation's economy.

Unreasonable Schedule

A related matter is the need for changing the unrealistic way that improvements made to leased premises are depreciated under current law. Such "leasehold improvements" include changes to walls, floors, ceilings, lighting, plumbing, etc. that will meet the needs of an existing tenant or a new tenant moving into space vacated by an old tenant. While such reconfigurations or buildouts are commonplace -- the average lease length is 5 to 10 years -- improvements made to a tenant space *must now be depreciated over 39 years.* This 39-year rule applies even when improvements are no longer in effect because the given tenant has moved out or the improvements themselves have been demolished. In such cases, the owner is prevented from "closing out" and deducting in the current tax year his/her unrecovered costs connected with the improvement. Those costs must still be recovered over 39 years.

At Odds With Common Sense

This situation runs counter both to common sense and the reality of the marketplace. Over a 39-year period, the typical tenant space may be reconfigured five times or more. The improvements made in each case are only "useful" for the life of the lease or the length of time the work serves the given tenant's needs. The 39-year period is also out of sync with the expectations of lenders as to when they will be repaid by building owners for the financing of tenant buildouts. In addition, when federal government agencies lease space from the private sector, they expect rent and other costs to be broken out by the length of the lease -- not some 39-year period that bears little or no relation to reality.

Where larger offices are concerned, the cost of building out tenant spaces can exceed a half-million dollars. The lengthy depreciable period in current law has the effect of delaying or discouraging such expenditures -- including desirable upgrades to more energy efficient lighting, heating, and cooling systems.

Progressively Worse

The tax treatment of leasehold improvements has not evolved for the better. Before 1981, a reasonable policy was in effect whereby the costs of leasehold improvements could be recovered over the *useful life* of those improvements (typically the length of the lease). After the 1981 Economic Recovery Tax Act, costs had to be recovered over the same depreciable period as that of the building, which at the time was 15 years. The 1986 Tax Reform Act changed the depreciation schedule for commercial buildings (and leasehold improvements) to 31 and-a-half years. The 1993 Omnibus Budget Reconciliation Act further lengthened that period to 39 years.

BOMA urges Congress to shorten the depreciable period for commercial properties so that the costs connected with leasehold improvements can be deducted over a period that reflects the *useful life of the improvements, i.e., 10 years or the length of the lease.* Clarification is also needed so that building owners know they are permitted to close out unrecovered expenses if the construction has been permanently taken out of service. We believe this approach is necessary to address the particular situation of real estate, beyond the "Neutral Cost Recovery System" proposed in H.R. 9.

Boost to Recovery

In decreasing the capital gains tax and providing for a more rational treatment of leasehold improvements, Congress has a dual opportunity: to advance sound tax policy while facilitating real estate's economic recovery.

Our industry is finally turning the corner after its worst slump in 60 years. The nationwide vacancy rate for office buildings is inching downward, from 18.3 percent a year ago to 16.9 percent currently.* These numbers are still high, however -- and are even higher in particular markets. With the excess development of the 1980s freshly in mind, building owners realize that investment opportunities must be carefully weighed and purposefully pursued. Very few new office buildings are being built, and not many are expected to be built until existing vacant space is sufficiently absorbed. It is still a "tenant's market" in most regions of the country, so, to the extent that investments are being made and construction is occurring, the bulk of the activity stems from the renovation and remodeling of older properties. It is just such building upgrades that Congress can expect to spur with capital gains and depreciation changes -- not a headlong rush to new construction.

Traditionally, real estate powers America's economic engine. We are in position to boost the recovery now taking place through the unlocking of capital and by returning to a sensible method for depreciating leasehold improvements. BOMA welcomes Congress' consideration of such changes, and we look forward to having the Ways and Means Committee enact this fair, necessary and productive legislation soon.

* (Figures taken from BOMA's 1993 and 1994 *North American Office Market Review)*

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Founded in 1907, the Building Owners and Managers Association (BOMA) International is a dynamic federation of 98 local associations whose members own or manage over 6 billion square feet of commercial property in North America. The membership -- composed of building owners, managers, developers, leasing professionals, facility managers, asset managers, and providers of goods and services -- collectively represents all facets of the commercial office building industry. BOMA is firmly established as the respected resource on national matters affecting the industry.

STATEMENT
of
COMMONWEALTH EDISON COMPANY
before the
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
regarding the
NEUTRAL COST RECOVERY SYSTEM
proposal of the
JOB CREATION AND WAGE ENHANCEMENT ACT OF 1995 (H.R. 9)
February 3, 1995

INTRODUCTION

This statement is being submitted by Richard P. Roling, Assistant Comptroller, Commonwealth Edison Company, on behalf of Commonwealth Edison. Commonwealth Edison is an investor-owned electric utility serving more than 3.3 million customers and 8.1 million people in the northern one-fifth of the state of Illinois, including the city of Chicago. Commonwealth Edison appreciates the opportunity to submit its views of the neutral cost recovery system (NCRS) proposed in Section 2001 of the Job Creation and Wage Enhancement Act of 1995 (H.R. 9) and respectfully requests that this statement be made part of the record of the hearings on the tax provisions in the Contract with America.

The capital requirements of producing, purchasing, transmitting, distributing, and selling electricity to wholesale, industrial, commercial, and residential customers are quite substantial. Commonwealth Edison forecasts a need to invest approximately $3.1 billion in electric utility property (i.e., nuclear and steam production property, transmission and distribution plant, and nuclear fuel assemblies) during 1995 through 1997 in order to serve its ratepayers in accordance with its obligations as a public utility. Accordingly, Commonwealth Edison is very supportive of Congressional recognition of the need for, and its efforts to provide, tax incentives in the Internal Revenue Code to encourage capital formation by U.S. companies.

This need was most recently addressed in legislation by a modification to the alternative minimum tax (AMT) provisions in the Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66). The modification repealed the adjusted current earnings (ACE) depreciation adjustment prospectively for property placed in service in tax years beginning after December 31, 1993. (The ACE adjustment had the effect of partially negating the tax deferrals provided by the modified accelerated cost recovery system (MACRS).)

The NCRS proposal is a major improvement to the current depreciation system, MACRS, in terms of encouraging capital formation. Commonwealth Edison enthusiastically endorses the goals of the NCRS proposal and generally supports the mechanics of the provisions of H.R. 9 which modify the current depreciation rules. The feature of importance is the inflation adjustment. However, in order for a public utility to fully achieve the capital formation incentives intended by the NCRS proposal, the proposal must contain normalization requirements to provide guidance as to the ratemaking treatment of the tax benefits. Normalization requirements have been included in every major modification to the depreciation rules since the Tax Reform Act of 1969. Public utilities may not realize the same incentives as other industries if normalization requirements are absent from NCRS because some rate-setting public utility commissions could flow through the tax savings to existing customers rather than allow the utilities to reinvest the savings in their plants.

Commonwealth Edison also offers a recommendation to simplify the calculation of the inflation adjustment and comments on the disadvantages to certain industries resulting from the inequity in computing the annual inflation adjustment for long-lived assets relative to short-lived property.

NEED FOR A NORMALIZATION REQUIREMENT

Whether or not the Congressional intent of encouraging capital formation may be achieved by rate-regulated companies will be decided by state and public utility commissions unless a

normalization provision is added to the NCRS proposal. The incentives that would be granted by Congress under NCRS are similar to the excess deferred tax reserves created as a result of the reduction in the corporate income tax rates from 46 percent to 34 percent by the Tax Reform Act of 1986 and to the tax savings resulting from the investment tax credit (ITC) provisions existing at various times between 1962 and 1986. Both the reduction in tax rates and the provision of an ITC created permanent benefits to taxpayers, including utilities. Both of the tax benefits were accompanied by normalization provisions to regulate the sharing of tax benefits between utilities and their ratepayers. Similarly, Commonwealth Edison believes that the sharing of incentives in the NCRS proposal should be governed by normalization provisions in order to achieve intent of Congress.

* * * * *

In 1954, Congress rewrote the Internal Revenue Code. Among the provisions included in the rewritten Code was the right of all taxpayers to claim depreciation allowances that were based on other than a straight-line method, which was, and still is, the method generally used for financial reporting purposes. The 1954 Code provided methods (double-declining balance, sum-of-the years' digits, etc.) that do not change the total amount of tax depreciation, but allow greater amounts in earlier years and offsetting lower amounts in later years. Subsequent additions and revisions to the Internal Revenue Code included the (a) Asset Depreciation Range (ADR) provisions of 1971, which reduced tax lives, (b) the Accelerated Cost Recovery System (ACRS) in the Economic Recovery Tax Act of 1981, which continued to allow acceleration of tax deductions, and (c) the Tax Reform Act of 1986, which reduced but did not eliminate the acceleration.

Congress stated in the Committee Reports accompanying these pieces of legislation that the incentive of accelerated depreciation was being granted by Congress to all taxpayers for purposes of encouraging the modernization of the nation's industrial facilities and improving productivity. (Similarly, Representative Nick Smith, who introduced NCRS in H.R. 539 and H.R. 9, advocates NCRS as a means to encourage businesses to invest in machinery and equipment.) The economic effect of the incentive of accelerated tax depreciation over straight-line depreciation is equivalent to an interest-free loan from the U.S. Treasury to the taxpayer. This loan, measured by the tax rate times the difference between accelerated depreciation and straight-line depreciation, builds up in the earlier years of a property's life and then is repaid in the later years. It is important to recognize that the only benefit of accelerated depreciation to taxpayers is an interest-free loan provided by the postponed, but not forgiven, tax payments. The principal of the loan has to be repaid. Because Congress has made these interest-free funds available during the life of the property, less outside financing is required, thereby reducing financing costs. These reduced financing costs are realized over the life of the property. This benefit granted by Congress is available to all taxpayers.

Congress initially did not provide guidance as to the ratemaking treatment of these benefits. Some regulatory commissions reduced the rates charged to current customers by the amount of the loan itself, rather than the value of the interest-free nature of the loan. Passing the principal of the interest-free loan to customers is referred to as "flow-through" ratemaking. These commissions implicitly assumed that the utilities would recover these costs in the form of higher rates from future ratepayers. A majority of regulatory commissions, however, adopted ratemaking procedures which reduced customer rates by only the reduced financing costs. These commissions generally passed on to customers the real economic benefit of these loans by requiring that the accumulated deferred income tax balances (i.e., the loan to be repaid) be deducted from the utility company's rate base on which it was entitled to earn a return. This type of ratemaking, referred to as "normalization," is more beneficial and equitable to customers in the long run and is consistent with the Congressional intent of reducing financing costs over the life of the property. Congress ultimately enacted normalization provisions to incent regulatory commissions to use normalization ratemaking in setting utilities' rates.

It is important to note that Congress has not required the regulatory commissions to follow any particular form of ratemaking. Rather, Congress indicated that if a regulatory commission

were to follow ratemaking procedures with respect to tax incentives that created economic results contrary to the intent of Congress in granting such incentives, those incentives would no longer be available to the taxpayer subject to such ratemaking procedures. The practical effect, of course, is that regulatory commissions recognized the benefit to customers of these interest-free loans and did not want to do anything that would jeopardize the right of the utility companies to utilize them.

The reduction in the corporate income tax rate in the Tax Reform Act of 1986 from 46 percent to 34 percent, had the effect on all taxpayers of reducing the loan that must be paid back to the U.S. Treasury. Congress essentially forgave a portion of the interest-free loans outstanding at December 31, 1986. Although a portion of the interest-free loans has been forgiven, Act Section 203(e) specifies that the related economic effect should continue to be handled in a manner consistent with the Congressional intent for providing accelerated depreciation as a tax incentive for plant modernization and improved productivity. The average rate assumption method mandated by Act Section 203(e) provides that the excess tax reserve resulting from the forgiveness must not be reversed (i.e., used to reduce rates) any more quickly than the timing difference between the book and tax depreciation method reverses. Congress chose not to allow utilities to permanently retain the tax benefit and chose not to flow the benefit through immediately to current ratepayers. Instead, Congress opted for an equitable sharing among utilities, current ratepayers, and future ratepayers.

Commonwealth Edison believes that the tax savings under NCRS, which are economically similar to the excess tax reserves normalized under Act Section 203(e), should also be governed by a normalization provision so that the tax benefit is shared among utilities, current ratepayers, and future ratepayers. Otherwise, the opportunity of achieving the Congressional intent of fostering capital formation may not be attainable by rate-regulated utilities.

Congress has allowed an ITC at various times between, generally, 1962 and 1986 in order to encourage capital formation by taxpayers. Credits, including the ITC, provided in the Internal Revenue Code have the effect of reducing tax liability on a dollar-for-dollar basis. Unlike accelerated depreciation, which results in the temporary benefit of an interest-free loan from the government to taxpayers, ITC results in a permanent benefit to taxpayers. ITC, therefore, is a powerful incentive to taxpayers to invest in qualifying property. The benefit generated by ITC is economically similar to the forgiveness of the interest-free loan resulting from the reduction in tax rates in the Tax Reform Act of 1986.

Congress intended the ITC to be an incentive for modernization and growth of private industry; it did not intend for the ITC tax benefits to be used to immediately reduce rates of current ratepayers. Accordingly, Congress enacted a normalization provision for ITC in the Revenue Act of 1971 to mandate an equitable sharing of the tax savings arising from ITC among utilities, current ratepayers and future ratepayers. Normalization provisions have also been an integral part of all subsequent ITC allowances in the Internal Revenue Code.

The incentives underlying the NCRS proposal, including the inflation adjustment, are similar to that of other accelerated depreciation systems and the ITC. Congress recognized that both incentives needed normalization requirements in order to achieve their capital formation purpose. The economic benefits of NCRS inflation adjustments are economically similar to that of the excess deferred tax reserves created as a result of the reduction in the corporate income tax rates from 46 percent to 34 percent by the Tax Reform Act of 1986 and to the tax savings resulting from ITC. Again, Congress recognized and provided normalization requirements for these tax benefits. Accordingly, Commonwealth Edison believes it is appropriate and necessary for Congress to provide normalization requirements under NCRS for the inflation adjustments in order to allow utilities the same incentives and opportunities for capital formation as non-rate-regulated companies.

SIMPLIFICATION OF CALCULATION OF ANNUAL INFLATION ADJUSTMENT

The mechanics of determining NCRS depreciation adjustments, which aim to provide the approximate economic equivalent of currently deducting the cost of assets, involve the indexing of depreciation deductions for inflation. Briefly, depreciation for a NCRS asset in a given year would equal depreciation based on the 150 percent declining balance method multiplied by the "applicable neutral cost recovery ratio." The applicable neutral cost recovery ratio for a given recovery year is based upon the gross domestic product deflator for the calendar quarter the asset is placed in service as well as the gross domestic product deflator for such recovery year.

Under MACRS, taxpayers generally use a single depreciation rate in a given recovery year for personal property within a single asset class placed in service in the same tax year. The only situation in which quarterly records (i.e., different depreciation rates for a given recovery year for personal property within a single asset class placed in service in different quarters of the same tax year) are required to be maintained under MACRS occurs when a taxpayer does not meet the requirements of the half-year convention. (A taxpayer may not use the half-year convention and must use the midquarter convention for personal property of any vintage year in which 40 percent or more of its personal property additions are placed in service in the last quarter of the year.) The proposed calculation of the applicable neutral cost recovery ratio would needlessly cause the vast majority of taxpayers mandated to use the half-year convention to increase their record-keeping burden. Commonwealth Edison believes that basing the calculation of the applicable neutral cost recovery ratio for taxpayers using the half-year convention on a single gross domestic product deflator (i.e., the deflator for the month closest to the date the property is deemed to be placed in service under the half-year convention) would likely have an immaterial effect on the aggregate NCRS depreciation adjustment for assets within a given asset class relative to the proposed method of using four deflators per year. Commonwealth Edison, therefore, recommends that the selection of the gross domestic product deflator under the NCRS proposal be consistent with taxpayers' applicable convention under IRC Section 168(d) so that administrative complexity is not needlessly created. The calculation as proposed would be used for property vintages to which the midquarter convention applies and the calculation under NCRS would be revised for taxpayers subject to the half-year convention to be consistent with the current MACRS requirement of using a single depreciation rate for property within each asset class of each vintage year.

INEQUITY TO INDUSTRIES USING LONG-LIVED PROPERTY

One of the stated reasons for the NCRS proposal is recognition that MACRS depreciation deductions do not allow businesses to recover the true economic cost of their business investments. The NCRS proposal is intended to increase depreciation deductions to approach the economic equivalent of expensing capital additions. This is achieved by indexing depreciation by the applicable neutral cost recovery ratio. For short-lived personal property, the ratio is based upon a 3.5 percent annual return and actual inflation. For 15-year and 20-year personal property, realty, and certain other property, the applicable neutral cost recovery ratio is based solely upon actual inflation. Under the proposal, businesses investing heavily in such property would not be afforded the same opportunity to achieve true economic cost recovery on such assets as would businesses investing primarily in short-lived assets. Industries investing heavily in assets which would not qualify for the full NCRS adjustment include, but are not limited to, electric, gas, water and sewer utilities, railroads, telecommunications providers, cement manufacturers and real estate lessors. Commonwealth Edison believes it would be inequitable to favor certain industries over others under a revised cost recovery system described as "neutral." Commonwealth Edison recommends that this disadvantage be eliminated by providing for a full NCRS adjustment for all assets.

Testimony of
Robert E. Friedman* and Cicero Wilson**
Corporation for Enterprise Development***
Before the Committee on Ways and Means of the
U.S. House of Representatives

Hearings on Savings and Investment Provisions of the
Contract With America
January-February, 1995

Mr. Chairman and Members of the Committee:

Thank you very much for the opportunity to submit this testimony on the provisions of the American Dream Savings Account ("ADS Account") for your consideration.

For the past fifteen years the Corporation for Enterprise Development (CFED), a national, non-profit economic development policy organization, have been working largely at the state and community level to develop and test effective strategies for creating enterprises, jobs and viable economies in low income communities. To that end, we have helped a number of states develop comprehensive economic development strategies, and have issued The Development Report Card for the States (generally regarded as the auditing standard for state economic health) for 8 years. We sponsored the five-state Self Employment Investment Demonstration for welfare recipients, and helped create the national microenterprise movement. We have helped a number of states craft human investment and welfare reform initiatives, including Iowa's Family Investment Program which has already resulted in a 70% increase in employment and a 7% reduction in average grant levels. Finally, we have been leading advocates for asset-building anti-poverty strategies, and have worked to launch Individual Development Account demonstrations at the community, state and Federal levels.

The American Dream Savings Account proposal recognizes the importance of encouraging savings and investment in education and home ownership not only for the economy as a whole, but for the long term welfare of all American families -- including low income Americans. This represents an important departure from traditional policy which has subsidized asset acquisition for the non-poor while it has actually penalized asset-acquisition by the poor. Unfortunately, as currently written, American Dream Savings Account proposals would continue this discriminatory policy: for example, the Administration's proposal and S. 12, the "Savings and Investment Act of 1995," would devote tens of billions of dollars worth of tax expenditures to subsidizing the savings of non-poor Americans as an entitlement with no evaluation measures, while for the poor it would simply allow asset acquisition, and then in a time-limited demonstration subject to rigorous evaluation requirements. This hardly levels the playing field -- a playing field that is dramatically uneven both in terms of the existing distribution of assets, and in the weight of current policy. At the same time, we believe the American Dream Savings Account proposals have great promise for building families, communities and the economy as a whole if amended.

We recommend that the "Savings and Investment Act of 1995 and similar proposals be amended to provide a refundable tax credit equivalent in value to the tax deductions provided the non-poor to savings placed in the ADS Accounts of Americans in households with incomes below $25,000 per year.

We also recommend that the allowable uses of the ADS Accounts be expanded to include "verifiable investments in the business of an account holder."

We have calculated that this investment in the economic futures of low income Americans will yield returns several times greater that the initial investment requires. It will create jobs and businesses, expand home ownership and skill levels, increase incomes and business revenues, strengthen families and community economies, and increase tax revenues and GNP. Perhaps most importantly, these changes would extend an investment system to low income Americans, and in so doing, would reintroduce the American Dream into thousands of communities and millions of households who have ceased to hope.

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* Robert E. Friedman is Chairman and Founder of the Corporation for Enterprise Development, author of the book The Safety Net as Ladder: Transfer Payments and Economic Development, and has spent the last two decades researching, developing, demonstrating and disseminating economic development strategies.

** Cicero Wilson, Project Director with the Corporation for Enterprise Development, formerly headed the Neighborhood Revitalization Program at the American Enterprise Institute, and has run youth programs, small businesses, and evaluated and researched program and policies for Abt Associates.

*** The Corporation for Enterprise Development is a national non-profit economic development policy research and consulting organization founded in 1979.

I. Building assets of all Americans -- including low income Americans -- is critical to individual welfare and national economic prosperity.

As Michael Sherraden argued in his seminal book, Assets and the Poor: A New American Welfare Policy[1], people escape poverty and achieve wealth through asset acquisition, not simply income. Owning assets give people a stake in the future -- a reason to save, to dream, to invest time, effort, resources in creating a future for themselves and their children. As Sherraden notes, "Income may feed people's stomachs, but assets change their heads."

In the earliest stages of this Republic, Thomas Jefferson recognized that property-holding lay at the heart of full participation in American political, social and economic life. In Assets and the Poor, Sherraden notes that people escape poverty the same way they achieve wealth: through asset acquisition. Accumulating even a small pool of savings buffers a family from the illnesses and accidents that otherwise become crises; they give the luxury of imagining a future brighter than the present; they enable people to plan and prepare for that future, and ultimately to invest in themselves and their children. People are often surprised at the suggestion that welfare recipients who scarcely have adequate resources to eat or find shelter might be willing to save money. But in public housing complexes and poor communities around the country families choose to forgo current consumption and put a few dollars away... because that is the price of family stability, the price of hope. It is people without hope that have children they can't care for and trifle with their own lives and those of others; "Assets," notes Sherraden, "are hope in concrete form."

Indeed, some of the most successful economic and social policies in our history -- policies which produced significant, long-term, widely shared economic growth -- have been democratic investments in the assets of common Americans. The Homestead Act, wherein we provided 160 acres and a mule to Americans willing to work the land, under girded the development of whole states (and the families that built them). Through the GI Bill, we bought college education's for a generation of people who served their country in time of war; they in turn drove our post-war economic expansion. Now we need to offer a way back in to the economic mainstream for the third of our nation that is falling behind and away with each passing year.

II. Both the distribution of assets and our policies for building assets are dramatically unequal and discriminatory.

One third of American households have no or negligible investable assets.[2] Twice that -- some 67% of African Americans -- are asset-poor. And asset poverty has been increasing for at least two decades.[3] This comes at a time when the price of entry to the American economic mainstream -- measured in terms of the cost of an adequate education, business capitalization or home ownership -- has increased. Asset owning has become a sort of economic grandfather clause, every bit as insidious as the voting clauses of days passed that said you could only vote if your grandfather did.

This pattern of asset-holding is abetted by a bifurcated national policy: we subsidize asset acquisition for the non-poor to the tune of $160 billion annually at the Federal level in the form of the home mortgage deduction and retirement savings incentives. Meanwhile, we actually penalize asset acquisition by the poor by denying eligibility to welfare recipients who exceed the $1000 asset limitation by acquiring the piece of business machinery that could enable them to create their own job, or saving for their or their children's college education, or acquire a car capable of reliable transportation to work.

American Dream Savings Account proposals like S. 12 recognize that low income Americans have an interest in developing assets and would therefore raise the asset limits which currently prevent AFDC, Food Stamp recipients and other low income Americans from acquiring assets. But, unfortunately, as currently proposed, proposals like the "Savings and Investment Incentive Act of 1995" would continue the discriminatory bifurcated policy that offers tens of billions of tax incentives to the non-poor while leaving most poor and working poor out. To the credit of the sponsors of this legislation, it does address the issue of assets for the poor -- it contains provisions that would lift the asset penalties for AFDC savers noted above. But while it would allow the poor to accumulate assets in a demonstration under rigorous evaluation requirements, it would provide tens of billions of dollars in tax incentives to the non-poor as an entitlement and without any evaluation.

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[1] Michael Sherraden, Assets and the Poor: A New American Welfare Policy, Armonk, NY.: ME. Sharpe, Inc., c1991.

[2] M.L. Oliver and T.M. Shapiro, "Wealth of a Nation: At Least One Third of Households are Asset-Poor," *The American Journal of Economics and Sociology*, vol. 49, No. 2, April 1990. pp 129-150.

[3] Ibid.

We need to develop policies which will help all Americans, including welfare recipients and the working poor willing to work and save, build the assets which they need to achieve self sufficiency for themselves and growth for the economy.

There are several Individual Development Account (IDA) pilot projects currently being operated by churches, corporations and community based organizations around the country -- in places as far flung as Tupelo, Mississippi, Indianapolis, Indiana and Bozeman, Montana. "I Have A Dream" Programs in 44 cities promise college tuition's to students who stay in school; savings clubs proliferate in public housing complexes where women match each others savings to provide an emergency fund all can tap; banks and churches are developing home ownership programs wherein savings for down payments on houses are matched; and low income entrepreneurs build up assets in their businesses. Six states have sought or been granted waivers which allow AFDC recipients to build up savings in qualified asset accounts. Iowa has authorized a pilot program of Individual Development Accounts under which the state will provide refundable tax credits to Iowans below 200% poverty. Oregon's Jobs Plus program provides that employers who hire welfare recipients with a hiring subsidy paid for by cashing out AFDC and Food Stamp benefits deposit $1 for each hour worked into an IDA earmarked for future education and advancement. More states, organizations as diverse as the Congress of National Black Churches, the National Federation of Community Development Credit Unions, banks, and thousands of microenterprise programs and neighborhood development corporations stand eager to launch IDA programs if only the Federal government will become a partner.

If we would know the potential efficacy of such policies, we may look to our own history, or to other countries. Japan financed much of its post-war recovery through the small savings of common citizens prodded by the availability of Postal Savings Accounts. Singapore has built its whole social policy around government incented private savings in the Central Provident Fund. Not only has the system resulted in home ownership rates now exceeding 92%, but it has resulted in the highest level of foreign reserves per capita of any nation on the globe.

III. American Dream Savings Account proposals should encourage and support the savings and productive investment of low income Americans to the same degree that they encourage those of wealthier Americans.

What is good for the non-poor is good for the poor. ***We recommend that these "super-IRA" or "American Dream Account" proposals be amended to add a refundable tax credit equal in value to the benefit conferred on higher income savers for American households with less than $25,000 a year in household income.*** These tax credits should match all savings in a qualifying account up to $500 per year up to a total of $1,000 - 2,000. This would encourage private, state and local matches. The refundable tax credit could be deferred until withdrawal from the account.

More specifically, we would recommend that such a tax credit provide a:

- 100% match to the savings in the ADS Account of a individual below the poverty line 100% up to $500 per year for up to four years;
- 50% match to the savings in the ADS Account of a individual between the poverty line and $25,000 per year up to $500 per year for up to four years.

There are a number of reasons for extending asset building incentives to low income communities in this way, but chief among them are:

- **Fairness:** The proposed ADS Accounts represent a national tax commitment numbering in the tens of billions of dollars over the next ten years; a reasonable portion of this should accrue to the benefit of low income Americans, especially given that they cannot participate in the $160 billion of asset subsidies we currently provide the non-poor for home mortgage and retirement savings. The proposed ADS Accounts would provide a tax benefit in excess of $600 to the average taxpayer who saved $2,000 per year and withdrew the savings in year 5 (his or her tax benefit would grow each year thereafter). We should extend this benefit to low income savers as well.

- **Need for an Inclusive Investment Policy:** Ever since the New Deal, we have spent on the poor, but have not invested in them. The limits of that almost exclusive reliance on consumption maintenance and social services has helped curb the pain and effects of poverty, but has not affected its causes. Now we need an inclusive investment policy which encourages and enables low income Americans to build their productivity and ours. We need an asset policy to augment income policy.

- **Earned:** Low income Americans would only get the benefit of tax credit if they chose to save, with the immediate sacrifice that implies for families living on such limited income.

- **Productivity of Capital:** One of the major criticisms of savings incentives like those for IRAs or the proposed ADS Accounts is that rather than inducing net new savings, the subsidy simply induces a transfer of savings from non-subsidized to subsidized forms. In the case of low income Americans, however, the likelihood of such shifting is much less, and any savings are most likely to represent a shift from consumption to investment.

- **Political Support:** Making ADS Account incentives include low income Americans could draw support from quarters likely otherwise to oppose the proposals. Already Individual Development Account proposals which aim at helping low income Americans build assets have drawn excitement and support from groups as diverse as the National Congress of Black Churches, the National Federation of Community Development Credit Unions, and political leaders as diverse as Bill Bradley, Orrin Hatch, Tony Hall, Bill Emerson, Cardiss Collins, Jack Kemp and Bob Woodson.

- **Leverage:** Community groups and states stand ready to launch ADS Account initiatives and leverage Federal investment if only given the signal.

Costs and Returns: The extension of a refundable tax credit to low income Americans is not an inexpensive change. Assuming an average benefit of $250 per low income saver per year, and that only one in five eligible Americans opts to participate, we estimate an annual cost of $1-2 billion once withdrawals are permitted.

But we calculate that the direct proceeds to the Federal government -- ignoring the returns to individuals and the society at large -- will exceed $4 for each dollar invested over a 10 year period. States will get back $5 for each dollar invested and participants would receive $7 in benefits for each dollar invested.

These figures assume that one-half of the outputs noted above would have occurred otherwise; that is, we cut the estimated returns in half. They do not quantify expected changes in hope, initiative taking, family stability, civic participation, and involvement in childrens' educations.

American Dream Savings Accounts for low income families represent the center of a new investment policy in contrast to the current income/consumption maintenance policies. We use investment in the old-fashioned and precise sense of an application of resources today that creates greater returns tomorrow. We at CFED have recently estimated the likely outputs of an investment in IDAs, and will soon release a return on investment analysis based on the best available data. We estimate that 100,000 accounts with an average personal saving of $10 a month by low income Americans, matched 1:1 by private individuals and state and local governments, with the Federal government matching those contributions will produce in 10 years (please note that these are preliminary calculations which are subject to change):

- Over 46,000 job-years, at
- 6,000 new businesses
- $150 million in business revenues
- 4,500 new homes built
- 3,000 more college graduates
- 11,000 High School dropouts now getting a HS degree or equivalency
- Medicaid savings of over $171,000,000
- Welfare savings of nearly $37,802,000
- $419,502,000 in savings

Estimating an internal rate of return on this investment, the Federal government's return is 30%; the state government's return is 39%; and the rate of return for the average participant is 154%, well above the interest in Treasury bills.

In a larger sense, of course, these projections are like the returns included in the business plans of proposed ventures: we will never know the true returns unless we risk the investment.

Other Recommendations:

Recommendation 2: Extend the permissible uses of ADS Accounts to include "verifiable investments in the business of an account holder." We assume that business investments were left out because of the greater difficulty of policing such investments and the greater possibilities of fraud. But the benefits of greater entrepreneurship in terms of jobs, community and economic development, competitiveness and skill-building are so great that we should accept some reasonable risk to seize these benefits. Between 1989 and 1991 (the most recent period for which this data is available), for example, microenterprises involving only the

self-employed owner and 1-3 family members or colleagues created virtually all of the net new jobs in the country (some 2.6 million jobs net).[4]

Investments in business equipment and business leases should not be appreciably more difficult to verify than tuition and mortgage payments; they are similarly large and made out to third parties. Moreover, banks or reputable business assistance providers willing to verify payments according to a written business plan should be able to provide reasonable assurance that ADS Accounts were used as intended. At any rate, the burden of proof can be shifted to the taxpayer to provide reasonable proof.

Recommendation #3: Provide an up-front tax deduction/credit as IRA's do now rather than the back-ended deduction/credit upon withdrawal. This increases the early costs of the proposal, but it allows a more honest accounting of costs, and increases the power of the incentive.

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[4] "New Data Show Smallest Firms Are Nation's Greatest Job Creators," Washington, D.C.: Small Business Administration, Press Release, September 30, 1994.

TESTIMONY OF JAMES A. DOUTT
FALMOUTH, MA

There is, before the House ways and means committee (Advisory # FC-2), a proposed tax measure which would adjust capital gains for inflation. I strongly believe that passage of such a measure is ESSENTIAL.

The present system is grossly unfair. I an willing to support the activities of my government through taxation of income I receive. However my blood boils when I have a "phantom gain" (a loss when inflation is taken into account) and am forced to pay tax on it.

The success of the US tax system depends on treating the taxpayers fairly in order to ensure the taxpayers willing compilance. That is not being done with capital gains under the present system.

I also support the idea of allowing homeowners who sell their homes at a loss to take a capital loss deduction. Of course, inflation should be taken into account when determining the gain (or loss) when selling the home.

In addition, I support the increase in the estate and gift tax exemption, and the indexing of it for inflation.

I strongly encourage your committee to support such reform.

my name: James A. Doutt
capacity: Citizen & Taxpayer
address: 47 Sippewissett Rd.
Falmouth, MA 02540
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Mr. Chairman, and members of the Ways and Means Committee, The ESOP Association submits this written testimony to address various issues that have surfaced during the Committee's hearings on the tax provisions of the "Contract with America".

This written submission is from The ESOP Association, and was primarily prepared by J. Michael Keeling, president.

The ESOP Association represents approximately 1,100 U.S. companies that are all or partially owned by their employees through an Employee Stock Ownership Plan, or ESOP. The Association's activities and services are open to the approximate 1 million American employees participating in these companies' ESOPs. As a Code Section 501(c)(6) organization, the Association is the only entity in America that communicates regularly with Federal decisionmakers on policies and ideas that may impact employee ownership in America.

Originally, The ESOP Association felt that submitting testimony on the tax provisions of the Contract with America was not appropriate, as there is nothing in the Contract that deals directly with employee ownership or ESOPs. We wish there were, but this is just not the case.

An advantage of submitting written testimony to the Ways and Means Committee versus testifying verbally is that the submitter can review the testimony and dialogue from others before putting pen to paper.

We note that many groups representing American business have come to your Committee recommending alterations and additions to the Contract as it pertains to estate taxes, capital gains taxes, and investment cost recovery by U.S. corporations.

Given the fact that over recent years a significant number of the members of the Ways and Means Committee has expressed support for legislation entitled the "ESOP Promotion and Improvement Act", and given the fact that the legislation contains provisions related to the specific topics expanded during the Committee hearings, The ESOP Association feels that it is appropriate to link certain tax ideas that do relate to ESOPs and current and proposed tax law changes pending before the Committee.

(For example, 10 members of the Committee, 9 members of the majority, and 1 member of the minority, sponsored H.R. 2088 during the 103rd Congress, the "ESOP Promotion and Improvement Act" of 1993.)

Specifically, on several occasions in recent weeks, the Committee has heard that small business needs certain alterations in the Contract proposals affecting small business. The suggestions are made in a positive sense in that the alterations are put forth as coming closer to the goals of the Contract than the specific proposals embodied in legislation that was to implement the Contract.

Everyone agrees that a significant number of small businesses operate as Subchapter S corporations, and that assisting those corporations assist small business as a general rule.

The ESOP Association respectfully suggests that now is the time to amend the Subchapter S laws to permit a Subchapter S corporation to sponsor an ESOP, and thus employee ownership. H.R. 2088 contains such a provision, designed to limit, or even enhance revenue adjustments if Sub S's are permitted to sponsor ESOPs.

Many business leaders have come to the Committee pointing out that the cost recovery provisions of the legislation to implement the Contract are not as helpful compared to other things the Committee could do in the area of business taxation. Frequently suggested is outright repeal of the corporate alternative minimum tax. Should the Committee open up a deliberation on the corporate alternative minimum tax, we ask that you review the IRS's retroactive regulations, that imposed a tax on ESOP deductible dividends, many first paid in 1987, because of an 1989 amendment to the corporate alternative minimum tax.

The unfairness of the IRS position is real, and the ESOP community would welcome the opportunity to go over this IRS regulation and the provision of H.R. 2088 that clarifies that the Congress never enacted any provision supporting the IRS position.

And, the Committee has heard much about the unfairness of the estate tax on small and family businesses. Discussion about raising the estate tax deduction limit is strong. H.R. 2088

contains a provision that the Committee might review if it alters the estate tax provisions of the Contract. From 1987 until late 1989, a small business could accept employer securities from an estate of a significant shareholder, put those securities in an ESOP, and assume the estate tax liability of the deceased. This provision of law never resulted in a loss of Federal revenue greater than $5 million per year. It would open another option to expand employee ownership in a manner that preserves small, closely held businesses.

But clearly, the heaviest debate surrounding the Contract and its tax provisions arise in the area of capital gains, and the rate of tax to be applied to long term gains. Many have suggested expanding the Contract provision, others shrinking, and some suggest forgetting it.

Again, if the Committee commits to moving into a variety of issues involving capital gains, The ESOP Association feels that a provision of law permitting capital gains tax deferral under certain conditions if the gains arise from a sale to an ESOP is currently not as fair as it should be. Under current law, an employee who holds stock because of his/her status as an employee is not permitted to sale the stock to an ESOP and defer the capital gains tax under Code Section 1042, whereas a person who holds stock otherwise can. In other words, an employee with stock as a result of stock option, stock purchase, stock compensation, etc. cannot sale to the ESOP and defer the capital gains tax. This restriction should be lifted.

In all of the four matters mentioned above, the revenue impact is not significant. The subchapter S provision would result in taxes paid through the UBIT provisions of the Code; the correction of the IRS AMT position is a clarification of law; the estate tax provision never cost more than $5 million per year; and the entire Code Section 1042 provision is scored at a revenue less of less than $50 million per year, and thus an expansion should be a significantly smaller amount than $50 million.

The ESOP Association appreciates the opportunity to submit this statement to the Committee, its members, and its staff.

STATEMENT OF

HOME OFFICE ASSOCIATION OF AMERICA
SUBMITTED TO
HOUSE COMMITTEE ON WAYS AND MEANS

RELATING TO THE SAVINGS AND INVESTMENT HEARINGS

February 2, 1995

Chairman Archer, Representative Gibbons, and Members of the Committee on Ways and Means, my name is Richard Ekstract. I am Chairman of the Home Office Association of America ("HOAA"), an organization dedicated to serving the needs of individuals whose offices are in their homes. I appreciate the opportunity to submit testimony on two issues of vital importance to HOAA: the home office expense deduction and the self-employed health insurance deduction.

Background on Home Office Expense Deduction Issue

Up until enactment of the 1976 Tax Reform Act, taxpayers were able to take liberal advantage of home office deductions for most types of work conducted at their personal residences, either as an ordinary and necessary business expense under tax code section 162 or as an expense for the production of income under section 212. In response to perceived abuses of the deduction, Congress enacted section 280A, which sets forth rules and limits on the deductibility of expenses attributable to the business use of homes for individuals and S Corporations.

These rules and limitations no longer reflect the realities of how individuals work in today's world. Section 280A states that no home office deductions are allowed unless the deduction meets specific, and in our view overly complex, statutory requirements. It is virtually impossible for a large number of home office workers to qualify under these rules, and those that qualify cannot be sure that they do.

The rules state that the portion of the home that is used for business must be used exclusively on a regular basis,1/ and in only one of the three following ways: (1) as the principal place of business for any trade or business;2/ as a place normally used by clients, patients, or customers;3/ or in connection with the taxpayer's trade or business if the taxpayer is using a separate structure unattached to the personal residence.4/ Of these additional requirements, we have found that defining a taxpayer's

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1/ See § 280A(c)(1).

2/ § 280A(c)(1)(A).

3/ § 280A(c)(1)(B).

4/ § 280A(c)(1)(c). Two additional exceptions are provided in the statute which do not require exclusive use of a portion of a residence. A taxpayer in the business of selling products at retail or wholesale may take deductions allocable to space within the residence which is used on a regular basis as a storage unit for inventory of the business. This exception is only available if the residence is the sole fixed location of the business. See § 280A(C)(2). A taxpayer regularly using the residence to provide day care for children, adults over age 65, or mentally or physically disabled persons may qualify for deductions allocable to the day care business. See § 280A(c)(4). Deductions under § 280A are limited to the excess of (1) gross income from the use of the dwelling unit over (2) the deductions allocable to the unit which are allowable without regard to business use. See § 280A(c)(5).

"principal place of business" is the most difficult, and the various tests which have been formulated by the courts cannot achieve equitable results.

Supreme Court Restrictions Are Not Reasonable

In *Soliman v. Commissioner*,5/ the Supreme Court exacerbated the statute's already confusing scheme. In that case, the Court attempted to address the appropriate factors a taxpayer must use in determining whether a home office is his or her "principal place of business." The taxpayer in *Soliman* was an anesthesiologist who was employed by three hospitals, but who maintained a home office as a principal place of business used exclusively two to three hours a day for contacting patients and surgeons, and for performing related activities.

Even though the hospitals provided no office space to the taxpayer in *Soliman*, the Supreme Court reversed the lower court decisions which had allowed the deduction.6/ The Court's effort significantly narrowed the scope of the home office deduction by setting up a comparative test for determining whether an individual's home office is that person's principal place of business.7/

The comparative test does not work. The Court's two primary factors -- (1) the relative importance of the activities performed at each business location, and (2) the amount of time the taxpayer spends at each place of business -- are too vague.8/

The IRS' subsequent explanation of how it will apply the "relative importance" and "time" tests highlights the complex problems that the normal, unsophisticated home office worker must now confront.9/ Under this ruling, the Service said it will first apply the "relative importance" test, and if this test yields no definitive answer, it will look to the "time" test.10/ There is no way for a home office worker to achieve any level of comfort with these rules without expending considerable funds in lawyer or accountant fees.

5/ 113 S. Ct. 701 (1993).

6/ 113 S. Ct. at 708.

7/ Id. at 706. The Court rejected both the "focal point" test formerly favored by the Tax Court and the facts and circumstances test subsequently adopted by the Tax Court, which had won approval of the U.S. Court of Appeals for the Fourth Circuit.

8/ Id. In denying the home office deduction, the Supreme Court determined that the taxpayer's treatment of patients at the three hospitals was the "essence of a professional service" and the "most significant event in the professional transaction." The home office activities were regarded as less important to the taxpayer's business than his work at the hospitals. Id. at 708.

9/ Rev. Rul. 94-24, 1994-15 I.R.B. 5. The IRS had previously announced that it will not challenge home office deductions taken for 1991 and earlier tax years if the taxpayer reasonably fell within the scope of previous guidance issued by the IRS. See Notice 93-12, 1993-8 I.R.B. 1. The Service has also withdrawn a portion of proposed regulations under § 280A (issued in 1983) to reflect the *Soliman* decision. See IA-23-93, 59 Fed. Reg. 26466 (May 20, 1994).

10/ Rev. Rul. 94-24, 1994-15 I.R.B. 5.

Responses to *Soliman*

We applaud Congress' response to the *Soliman* decision, as numerous bills were introduced in the 103rd Congress. In particular, we strongly supported the Home Office Deduction Act of 1994, introduced in the House by former Representative Hoagland (D-NE) (H.R. 3407) and in the Senate by Senator Hatch (R-UT) (S. 1924).11/ The bill would have provided that a home office can qualify as a principal place of business if "the office is the location where the taxpayer's essential administrative or management activities are conducted on a regular and systematic (and not incidental) basis by the taxpayer," and the office is necessary because the taxpayer has no other location for the performance of such activities. The bill also contained a provision allowing for the deduction of business expenses attributable to home storage space for product samples. Currently, tax code section 280A(c)(2) allows a deduction for storage space for inventory only.

We were extremely pleased to see that Chairman Archer included the provisions of the Home Office Deduction Act in sections 12003 and 12004 of the Job Creation and Wage Enhancement Act of 1995 (H.R. 9), introduced on January 4. We urge their inclusion in the first tax bill which the Congress sends to the President this year.

Clarifying Home Office Expense Deduction Makes Sense for the 1990s and Beyond

The *Soliman* decision is not in step with commercial practice and economic reality. Home-based businesses have been growing in number and will likely continue to do so for the indefinite future.12/ These businesses create opportunity and jobs.

Many individuals affected by corporate downsizing have responded by creating small businesses operated out of the home. With the advent of fax machines, personal computers, and other telecommunications advances, these entrepreneurs have been able to run businesses out of the home that traditionally required an office setting. The success of many of these businesses has depended on whether or not they could be started up as home-based enterprises. The existence of a tax deduction for home office expenses can make an important difference for these fledgling companies.

Clarifying the home office expense deduction also makes sense from a family perspective. Home-based businesses have become an attractive option for parents who choose to work at home to spend more time with their children or elderly parents. Taxpayers should not be penalized for making such a choice.

Background on Self-Employed Health Insurance Tax Deduction

We also strongly support enactment of legislation allowing self-employed individuals to deduct their health insurance costs.

11/ H.R. 3407 had 83 cosponsors (37 Democrats/46 Republicans), including 13 Members of the Ways and Means Committee. S. 1924 had 15 cosponsors (7 Democrats/8 Republicans), including 3 Members of the Finance Committee.

12/ One 1992 news article reported that approximately 30 million Americans work out of the home. See G. Hall, Home Based Businesses Create Local Controversies, Gannett News Service (Nov. 10, 1992); see also New Publishers Serve At-Home Workers, L.A. Times, Feb. 14, 1993, at D10. The number of publications serving the growing number of at-home workers has risen dramatically. At present, there are approximately 50 publications. See id.

Prior to January 1, 1994, a self-employed individual generally could deduct 25 percent of the amount paid for health insurance for the taxable year on behalf of the individual and his or her spouse and dependents.13/ Congress' purpose in establishing this deduction in 1986 still exists today. At that time, lawmakers expressed concern about the disparity in tax treatment of health benefits between self-employed individuals and owners/employees of incorporated businesses.14/ The 25 percent deduction that self-employed individuals received for their health insurance premiums was designed to provide at least some portion of the favorable treatment for health insurance afforded employees covered under an employer-provided plan.15/

Restoring Self-Employed Deduction Would Represent Strong Step Toward Providing Equitable Treatment to Home Office Businesses

Mr. Chairman, a sense of excitement exists when entrepreneurs start up their home office businesses. Many express relief to be free from headaches like commuting, endless meetings, and office politics. They feel that they will be as free to go as far as their abilities will take them. Then, reality sets in. They realize that they often have to pay more for everything. For starters, they realize that they have to buy their own health insurance coverage at outrageous costs, and that the Federal Government, by providing disparate treatment with respect to health care expenses, caters to big business, not to them.

HOAA believes it is unfair and unjustified to premise the availability of a tax benefit on whether a taxpayer works for a Fortune 500, Subchapter C corporation or for himself or herself in an unincorporated business. Such treatment is simply one example of the ways home office businesses operated by self-employed individuals are treated as second-class businesses. Retroactively restoring the 25 percent deduction for self employed persons would represent a strong first step toward providing more equitable treatment to home office businesses. We urge you to do so prior to the April 15 filing deadline for individual tax returns. We also hope that lawmakers will ultimately enact legislation providing a 100 percent deduction for the health care costs of self-employed individuals, as has been proposed by numerous lawmakers and the Clinton Administration.

Conclusion

To conclude, I appreciate the opportunity to submit testimony on the importance to HOAA of preserving the home office expense deduction and reinstating the health insurance tax deduction for

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13/ This provision expired on December 31, 1993. See § 162(l). Sole proprietors, working partners in a partnership, and S corporation employees who own more than two percent of the corporation's stock could take advantage of the deduction. See Senate Committee on the Budget, Tax Expenditures: Compendium of Background Materials on Individual Provisions, S. Prt. 101, 103rd Cong., 2d Sess. 425 (1994) ["Tax Expenditures"].

14/ Tax Expenditures, supra note 13, at 428. An employer's contribution to a plan providing accident or health coverage to an employee and the employee's spouse and dependents is excludable from an employee's income. Further, businesses can generally deduct as an employee compensation expense the full cost of health insurance coverage provided to employees. See Joint Committee on Taxation, Summary of Revenue Provisions in the President's Budget Proposal for Fiscal Year 1993, JCS-3-92 46 (Feb. 6, 1992).

15/ Tax Expenditures, supra note 13, at 428.

self-employed workers. The *Soliman* decision is ill-suited to the modern economy. Clarification of the home office expense deduction rules makes sense from both a business and family perspective. Further, extending the health insurance tax deduction for self-employed workers will at least begin the process of equalizing the treatment of self-employed workers and those who work for Subchapter C corporations.

STATEMENT OF THE INDEPENDENT BANKERS ASSOCIATION OF AMERICA

Mr. Chairman, Members of the Committee: The Independent Bankers Association of America (IBAA) appreciates the opportunity to express its views on two matters of long-standing interest to our membership, savings incentives and the estate and gift tax laws that are now before the Committee.

IBAA is the only national trade association that exclusively represents the interests of the nation's community banks.

IBAA SUPPORTS ENHANCED SAVINGS INCENTIVES

For the past several years, IBAA has expressed its support of tax incentives for savings in resolutions approved by our entire membership. These resolutions specifically endorse expanding existing Individual Retirement Accounts (IRAs) as well as the establishment of other tax-advantaged savings products.

IBAA very much appreciates the opportunity to present its views to the Ways and Means Committee at this time, because the subject is of special significance to community banks. IBAA commends the Chairman (Mr. Archer) and the Committee on the prompt scheduling of these hearings. IBAA also commends the new House Leadership for making the encouragement of savings a national priority issue in 1995. We also commend the Administration for its proposal to expand the income limits on existing IRA accounts.

Our statement addresses the issues we believe are involved.

NEED FOR SAVINGS INCENTIVES

IBAA feels it is not an exaggeration to say that the U.S. is experiencing a "quiet crisis" of inadequate savings and investment.

Federal Reserve Chairman Greenspan said as much to this Committee in a 1991 hearing on tax policy: "the national balance sheet has been severely stretched" by large accumulations of debt in the 1980s by corporations (for mergers and buyouts), by real estate firms (for development of offices and other commercial space), and by consumers (for motor vehicles and other durables). The aftermath, Greenspan said, "is a considerable degree of financial stress . ." (Testimony by Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, December 18, 1991).

The Chairman's principal recommendation was as follows:

> "I and others have long argued before this Committee that the essential shortcoming of this economy is the lack of savings and investment. It's here that our major policy focus should rest. Investment is the key to enhanced productivity and higher living standards. . . Bolstering the supply of savings available to support productive investment must be a priority for fiscal policy (Loc. cit., pages 6-7).

From the standpoint of both national and personal saving, the situation seems to have gone from bad to worse since Chairman Greenspan's appearance.

The nation's largest securities firm reported that, during 1992, America's net national savings rate -- the sum of savings by governments, businesses and individuals -- fell to 1.7 percent, the lowest level since World War II ("National Saving: Key to Investing in the Future," Merrill Lynch Pierce Fenner & Smith, Inc., 1993, page 1). This 1.7 percent figure is consistent with a tabulation by the Organization for European Development and Cooperation, showing U.S. net national savings, as a percentage of Gross Domestic Product, was even lower in 1993 -- 1.2 percent ("OECD IN FIGURES," Statistics on the Member Countries, Supplement to the OECD Observer No. 188, June/July 1994).

The U.S. net national savings rate is thus smaller than all but five of the 24 industrialized members of the OECD. By comparison, the 1993 savings rates for other countries with which the U.S. must compete, were: Belgium 11.5%, France 6.5%, Germany 9.8%, Japan 19.5%, Switzerland 19.3%, Turkey 10.2% and the United Kingdom 2.0% (OECD, loc. cit., pages 24-25).

For personal savings, the story is similarly dismal. From the 1960s to the mid-1980s, personal savings in the U.S. cycled between 6 and 9 percent. However, in the seven years between 1987 and 1993, the average personal savings rate declined to 4.6 percent. Then, in the 12 month period ending in August, 1994, the rate fell to 3.8 percent, the lowest level in U.S. history (see "Americans Run Out of Options to Boost Their Spending," by John Berry, Washington Post, October 20, 1994, page B13). A table comparing U.S. personal savings rates with those of other OECD nations since 1977 is attached as Exhibit 1.

As an economist, before becoming Treasury Undersecretary for International Affairs, Lawrence H. Summers concluded that reductions in U.S. personal savings during the 1980s accounted for more than twice the decrease in national savings than did the increase in government deficits ("Savings: The Hidden National Crisis," Merrill Lynch, Inc., 1992, page 5).

This shortage in savings means there is less money available for investment in long-term municipal and other bonds to fund improvements in the U.S. infrastructure.

The deterioration of or national infrastructure has been a matter of increasing concern for a decade. As to just one segment, the 3.9 million mile U.S. highway system: the Department of Transportation (DOT) estimates that half the nation's roads are substandard and, of the 573,660 bridges more than 20 feet long, 1/3 are in substandard condition and about 1/5 are functionally obsolete. The DOT Road Information Program estimates that the cost of additional fuel and vehicle wear and tear resulting from these conditions is about $17.5 billion annually (White Paper, American Road and Transportation Builders Association, Dec. 16, 1994). DOT's report on "The Status of the Nation's Highways, Bridges and Transit" estimates a $290 billion backlog of needed but unfunded road and bridge projects. Increased savings would make it possible to address vital highway, bridge, transit and air travel problems.

One observer estimated that half of U.S. domestic investment in the 1980s was financed with foreign capital ("Savings: The Hidden National Crisis," Merrill Lynch etc., loc. cit., page 2).
This is not a healthy situation.

A growing literature documents the inadequacy of household savings, especially for retirement. According to Merrill Lynch, the ratio of household assets to household debt has dropped from 20:1 in the 1940s to about 5:1 in 1993 ("National Saving: Key to Investment in the Future," Merrill Lynch, loc. cit., 1993, page 3).

One study, commissioned by Merrill Lynch found that families headed by individuals less than 45 years old had median net financial assets of only $700, while families headed by individuals in the 55-64 age bracket (e.g. approaching retirement), had median net financial assets of $6,880, and families headed by individuals aged 65-74 had median net assets of $10,000. Merrill Lynch states that the results of this current study, based on 1991-93 data, is "virtually unchanged" from a similar analysis based on 1987 data ("New Data Shows Wealth of American Families at 'Woeful Low'," Merrill Lynch & Co., Inc. press release, December 21, 1994). A table from this study is attached as Exhibit 2.

Merrill Lynch also commissioned a study of the savings habits of 2,015 households representative of the 76 million "baby boomers," who will live longer than their parents. The survey found, that under current fiscal assumptions, these households are saving at a rate of 35.9 percent of what would be required to enjoy a retirement "consistent" with their current lifestyles ("The Merrill Lynch Baby Boom Retirement Index," 1994, page 1).

IBAA's conclusion from this information is that there would be manifold benefits from encouraging personal savings. Initially, increased personal savings prepare families better for major expenditures, such as home and car buying, college and retirement, as well as medical and other emergencies.

Such savings increase the capacity of financial institutions to fund the debt of governments and corporations through domestic resources, rather than foreign capital, to upgrade America's infrastructure through investment in municipal bonds, to build productive capacity of corporations through investment in corporate bonds and stocks, and to enhance job creation and innovation through loans to small enterprise. The combination of these results would enhance the performance and competitiveness of the U.S. economy all along the line.

BENEFITS TO COMMUNITY BANKS OF SAVINGS INCENTIVES

Smaller, independent community banks have a real stake in the possible enhancement of savings incentives, because community banks rely for their funding almost exclusively upon domestic deposits (96.5 percent). Larger banks, with multiple sources of funds, rely far less on domestic deposits (68.4 percent), as shown in the following table:

Relative Importance of Domestic Deposits
To U.S. Banks of Different Sizes

	Less than $100 million	$100 million to $1 billion	$1-10 billion	Greater than $10 billion
Total assets:	$320.3	$687.7	$1,087.6	$1,836.7
Deposits:	278.3	569.7	776.6	1,168.6
Assets less equity: (Liabilities)	288.3	620.0	997.5	7,707.8
Deposits as percentage of Liabilities:	96.53	91.89	77.85	68.43

Accordingly, increased savings incentives could be even more valuable to smaller banks and their customers than to larger banks.

This value of dedicated savings to independent banks is confirmed by the following figures on the distribution of IRA and Keogh Plans, which indicates that the value of these savings plans in community banks (about 10.7 percent) is slightly higher than their share of overall deposits (about 9.96 percent).

IRA & KEOGH PLANS*				
	# of Banks	Totals for IRAs & Keogh	Average per Bank	Median Amount
< 100M	7,412	15,519,659,000	2,093.855	1,647
100M-1B	2,791	35,002,962,000	12,541.369	9,284
1B-10B	335	46,060,219,000	137,493.191	121,185
> 10B	57	47,863,851,000	839,716.684	911,258

Data as of 9/30/94, One-Source, Sheshunoff Information Service, 1st quarter 1995

BENEFITS TO SMALL BUSINESSES

Small enterprise is one of the most important elements of U.S. economic life. According to the Small Business Administration (SBA), small businesses account for 53-55 percent of U.S. sales and 52-53 percent of U.S. jobs.

However, of great significance in an era of large-corporate downsizing and large-bank consolidations, is the SBA finding that, between 1976 and 1990, small businesses (500 employees or less) accounted for nearly 2/3 of the net new jobs in our economy (65 percent). Small independent businesses are often the anchors of towns and communities across the country, and are therefore a tangible factor in the quality of American life. And, small business lending is the bread and butter of community banking.

A study of the 1993 Federal Reserve Call Report data by Robert Morris and Associates illustrates how strongly small banks support small businesses. Banks with less than $100 million in assets, which would have up to 50 employees, rank, generally, as community banks. These institutions appear to make more than a quarter of all small business loans of less than $100,000 (28.17 percent, or $21.8 billion out of a total of $77.4 billion). The $21.8 billion amount of these loans by the smallest banks exceeds the total amount of such loans by any category of banks. ("Credit Availability for Small Businesses," The Journal of Commercial Lending, April, 1994, page 51).

Banks with under $100 million in assets thus concentrate on small business lending. Almost 3/4 of all their commercial and industrial loans (73.65) are of less than $100,000. Banks with assets of $100 million to $300 million make about half of their loans in amounts of less than $100,000 ($17.7 billion out of $34.2 billion, or 51.75 percent). The largest banks (over $5 billion in assets) made $17.6 billion or 6.73 percent of their loans in amounts of under $100,000

There is also evidence to suggest that megabanks, that intensely compete with other megabanks, are increasingly shying away from small business lending, where margins are slimmer, or resorting to formula-based decision on small business loans which inhibits the diversity and creativity of small business enterprise ("Is it Banking Without Boundaries or Megabanks Without Constraints? by Kenneth A. Guenther, Executive Vice President, IBAA, Washington Post, January 17, 1995).

Thus, an increased flow of funds into IRA-type retirement vehicles, or similarly structured savings accounts, is very likely to generate a significant additional "bang for the buck" in terms of financing for job-creating, innovative, revenue producing small independent businesses.

LEGISLATIVE ISSUES INVOLVED WITH SAVINGS INCENTIVES

The legislative history of IRAs indicates that there have been a variety of policy approaches to savings tax incentives over the years.

When IRAs were created in 1974, as a part of the Employment Retirement Income Security Act (ERISA), they were designed as a retirement savings vehicle for employees not

otherwise covered by a pension plan. The Tax Reform Act of 1981 made all workers eligible for IRA deductions of up to $2,000 per year (a so-called "universal" approach). The Tax Reform of 1986 than restricted IRA eligibility to single taxpayers with incomes of less than $25,000 and married taxpayer couples with incomes of less than $40,000, on condition that these taxpayers were not covered by pension plans.

In recent Congresses, Senator Lloyd Bentsen, prior to his tenure as Treasury Secretary, collaborated with Senator William Roth to introduce a "Super-IRA" bill, which proposed to restore universal eligibility and provide options of either the tax deductible contribution of existing IRAs or a "back loaded" alternative that would be funded with after-tax money, but could be removed tax free after age 59 1/2. Another proposal by Senator Kay Bailey Hutchison, S. 1669 of the 103rd Congress, was to permit a tax-deductible contribution by a non-working spouse. IBAA supported these proposals.

The Contract With America proposed:

- to restore universal eligibility,
- to permit a $2,000 (single taxpayer) or $4,000 (joint return) contribution,
- to have this contribution non-deductible, but to allow withdrawal for retirement and, after a prescribed period, for other specified purposes such purchase of a first home (owner occupied), education (college or above), or medical expenses, including insurance for long-term care. The Contract measure was introduced in the 104th Congress as the American Dream Savings Act on January 4, 1995 (H.R. 6). A more detailed bill is being authored by Rep. Bill Thomas of California.

In the Senate, also on January 4, 1995, Senators Roth and Breaux introduced S. 12, the Savings and Investment Incentives Act of 1995. This bill proposes "front-loaded" deductions that index the current $2000/$4000 limits to the rate of inflation after 1995. The income eligibility would be expanded from the present $25,000 for single taxpayers, to $125,000 by 1998; and for joint return taxpayers, from the present $80,000 to $140,000 by 1998. This measure would also permit a "homemakers" deduction of up to $2,000, but limited to the amount of compensation earned by a spouse.

Consistent with past years, the Senate bill also provides an option of an "IRA-Plus" Account that would be subject to the same contribution and eligibility limits. These sums would not be tax deductible at the outset, but the earnings would be tax free and the proceeds could be withdrawn after five years penalty free to purchase a first home, pay higher education expenses, or defray catastrophic medical expenses.

Also part of the picture is the President's proposal to double the income limitations of the existing IRS program, to $50,000 for single taxpayers and $80,000 for joint return taxpayers.

EVALUATION OF PROPOSALS

After its preliminary review of the various proposals, IBAA has several comments. However, the association also wants its pertinent banker committees to review these matters, so that we provide detailed comments.

On the basis of its on-going study of these issues, IBAA can observe that tax incentives for saving are a "going concern." They are familiar to many Americans and most financial institutions. IRA accounts are currently found at 10,655 commercial banks, more than 2/3 of which (69.6 percent) are community banks with assets of less than $100 million. These numbers testify to the fact that IRA-type saving is well established in this country and that an expansion of such a program would be accomplished speedily and with few administrative problems.

IRAs at banks are insured, to $100,000, by the federal government, so there is no question of safety and soundness of future IRA-type investments in a banking environment.

Thus, an expansion of tax incentives for saving, particularly bank based savings, is a matter of utilizing an existing, proven system. The additional savings that flow into that system will help those who save, the institutions that receive the funds (especially community banks), the customers of those institutions (including prominently, in the case of banks, small business enterprise), and the national economy.

At present there is considerable debate on how much of funds devoted to tax-advantaged accounts is new savings and how much is transferred from elsewhere. For example, see "The Coming Changes in IRA's Will Be Popular, But They Won't Make American's Save More" Barron's Magazine, January 16, 1995. Barrons' conclusion is based on the work of a National Bureau of Economic Research study by Attanasio and DeLeire. However, the NBER study has been criticized as incorrect on the law, facts, and interpretation by a study performed for the Securities Industry Association by Hubbard and Skinner. The SIA study concludes that raising the IRA contribution limit would increase the nation's capital stock by $4 for each dollar lost in government tax revenue ("The Effectiveness of Savings Incentives: A Review of the Evidence," Hubbard and Skinner, January 19, 1995, Executive Summary).

IBAA finds desirable features in all of the current proposals, and believes any tax incentive legislation passed by this Congress could provide that questions of effectiveness and the structure of the tax-advantaged savings be studied with care, so future decisions would be informed by such analysis. Because savings tend to be a long-term matter, this area of policy seems to be susceptible to such a studied approach.

IBAA thus has no hesitation in urging that the Ways and Means Committee and the House of Representatives move forward with the maximum limits and flexibility for savers that is consistent with budget constraints.

IBAA will be delighted to work with the Committee on Ways and Means and the House of Representatives to resolve outstanding issues as the American Dream Savings proposal works its way through the legislative process.

THE IMPACT OF ESTATE TAXES ON BUSINESS ENTERPRISE

According to the briefing papers for the White House Conference on Small Business, about 30 percent of businesses are passed down to a second generation and only 13 percent reach a third generation. Although there many reasons for this, federal estate and gift taxes are significant barriers to succession of ownership of smaller business.

Community bankers are affected directly and indirectly. Many banks are multigenerational enterprises, founded when land and structures were inexpensive. As branch locations have been added to serve growing populations, and population growth has brought residential and commercial development to the doorsteps of community banks, the value of even very small family banks can go up dramatically.

An example is a one location, 8-employee family bank in central Kansas, with assets of $15 million. The bank was founded after World War II by the father of the current president and his mother-in-law. Both were tax conscious, and approximately $50,000 was spent over the years with various tax advisors and trust expenses. However, after the founding father died in 1988, his estate paid the federal government $700,000 in estate taxes.

Banks are also impacted if a business customer must pay a heavy estate tax. Bank loans and the very existence of the firm may be at risk. Communities suffer because steeply graduated estate tax rates, reaching 55 percent at $3 million in taxable estate, cause many long-standing businesses to liquidate to pay the tax bill, or sell out to a large and/or absentee business to avoid such taxes. The loss of independent business usually means that suppliers and service providers in a local community are phased out in favor of firms doing business with a parent company elsewhere.

IBAA commends the House Leadership and the Chair of the Ways and Means Committee for its attention to estate tax matters through the Contract With America and these hearings.

For almost a year, IBAA has been actively working to define current estate and gift problems in order to be able to recommend solutions addressed to these problems.

There has been very little recent legislative attention to the consequences of the major estate tax changes of 1976, 1981 and 1986. One article by the Internal Revenue Service, based on 1989-91 data, finds that during the past decade, the number of estate tax filers has increased by 80 percent and the total estate of these filers increased by 94 percent. The fact that the largest block of assets in these estates tends to be stock in closely-held (small) businesses and

the fact that filers with assets of more than $5 million is the fastest growing element (increasing 137 percent since 1982) reflect the increasing scale of business enterprise in this country ("Estate Tax Returns, 1989-91" Statistics of Income, IRS, Summer, 1993, page 76).

The combination of a steep estate tax rate structure and major increases in cost-efficient scale of businesses spells estate tax trouble for America's closely-held community agricultural, commercial and financial businesses.

We applaud the proposal to increase the filing threshold from $600,000 to $750,000 in three stages that is contained in the Contract With America legislation (H.R. 9). Enactment of this provision would be an excellent first step, but it would not solve the fundamental problems with the current estate and gift tax structure, and the major economic problems of deterring investment and maintaining continuity of independent, job creating firms. A broader approach is needed.

In an effort to better define these problems, and to craft responsive solutions, the IBAA has contacted other associations, across the spectrum of American business, agriculture and finance to call for a common effort to improve the estate and gift tax laws.

IBAA had developed a questionnaire, which is presently in the hands of more than three dozen associations. This survey is designed to elicit current data on where problems are -- and where they are not -- and recommended solutions that fit various segments of the American small business community.

IBAA will be pleased to share the information we receive and our recommendations with the Committee and the House of Representatives as soon as possible.

Thank you again for this opportunity to express to the Committee our views on these important matters.

STATEMENT OF INVESTMENT COMPANY INSTITUTE BEFORE THE COMMITTEE ON WAYS AND MEANS U.S. HOUSE OF REPRESENTATIVES HEARING ON TAX PROVISIONS IN THE CONTRACT WITH AMERICA DESIGNED TO ENCOURAGE SAVINGS AND INVESTMENT

January 25, 1995

The Investment Company Institute respectfully submits this statement in connection with the Ways and Means Committee review of tax provisions in the Contract With America designed to encourage savings and investment. We applaud the Committee for considering legislative changes that would further these goals. In this statement, the Institute urges a few modifications to the provisions in H.R. 9 (the "Job Creation and Wage Enhancement Act of 1995") that would increase or "index" the cost basis of capital assets for inflation.

I. Introduction

The Investment Company Institute is the national association of the American investment company industry. Its membership includes 5,510 open-end investment companies ("mutual funds"), 471 closed-end investment companies and 12 sponsors of unit investment trusts. Its mutual fund members have assets of about $2.099 trillion, accounting for approximately 95 percent of total industry assets, and have over 38 million individual shareholders. The vast majority of open-end and closed-end investment companies are organized as regulated investment companies ("RICs").

The Institute submits that the Committee should take two principles into account when applying to RICs and their shareholders any proposal to index cost basis for inflation. First, any such legislation should follow the model of Subchapter M of the Internal Revenue Code and provide RIC investors with tax treatment comparable to that provided to direct investors in securities. Second, any legislation should be drafted to minimize the complexities that indexing would create for RIC shareholders.

We commend Chairman Archer for including in H.R. 9 indexing provisions that are generally consistent with the principles that we submit should apply to RICs and their shareholders. In addition, we are pleased that H.R. 9 resolves several implementation issues that would have arisen for RICs and their shareholders under bills considered in 1989 and 1992. Our comments today focus on a few technical issues that indexing would present for RIC shareholders and other investors.

II. Indexing Provisions in H.R. 9

H.R. 9, like earlier indexing bills, would index both portfolio securities held by RICs and RIC shares held by investors. Indexing a RIC's portfolio securities protects RIC shareholders from paying tax on inflationary gains realized by the RIC that otherwise would be distributed to shareholders as capital gain dividends. Indexing the basis of RIC shares protects RIC shareholders from paying tax on inflationary gains in the value of their RIC shares when those shares are redeemed.

Under the bill, RIC shares would be treated as an indexed asset for any calendar month in the same ratio as the value of the RIC's assets at month-end which are indexed assets bears to the value of all of the RIC's assets at month-end (the "indexed asset calculation"). For example, if 82 percent of a RIC's assets were indexed assets on January 31, that RIC's shares would be eligible for 82 percent of any inflation adjustment allocated to that month. Safe harbors in the bill provide that if (a) 90 percent or more of the RIC's assets were indexed assets for any month, the RIC would be deemed to be fully (100 percent) invested in indexed assets for that month, and (b) 10 percent or less of the RIC's assets were indexed assets for any month, the ratio for that month would be zero.

III. Indexing Issues for RIC Shareholders

A. The 90 Percent Safe Harbor

1. Issue

Institute data indicates that most RICs do not consistently invest at least 90 percent of their assets in equities.[1] Since most RICs would not, therefore, always meet the bill's 90 percent safe harbor, most RIC shareholders would not be able to fully index the cost of their shares. Thus, instead of using an inflation adjustment chart prepared by the IRS (that would show the appropriate adjustment for assets purchased and sold in specified quarters), RIC shareholders would be required to use a specialized chart, applicable to only one RIC, that reduced the otherwise applicable indexing adjustment to reflect the actual ratio of indexed assets in that RIC's portfolio. Any RIC shareholder or tax return preparer who used (a) the official government chart when the RIC had not always met the safe harbor or (b) a RIC-specific chart for any other RIC would improperly compute indexed cost basis.

2. Proposal

The ease with which indexing could be applied to RIC shares would be enhanced if the safe harbor were modified so that (a) determinations of the extent to which RIC stock would be treated as an indexed asset were made quarterly rather than monthly and (b) the safe harbor provision treated the ratio of indexed assets to all assets as being (i) 100 percent if 80 percent or more of the RIC's portfolio is in indexed assets, and (ii) zero if 20 percent or less of the RIC's portfolio is in indexed assets. Our data for the eleven quarters ending with the second quarter of 1994 indicates that 49 percent of all equity funds would have met our proposed safe harbor, whereas only 14 percent of all equity funds would have satisfied a 90 percent safe harbor tested quarterly.[2]

B. Return of Capital

1. Issue

One basis adjustment that could effect the calculation of indexed cost basis would be the distribution by a RIC of more than its taxable income (i.e., a return of capital). Returns of capital are more common for RICs than other corporations because RICs are subject to such stringent requirements on the current distribution of their income that very small errors in estimating or calculating income can result in overdistributions. If a RIC returned capital to its shareholders, the shareholders would be required under the bill to (a) index each block of shares for inflation occurring through the date the capital is returned, (b) reduce the cost basis of each block by its proportionate share of the amount of capital returned and (c) thereafter adjust this modified basis for any future inflation.

2. Proposal

Rather than requiring that all blocks of RIC shares be adjusted up for inflation and then down for a return of capital, we urge that the basis of RIC shares be adjusted when capital is returned on a first-in, first-out basis. To illustrate our proposal, assume that (1) a shareholder purchases RIC shares for $1,000 in each of ten years; (2) inflation totals 40

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[1] Institute statistical reports indicate that the 90 percent safe harbor test would have been satisfied on a quarterly basis (for the 11 quarters ending June 30, 1994) by only 14 percent of the 423 equity funds that provided the ICI with portfolio composition data for all 11 quarters. For these purposes, a fund is described as an equity fund if its stated investment objective (a) is to invest at least 65 percent of its assets in equities or (b) clearly indicates that it will invest principally in equity securities. Our data indicates that the percentage of funds satisfying the safe harbor drops significantly further when other funds that hold equity securities, such as "balanced funds" holding both stocks and bonds, are included in the data pool.

[2] Presumably, even fewer of these funds could meet H.R. 9's safe harbor, which tests portfolio composition on a monthly, rather than a quarterly, basis.

percent from the date of the first purchase; and (3) the shareholder receives a $100 return of capital. Under our proposal, the investor would index the basis in the first block of shares from $1,000 to $1,400 (to reflect 40 percent inflation) and then reduce this basis $100, to $1,300, for the return of capital. By adjusting only the first block, the investor has eliminated 90 percent of the computations that would be required under the bill (since only one of his blocks would be adjusted under our proposal).

C. Retained Capital Gains

1. Issue

Similar basis adjustments appear to be required under the bill if a RIC retains capital gains and pays a RIC-level tax. Pursuant to Code section 852(b)(3)(D), a shareholder in a RIC that retains capital gains includes in income his share of the retained gain, claims a tax credit corresponding to the tax paid by the RIC on the retained gain, and increases the cost basis of his shares by the remaining balance.

Under the bill, taxpayers holding stock of a corporation are to treat any "substantial contribution to capital" as a separate asset. It appears that this rule would apply to a RIC's retained capital gain by requiring the RIC's shareholders to index each block of shares for inflation through the date the gain was retained, proportionately increase the cost basis of each block of shares to reflect the retained gain and thereafter adjust these increased amounts for any future inflation.

2. Proposal

The Institute urges that the bill be modified to apply the substantial contribution to capital rule only to the first block of RIC shares acquired by an investor. Thus, if an investor's first block of RIC shares were purchased for $1,000, inflation had been 40 percent, and the full amount of the investor's basis adjustment under Code section 852(b)(3)(D) were $65, the investor would index the basis of these shares from $1,000 to $1,400 and then add the full $65 contribution to capital to these shares, thereby increasing the basis to $1,465. This approach would be simpler than indexing the cost basis of each block of shares and then spreading the $65 contribution to capital across all of the blocks of shares.

IV. Indexing Issues for RIC Shareholders and Other Investors

A. Calculating Inflation Using Prior Quarter Deflators

1. Issue

Under H.R. 9, inflation adjustments would be calculated by comparing the "first revised" Gross Domestic Product ("GDP") deflator for the quarter in which an indexed asset is disposed of with the "first revised" GDP deflator for the quarter in which the asset was acquired. Currently, this "first revision" is not available until approximately two months following the close of the quarter. In the case of RIC share redemptions occurring during October, November and December, for example, the GDP deflator number that investors would need to calculate inflation adjustments would not be available until approximately March 1 of the next calendar year (or a mere six weeks before their April 15 tax return filing deadline). Similarly, with respect to October dispositions of RIC portfolio securities, the GDP deflator number would not be available until after the RIC was required, by the Code section 4982 minimum distribution excise tax rules, to calculate and distribute these capital gains.

2. Proposal

These difficulties could be eliminated if the inflation adjustment were calculated using the GDP deflators for the quarter prior to the quarter of purchase and the quarter prior to the

quarter of disposition. The practical effect of this modification would be to credit an investor with inflation occurring during the quarter of purchase, but not with inflation occurring during the quarter of sale. The obvious benefit of this modification is that the inflation factor for all fourth quarter dispositions would be known in late November or early December of that quarter.

B. Indexing For Partnerships

1. Overview

The investment company industry is also interested in how indexing would apply to investments in partnerships. The principle reason for this interest is that some investment companies have recently begun to invest substantially all of their assets in a single investment pool that in turn performs the portfolio management function for its investors. In this so-called "master-feeder" structure, the "master fund" is usually structured as a trust and is classified for federal tax purposes as a partnership. Its partners (the "feeder funds") typically qualify as RICs. The master fund, as well as its RIC feeders, are registered as open-end investment companies under the Investment Company Act of 1940.

Under current law, a RIC investor effectively is in the same tax position whether his RIC purchases securities directly or instead purchases them indirectly through a master fund. Under H.R. 9, the same indexing benefit should be available whether the shareholder's RIC holds securities directly or holds them indirectly through a master fund.

2. Issue

The only provision in H.R. 9 dealing with indexing for partnerships is new Code section 1022(f)(1), which provides that indexing adjustments made at the partnership level would be passed through to the partners. The bill provides no other mechanism for a partner to adjust the basis of his partnership interest for inflation. In contrast, earlier indexing bills provided that a partner's basis in a partnership that held indexed assets would be adjusted when the partner transferred the interest if the partnership had made an election under Code section 754.

3. Proposals

For indexing to work properly for investors whose RICs invest substantially all of their assets in a master fund, a RIC partner that withdraws from a master fund partnership should be permitted to index its basis in the partnership in order to reflect the effects of inflation on the indexed assets held by the partnership. This adjustment could be dependent upon whether the partnership had made an election under Code section 754 (or perhaps a new election tied specifically to indexing).

Similarly, a master fund should be permitted to periodically (e.g., quarterly) adjust its basis in its indexed assets (as if the partnership had made a disposition of the assets at the time of the periodic adjustment). This would permit a corresponding adjustment to each feeder fund's basis in its partnership interest, which is important for purposes of properly determining the effect of cash distributions on a partner's basis. Such distributions will occur, for example, when a feeder fund needs cash to meet redemptions of its shares.

V. Conclusion

The Institute urges consideration of these modifications needed for regulated investment companies and their over 38 million individual shareholders. We would be pleased to discuss these issues further with the staff of the Committee.

Statement by the

National Association of Real Estate Investment Trusts®

to the

House Ways and Means Committee

regarding the Hearing on

The Job Creation and Wage Enhancement Act of 1995

Submitted by Mark O. Decker, President and CEO

January 26, 1995

We appreciate the opportunity to comment on the capital formation provisions of the Job Creation and Wage Enhancement Act of 1995. The National Association of Real Estate Investment Trusts® ("NAREIT") represents over 240 real estate investment trusts (known as "REITs"), about 200 of which trade on the New York Stock Exchange, the American Stock Exchange, or the National Market System of the NASDAQ. In addition, NAREIT represents over 1,600 lawyers, accountants, analysts, investment bankers, and others who provide services to the REIT industry.

Congress established REITs in 1960 to allow small investors to obtain the diversification and professional management of real estate that beforehand were only available to large, sophisticated investors. Capital formation has been essential to the growth and success of REITs ever since, and the promise of a large scale, widely held real estate capital market has begun to become a reality. The market capitalization of publicly held REITs has blossomed from under $9 billion at the beginning of 1991 to about $45 billion today. This success story is due in large part to the tax modernization reforms adopted by Congress over the years, as advocated by you, Mr. Chairman, and others on this Committee.

The maturation of the REIT industry would not have been possible without capital formation. Thus, NAREIT applauds the intent of H.R. 9 to create further incentives for the public to invest in the stock market. Specifically, NAREIT wholeheartedly endorses the proposal to reward the entrepreneurial risks of investing in stock by reducing the capital gains tax.

In addition, NAREIT supports the intent of H.R. 9 to index the tax basis of investors' stock to avoid taxing the noneconomic increase of value attributable to inflation. However, there appears to be some provisions in H.R. 9 that could deny such indexing to investors in REIT stock. Such a result would be terrible for the REIT industry because investors would have an incentive to invest in other companies for which they could receive the benefits of indexation.

H.R. 9 would allow stock in a REIT to be fully indexed only if 90% of the REIT's assets are "indexed assets," that is, corporate stock or tangible property. I will briefly summarize the three major technical provisions in H.R. 9 that could disqualify REIT shares from full indexation.

First, H.R. 9 excludes as an "indexed asset" any "net lease property." The nature of the real estate business is such that this definition could easily prevent more than half of today's REITs from qualifying for indexation. For example, many of our shopping center, health care, industrial, hotel, and net lease REITs own and operate portfolios of properties that fall under the net lease definition in H.R. 9. These REITs are in the ongoing real estate business and are completely different

from the single shot, financing vehicles that the original net lease definition was meant to encompass.

Second, many REIT investments are made through partnerships. However, H.R. 9 could be interpreted to exclude as "indexed assets" properties held through a partnership. Such an interpretation would be contrary to the tax Code's usual rule of treating a partnership as an aggregation of the partners rather than as a separate entity.

Third, the 90/10 safe harbor is a good idea because the administrative complexity of requiring REIT shareholders to adjust only a portion of their tax basis is not justified when most of the REIT's assets qualify as indexed assets. However, we recommend that the 90% threshold be reduced to provide REITs with greater flexibility in conformity with the REIT asset tests.

NAREIT urges the Committee to enact these capital formation incentives after making our suggested technical changes to allow REITs to raise capital on an even playing field. Thank you once again for the opportunity to comment on this important legislation.

NATIONAL ASSOCIATION OF STATE FORESTERS
444 North Capitol Street, NW Suite 540 Washington, D.C. 20001 202/624-5415

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February 3, 1995

The Honorable Bill Archer
Chairman, Committee on Ways & Means
1102 Longworth House Office Building
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

I am writing to add the voice of the National Association of State Foresters to the forestry experts who supported the capital gains tax revisions being considered by your committee on January 25. As public officials who work with this Nation's nearly 8 million non-industrial private forest landowners, we firmly believe that more equitable tax treatment will provide a major incentive for quality, long-term management of these lands, and will benefit both the economy and the environment.

The National Association of State Foresters represents the directors of the State forestry agencies from the fifty States and four U.S. Territories (American Samoa, Guam, Puerto Rico and the U.S. Virgin Islands), as well as the District of Columbia. Our members provide management and protection services on State and private forest lands, which make up over two thirds of the Nation's forests.

Taxes play a major role in landowner's decisions about the management of their lands. The 1986 revisions to the tax code imposed a harsh new tax burden on timberland owners, and is unintentionally providing a disincentive to sound forest management. The changes increased capital gains taxes on timber sales, and in some cases caused individual timberland owner's state taxes to jump as well. In addition, since landowners are no longer able to index their capital gains for inflation, those who hold long term investments are penalized when they sell their assets. Timber owners are particularly vulnerable to this problem due to the long-term nature of forestry investments.

The 1986 tax changes created major disincentives for landowners with forest land; higher tax rates and inability to index made reinvestment in forestry an unattractive proposition. Less money is available for reforestation after capital gains taxes are paid. High capital gains taxes put additional pressure on landowners to convert their lands to non-forest uses. As you heard from the forestry witnesses on January 25, since the tax code changes of 1986, tree planting is down and conversion of land to non-forest uses is up.

The NASF has endorsed the Congressional Forestry 2000 Task Force's Reforestation Tax Act for the last several years. In addition to the reduction in the capital gains tax rate contemplated in H.R. 9, we would hope the committee would also consider the following changes:

- allowing adjustment of timber capital gains for inflation;

- amending the passive loss rules to take into account the nature of forestry investments and management;

- increasing the reforestation tax credit to encourage reforestation and con servation of land in forest uses.

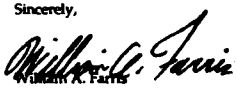
- allowing landowners to amortize reforestation expenses and to index these expenses for inflation.

Such changes will not only provide tax relief to one of the most important segments of our economy but provide an incentive for the type of forest management that produces multiple benefits (such as clean water, clean air, productive soils, and wildlife habitat) for the long-term.

While your committee does not have direct jurisdiction over forestry issues, you have as much power to positively effect management decisions as those that do. We hope you will consider making positive changes in the tax code which recognize the long-term, risky nature of forestry investments. We look forward to working with you as you re-examine the capital gains tax system. Please consider this letter as NASF's written testimony before your committee on this issue.

Please feel free to contact Terri Bates, NASF's Washington Representative, at 202/624-5415 if you have any other questions.

Sincerely,



William A. Farris
President

STATEMENT OF
MR. J. DREW HIATT
EXECUTIVE VICE PRESIDENT
DIRECTOR OF GOVERNMENT AFFAIRS
THE NATIONAL BUSINESS OWNERS ASSOCIATION
ON
THE JOB CREATION AND WAGE ENHANCEMENT ACT
JANUARY 24, 1995

Mr. Chairman, Mr. Gibbons, and Members of the Committee, my name is J. Drew Hiatt, and I am Executive Vice President and Director of Government Affairs for the National Business Owners Association. We appreciate very much the opportunity to present our views on the tax and business investment incentives contained in the Job Creation and Wage Enhancement Act of 1995 (H.R. 9), particularly as they affect American small business men and women.

The National Business Owners Association represents nearly 5,000 small business owners, and has an active and expanding membership. Its philosophy is based on the belief that a vibrant and robust private sector and a strong and competitive free enterprise economy are essential to create and increase economic growth, opportunity, jobs, and prosperity for all Americans. NBOA vigorously represents the interests of its members before Congress as well as federal, state, and local government. It also works to influence and enact national policies that promote economic growth and entrepreneurship. As part of its efforts to advocate and adopt beneficial laws and regulations, NBOA consistently communicates the concerns and legislative priorities of business owners to lawmakers, government officials, the public, and the media

We commend you, Mr. Chairman, for your leadership in convening this hearing today to examine how changes to the tax code proposed in the Job Creation and Wage Enhancement Act will create a more favorable economic and entrepreneurial climate. Your support of this legislation underscores your longstanding commitment to promoting and enacting sound fiscal and tax policies – workable policies that are based on common sense and the common good. We gratefully recognize your commitment. As a strong advocate for small business, you understand the daunting challenges that confront entrepreneurs, especially the financial consequences that taxes impose on hard-working small business owners. We appreciate your efforts as well as the understanding and concern you have shown for them over the years as demonstrated most recently by your introduction of H.R. 9. Our members support the tax and investment provisions of the Job Creation and Wage Enhancement Act in the belief that they can and will set the stage for a new American era of expanded economic growth, opportunity, and prosperity.

Small business owners will lead this new era – if their representatives on this Committee and in Congress will give them the chance. As the powerhouse of the economy, small businesses know how to lead. America's nearly 22 million small business owners generate about 40 percent of our gross national product and provide more than half our goods and services. Small business is the nation's leading employer. Today, six in 10 Americans take home a paycheck from a small firm. Small business is not only the nation's leading employer, it is also the major provider of new jobs. Over the last five years, small firms have created nine of 10 net new jobs. In fact, according to the U.S. Small Business Administration, they are expected to create more than three-quarters of the 43 million new jobs needed over the next 25 years.

We encourage you, as members of this Committee, and the Congress at large to enact the policies necessary for small business to create the economic growth America needs. Unless this Committee and this Congress remove the roadblocks and reform the policies that hold back small businesses, they will never achieve their full economic potential and all Americans will suffer the consequences – in lost opportunity, lost growth, and lost jobs. It is true that small business owners are succeeding in spite of these restrictive policies. But they are succeeding against the odds and obstacles because of their determination, hard work, and tenacity. If Congress removes the obstacles, there is no limit to what they can achieve. We believe there is a historic opportunity now to abandon these limiting policies. Lawmakers of both parties should work together to lay the groundwork that will help create the new American era of economic growth.

What's Wrong with Our Tax Policy?

On average, the U.S. economy invests 15-20 percent of its income in a given year. Is it enough? Our goal should be to create an economic climate in this country that is conducive to investment. It is investment that fosters economic growth, prosperity, job creation, and wage growth. We say that we are serious about and committed to investment. We say this is one of our highest national priorities, one our highest public policy goals – but is it really? Judging from the way in

which revenues from investors and investments are taxed in this country, investment may not be as high a priority as some in Congress believe or declare it to be. Our tax code punishes, not rewards, the very thing and the very people – risk-taking and risk-takers – that Congress professes to support. At best, it is a logical inconsistency and, at worst, a glaring contradiction to say that Congress, as a whole, encourages investment as a matter of public policy and national priority. It is an economic contradiction for some lawmakers to say they support investment in business startup, expansion, jobs, and economic growth and then to enact tax policies that discourage investment by levying higher – and some might argue excessive – taxes on investment. This inconsistent practice undermines and even destroys the investment business owners seek to make and nurture. Even worse, it punishes the handful of entrepreneurial risk-takers who would launch new ventures or expand businesses, and thereby denies hundreds of thousands of other Americans jobs, opportunities, and wages.

Investment fuels productivity, economic growth, and job creation. Maintaining high taxes or increasing taxes on investment does not. Congress needs to examine whether the sole goal of U.S. tax policy is to raise revenue to finance government services and programs or whether an equally valid objective of tax policy should be to encourage investment. This policy debate must focus on whether it is better to raise more revenue to support an inefficient, wasteful, bloated government that consumes wealth or to encourage more investment by allowing those who create our wealth to keep more of what they earn to invest. We believe that a dollar left in the hands of entrepreneurs can do more good than one that is sent to Washington and consumed with little or no result.

Savings and Investment: Keys to Productivity, Economic Growth, and Job Creation

Increased investment benefits the economy. But the United States has not always followed this formula for economic growth. In fact, the U.S. has devoted a smaller percentage of its gross national product to investment than almost any other industrial nation. Over the last three decades, Japan has invested 31 percent of its output and boosted productivity growth by more than five percent per year. Germany and France have earmarked slightly more than 20 percent of their output for investment, achieving annual productivity growth of more than three percent. In contrast, the United States has invested about 18 percent of its output and increased productivity growth just a little more than one percent.

Why has U.S. investment been so low? The answer is high capital costs. Savings provides funds needed for investment, and is an important source for investment capital. The problem has been that Americans do not save as much as many foreigners do. Consequently, our national rate of savings is one of the lowest worldwide.

An international survey conducted by the American Council for Capital Formation found with regard to personal saving incentives that the United States ranks among the lowest on a list of twelve countries. The U.S. capital gains tax rate on long-term gains on portfolio securities is higher than that of all other countries except Australia and the United Kingdom and even these countries index the cost basis of an asset for inflation. Four of the twelve nations tax interest income at rates below the U.S. maximum rate. Total income taxes (individual plus corporate) on dividends are lower in most countries than the United States because most other countries have some form of dividend tax relief. Individual retirement account deductions were found to be more generous in five of the twelve countries than they are in the United States. The study also found that half of the twelve countries allow deductions or tax credits for life insurance premiums, while the United States does not. And individual social security contributions to government-sponsored plans are deductible in most of the twelve countries, while they are not in the United States.

In view of weak U.S. savings incentives, it is no wonder that the U.S. personal savings rate, which averaged nearly 7 percent of disposable income over the 1975-1991 period, is far below that of our major competitors. The study found that Japan, for example, had a personal savings rate for this period of 17.3 percent; Germany's rate was 12.7 percent; Canada's was 12.5 percent. The increase in the personal savings rate is important in promoting U.S. economic growth and providing funds for investment.

In recent years, private savings has been diverted away from investments and used to finance public deficits and government spending. This has also contributed to higher capital costs. The resulting problem is that less money is available for investment or, where it is available, its cost is prohibitive.

Today, the great debate focuses on the best way to encourage investment. The best strategy for boosting investment is to create incentives for private investors. Cutting the tax on capital gains is one example of an incentive that would work. Reducing the tax will encourage investors to buy stocks of companies that retain earnings. This will lower the firms' cost of capital, while providing incentives for saving. Investment income that is taxed encourages consumption at the expense of savings. What we need is to promote investment and savings for the long haul. This is the key to productivity, job creation, and economic growth.

Investing for the short-term is short-sighted. Entrepreneurs need to invest today for the future. They need "patient" capital, long-term capital. Because entrepreneurs need patient capital, it is critical to eliminate the obstacles that often discourage investment for the long run. Business owners

and aspiring entrepreneurs must have capital in adequate supply to grow companies and launch new ventures. Congress' goal should be to create a highly favorable investment climate that will enhance and accelerate economic growth, business expansion, and job creation on an unprecedented scale.

Due to the realities of a global economy, it is necessary to encourage higher levels of investment and spending in the U.S. economy. American businesses and workers will continue to compete for customers against major competitors in Japan and Europe, as well as in the strong and emerging economies of the developing nations. Increased investment generates more productivity, which is the cornerstone of true economic wealth. Throughout our history, we have led the world because of our willingness to invest in new ideas, new opportunities, and people. This has helped us create the world's largest and richest economy. We will always reap the reward of investment today, but the United States must become a nation that saves and invests for the future if it is to remain the world's economic leader tomorrow.

A New Direction for U.S. Tax Policy: Toward A More Investment-Driven Policy and Economic Growth

A new direction in U.S. tax policy is needed to ensure that American businesses, particularly entrepreneurial small businesses, will be free to create the growth and jobs our nation needs. Maintaining or levying higher taxes on investors and investment is contrary to the national objective of long-term economic growth and employment. That is why we need an investment-driven tax policy, one that will promote investment by lowering taxes on profits and creating more capital formation for increased investment.

Small business owners are leading the nation in economic growth and job creation. Yet, the tax code offers very little help in the form of incentives that would assist small business owners in creating more jobs and growth through investment. It is important to remove additional disincentives to investment. A new direction in U.S. tax policy would recognize that the sole purpose of tax policy is not only to fund government services and programs, which is merely a collection of revenues, but that an equally important priority is to encourage investment that will contribute to economic growth, job creation, and prosperity for all Americans.

We must encourage Americans to save more to promote capital formation for investment in growth and jobs. We must remove the disincentives for savings that lead to consumption of income and instead provide incentives for Americans to save more of their income. Ideas such as American Dream Savings accounts, as proposed in the Contract with America, take a step in the right direction toward creating an environment in this country that will encourage savings. Unless Americans begin to save more, American businesses will continue to pay the price for the high cost of capital and this price will be reflected in lower levels of productivity, less economic growth, and fewer jobs for all Americans. Lowering the capital gains tax rate and adjusting gains for inflation would help increase investment. This would create large pools of capital for companies – both start ups and existing companies – to tap for economic growth. It would also create a tremendous potential for enormous economic expansion, for risk-taking, and for new technological development, all of which we need to become more competitive with foreign countries. Congress needs to remove the obstacles, the barriers in the tax code that make it more attractive to consume income rather than to save and invest it.

We need to provide additional incentives for entrepreneurs to invest in their businesses and to recover the full and real cost of their investments. At present, small business owners who invest in their companies are unable to recover the full cost of their investments in depreciable property because inflation erodes the present value of their investments and the time value of money is not accounted for in current write-offs. It is important to remove these obstacles to increase investment.

Disincentives for savings and investment that are ingrained in our current tax code must be replaced with incentives for savings and investment. This will put our nation on a path of growth and economic security in the years ahead.

THE JOB CREATION AND WAGE ENHANCEMENT ACT

Cutting Capital Gains and Indexing Them for Inflation

The House Republican Contract with America includes three capital gains incentive provisions: (1) a 50 percent capital gains deduction, (2) indexation of capital gains for inflation, and (3) allowing homeowners who sell their homes at a loss to deduct that capital loss. The 50 percent capital gains deduction and the home sale capital loss provision would apply to sales on or after January 1, 1995. The capital assets indexation would apply to inflation (and sales of assets) after December 31, 1994.

Fifty Percent Capital Gains Deduction

The bill would allow taxpayers – both individual and corporate – to exclude one-half of capital gains from income tax, with the effect of cutting the capital gains tax rate to one-half the rate of

ordinary income, which currently is capped at a rate of 28 percent. The new effective capital gains tax rates would be 7.5 percent, 14 percent, 15.5 percent, 18 percent, and 19.8 percent for individuals, depending upon the individual's tax bracket. Corporations would be subject to a top effective tax rate of 17.5 percent. The measure would not change the 1-year holding period requirement for long-term capital gains.

The 50 percent capital gains deduction would be taken against gross income. This change would ensure that the excluded half of the capital gain would not increase Adjusted Gross Income (AGI). Because capital gains are currently included in AGI, many taxpayers must forfeit personal exemptions and itemized deductions if they are above certain income thresholds. This change would have the effect of reducing the effective tax rate on capital gains by easing the impact of the personal exemption phaseout and the limitation on itemized deductions.

The capital gains deduction would not be a preference under the Alternative Minimum Tax (AMT). Therefore, the 50 percent deduction would be excluded from the AMT. This exclusion helps taxpayers avoid another tax rate on capital gains.

The bill would also reinstate the pre-tax Reform Act of 1986 rule for capital losses: only one-half of net long-term capital losses, to the extent that they exceed net short-term capital gains, would be deductible.

Capital Gains Indexation

The bill would halt the practice of taxing individuals and corporations on inflated capital gains. Under current law, taxpayers must pay capital gains taxes on the difference between an asset's sales price and its basis (the asset's original purchase price, adjusted for depreciation and other items), although the increase in value may be the result of inflation and not real gain. The measure calls for increasing the basis of most capital assets to account for inflation after 1994. Taxpayers would be taxed only on real, not illusory, gains.

Loss on the Sale of a Home

Under the bill, taxpayers who sell their principal residence at a loss may deduct that as a capital loss. Current law does not allow homeowners who sell their homes at a loss to take this deduction.

Why a Cut in Capital Gains Is Needed and Why Gains Should be Indexed

Capital is the lifeblood of enterprise and economic growth, yet too often risk-takers – energetic entrepreneurs with promising ideas and practical dreams – encounter obstacles in obtaining the capital they need to launch a new venture. Even well-established business owners – with strong track records and profitable companies – can run up against the same problem when seeking additional sources of financing to expand their operations. Our nation's future success depends on entrepreneurs and small business owners who can help fuel and drive our economy. They create our jobs and contribute to our growth and prosperity. But without the capital to start and expand businesses, they cannot succeed and ultimately we will all pay a price for their lack of success. It is time that Congress address the need for increased capital availability within the context of efforts to encourage increased business formation and expansion through investment. The current tax treatment of capital gains is an obstacle to the formation of additional capital that entrepreneurs must have access to for investment in growth and jobs.

The Effects of Taxing Capital Gains

Reduced Savings and Its Effect on Capital Formation and Investment

Subjecting capital gains to taxation penalizes those who save and invest, forcing them to pay tax not once but twice on the same income. From the standpoint of tax equity, the capital gains tax is punitive and discriminatory. High tax rates on capital gains tend to discourage savings because they lower the after-tax rate of return on savings. Such rates can distort individual decisions about savings. Faced with a choice between saving income – with a lower rate of return later – or spending it now, many Americans elect to consume income now rather than defer future consumption through savings. Since savings is essential for capital formation, the individual preference for current consumption, as compared to saving for future consumption, stymies capital formation. Reduced availability of capital equates to lower levels of investment in business startup, plant and equipment as well as in labor, with the consequence that productivity suffers and workers' wages can drop.

Decreased Risk-taking and Investment

High capital gains tax rates discourage venture capital and risky investments and harm small firms and new enterprises. These investments are critical to our nation's growth and economic

success. Over the last several years, entrepreneurial small companies have contributed to and accounted for nearly all of the economy's growth and job creation. Growing and emerging new companies need steady infusions of risk capital to nurture, support, and sustain expansion. Entrepreneurs need investors to buy stock and to invest in their companies. But investors will only commit their capital to such investments if they can be assured of a fair and reasonable return on their investment.

The taxation of capital gains acts as a significant drawback to riskier investments in new startup companies or those undertaking expansion. A lower capital gains tax rate would help channel more capital into new and growing small entrepreneurial companies – the nation's leading source of economic growth and job creation. This, in turn, would create a tremendous potential for increased economic expansion, encourage risk-taking on a larger scale, spur innovation, boost productivity, and add more Americans to company payrolls.

The Threat to U.S. Competitiveness

Higher capital gains tax rates undermine U.S. industrial competitiveness and threaten to challenge our longstanding role as the undisputed economic leader of the world. Capital is the key ingredient of investment and investment fuels growth and expansion; however, when capital costs too much, investment declines and productivity and economic growth suffer. Higher capital gains rates tend to discourage savings and investment, raising the cost of available capital. The effect of higher capital costs – either because of reduced supply or increased demand – is lower levels of investment in plant and equipment, technology, and labor. As a result, goods and services that are produced under this scenario cost more to produce. These costs must be reflected in higher consumer prices, making products less price competitive in the marketplace.

The United States already faces significant competitive challenges around the globe. In many cases, our competitors benefit from more favorable tax treatment of capital gains and savings, combined with lower labor, raw materials, and overhead costs, as well as reduced regulatory and paperwork burdens. This strengthens their advantages and increases their opportunities in the marketplace. Congress needs to stimulate business investment in technology, plant and equipment, and people to maintain our technological superiority, boost productivity, and increase our global competitiveness. That is why a lower capital gains tax rate is needed to reduce the cost of capital and to increase its availability.

Locking in Investors and Investments

Investors who contemplate selling assets or changing their investments understand the effect capital gains taxation has on anticipated profits from asset sales. They must weigh whether the expected return from the sale of an asset will result in a desired profit after the capital gains tax has been levied. When it is clear that the profit is less than expected, investors will generally for go or postpone the sale of an asset. This phenomenon of investors holding onto assets because the expected net return derived from the sale of an asset after the payment of capital gains tax is less than desired is known as the "lock-in" effect.

Taxing capital gains often saddles investors with assets they do not want but cannot afford to liquidate because of the undue financial consequences. This can cause capital to idle in non-productive assets. Moreover, the lock-in effect deters the redeployment of capital to more useful and productive investments. Since the lock-in effect caused by higher capital gains taxation can distort behavior, many investors seek out investments that will minimize tax liability. In such cases, tax avoidance becomes a major strategy in considering investments, rather than pursuing investments that make good economic sense and, while riskier than others, also provide higher rates of return.

Lowering capital gains taxes would unlock a huge amount of wealth in homes, land, farms, stocks, bonds, and other assets; and free investors to pursue new investments. Simultaneously, it would generate new revenues through increased realizations of capital gains.

Inflation

Of all the negative effects of taxing capital, perhaps none is more pernicious or harmful than inflation. The current tax treatment of capital gains is discriminatory and confiscatory, since taxes are paid on inflated and illusory, not real and actual, gains. Inflation erodes gains. Under current law, capital gains taxes are applied to nominal gains, which are gains that are not adjusted for inflation. This means that the effective tax rate on real capital gains is actually higher than the current prescribed legal rate. Since the appreciation in value of most assets, particularly those held for longer periods, is attributable to inflation, taxing nominal gains destroys the wealth of entrepreneurs, individuals, and families.

Capital gains must be indexed for inflation to halt the taxation of gains based solely on exaggerated values. This would help investors who currently avoid selling assets to take advantage of

higher risk investments – the chief source of economic growth. Further, it would allow investors to buy assets based on their true merits without regard to the effect of inflation on future returns or plan sales of assets based on artificial holding periods. Indexing capital gains for inflation also would help small business owners who want to sell assets to create or expand a business or sell their company.

In Defense of a Capital Gains Tax Cut: Answering the Critics

Critics of reducing the rate of capital gains have attacked the proposal on many fronts.

Argument: A Capital Gains Tax Cut Only Helps the Rich

Many charge that cutting the capital gains rate will disproportionately benefit taxpayers in higher income brackets. They contend that at least half of the direct benefits of a cut in capital gains will go to the top two percent of taxpayers nationwide. Opponents are concerned that this will result in a windfall to America's richest individuals and corporations at a time when there is a growing disparity between the country's rich and poor.

Underlying much of the opposition to reducing the capital gains tax is a false belief about our economy: that is, if one individual wins, the other must lose. Investors who save and invest their income and plough it into productive investments not only help themselves, but also countless more who share in the benefits from the initial investment. The direct benefits of investments include economic growth, increased productivity, new jobs, higher wages, and improved living standards, to say nothing of additional revenues that government realizes. Thus, investments produce a strong multiplier effect within the economy, helping investors and those who are beneficiaries of their investments. To paraphrase President Kennedy, 'a rising tide of investment lifts all boats.' But when higher capital gains taxes punish investors by devouring the value of their investments or diluting them through the taxation of inflated gains, they respond by saving and investing less. Ultimately, their reluctance – or refusal – to save and invest hurts the economy and everyone in it.

If Congress wants to create more jobs, expand the economy, improve income and wage opportunities, it must encourage more investment. To foster greater investment, Congress must first remove the disincentives to savings and investment – for rich, middle-class, and lower middle-class investors alike. Individuals respond positively to investment incentives, but they react negatively and predictably to investment barriers such as higher capital gains rates. Congress must create incentives for risk-taking, job creation, and expansion. Lowering the capital gains rate is a first step. This reform would help all income classes because it would improve the economy's performance and growth potential. It is a tenet of sound economic policy that economic growth increases when the cost of activities that foster it are lowered.

Critics of lowering the capital gains tax deride it as a boon to rich taxpayers. They labor under a false assumption; namely, that all those who pay capital gains taxes are rich. Low- and middle-income taxpayers bear a significant share of the cost as well. The reality is that many Americans with limited incomes have investments in stock, rental properties, and small businesses. They face the capital gains tax when they sell such assets. Michael Schuyler, Ph.D., of the Institute for Research on the Economics of Taxation, found that:

> Most distributional tables purporting to show who pays the capital gains tax overstate the wealth of people with capital gains because they include in a taxpayer's income the entire capital gain in the year in which the person realizes the gain. Since gains are typically realized irregularly, people tend to have unusually high incomes in the years when they realize their gains. A better measure of income is found by averaging the gains over several years' before adding them to income. And these corrected tables indeed show that the middle-class forks over a significantly higher share of the capital gains tax than is usually acknowledged. In addition, as politicians in Washington have sought higher taxes to finance more government spending, they have frequently found it convenient to redefine "wealthy" at lower and lower income levels.
>
> *Cut The Capital Gains Tax To Help All Income Classes*
> IRET Byline. September 22, 1989 No. 79

A high capital gains tax rate should not be used to extract more taxes from income earners in the top tax brackets any more than it should be used to punish those who are in lower and middle-class income brackets. Lowering the tax on capital gains has the potential to help Americans in all income classes by sparking greater growth in the economy.

Argument: A Capital Gains Tax Cut Will Break the Treasury and Increase the Deficit

Opponents of a lower capital gains tax rate maintain that reducing the rate could cause the budget deficit to rise unless Congress offsets the tax cut with spending cuts. They say that Congress must find the cuts or risk further interest rate hikes by the Federal Reserve. Opponents also argue that

a cut would kill prospects for improved economic growth that Republicans say they want to stimulate. The Congressional Joint Committee on Taxation estimates that the Republicans' proposed capital gains tax cut would cost $56 billion in lost tax revenue over the next five years. After that, it predicts, the cost of a capital gains tax cut would rise, mostly due to proposed adjustments in future capital gains to offset inflation. Opponents point out that Congress cannot dismiss the fact that the $160 billion deficit will begin rising again next year, and that the costs of the capital gains tax cut would add to that cost without offsetting spending cuts.

Republicans have vowed to cut spending to make room for the cuts they propose. The capital gains tax cut will not be a revenue loser as critics contend; in fact, it could prove to be a net revenue gainer. Mr. Gary Robbins, President of Fiscal Associates Inc, a leading proponent of dynamic estimating, predicts that the capital gains tax cut would produce $126 billion in new revenues by fostering widespread economic growth. We believe this could result in a windfall to the U.S. Treasury. A lower capital gains rate could boost tax revenues by encouraging investors to realize their gains sooner. A cut would encourage investors to liquidate assets and put their money into productive investments to such a degree that the cost of a capital gains tax cut would pay for itself in higher tax revenues later.

Critics say this is an unproven economic hypothesis. Yet, Warren T. Brookes, a respected journalist and economist, recounts in his book, *The Economy in Mind*, that the opposite is true:

> When the top marginal tax rate on capital gains was 46% (1946-63), or nearly double Mellon's maximum range of 25%, the taxes paid on capital gains steadily declined from 1961 through 1963. Then, as a result of the Kennedy across-the-board tax cut of 1963-64, the top marginal tax rate on capital gains was reduced from 46% to 35% – a cut of 24%. The revenues from this tax steadily rose, by 25% in 1964 and 27% in 1965. By 1968 they had nearly tripled in constant dollars, at a substantially lower marginal tax rate.
>
> Unfortunately, this growth in capital gains and investment was hit hard, first by a surtax in 1968-69, and then by an increase on capital gains put through by Senator Edward M. Kennedy in 1969, which had the effect of raising the top marginal tax on capital gains to its highest level in U.S. history, 49% in 1970. The results were immediately destructive. Tax revenues from capital gains plummeted, and over the next eight years remained consistently at a level nearly $1.5 billion lower than they were in 1968.
>
> Within a year of this tax increase, the entire equity capital market for small companies (which account for over 80% of all new jobs and 65% of new inventions) fell apart; and it continued to disintegrate over the next eight years. In 1969, before the tax hike, there were nearly 700 new stock offerings by small companies, with a total 1980 value of nearly $3 billion. But by 1977 this equity market had shriveled to only 13 offerings and less than $55 million – a compound annual decrease of nearly 40%, the worst collapse in equity sales in modern U.S. history.
>
> For all intents and purposes, Senator Kennedy's innocent little tax hike had virtually killed off the small-business equity market and countless thousands, even millions, of jobs along with it.
>
> *The Economy in Mind*, pp. 59-61

Later in the same chapter, Brookes describes the effort involved in trying to reverse the increase on capital gains.

> It was perhaps the best illustration of the Laffer Curve in action – so good, in fact, that a young Republican congressman, the late William Steiger of Wisconsin, decided in 1977 to try to convince an overwhelmingly Democratic Congress to repeal this massive mistake [sic: Senator Edward Kennedy's bill to raise capital gains] by showing his colleagues that as much as half of the new equity capital for the nation's fast-growing high-technology industries was, by now, coming from overseas rather than from our own equity markets.
>
> The dramatic fall, both in capital-gains tax revenues and in equity-investment, convinced the Congress to turn down President Carter's own surprising plan to increase the capital-gains tax rate still further (to 52.5%) and instead to adopt Congressman Steiger's amendment, which cut the rate from the 49% level down to 28% – a 43% tax reduction.
>
> The Carter administration, in an unsuccessful attempt to block this bold move, had warned that the Steiger Amendment could reduce Treasury revenues by more than $2 billion during the first year. Instead, the Steiger cut actually *raised* capital-gains tax revenues modestly in 1979, the first year following the 43% reduction, as the number of new equity offerings suddenly jumped from 20 per year to 81 in 1979. Then, during 1980, a recession year, 237 companies offered stock to the public for the first time (the greatest number since 1972) and sold $1.4 billion in shares – a huge increase from the 81 new

companies that had sold $506 million in 1979.
The Economy in Mind, pp. 61-62.

NBOA Position on Cutting Capital Gains and Indexation

The National Business Owners Association strongly supports the capital gains tax cut and indexation provisions contained in Job Creation and Wage Enhancement Act as introduced and as originally proposed in the Contract with America. We asked our members in a survey whether they would favor a capital gains tax cut. Respondents overwhelmingly expressed support for legislation to reduce the rate of taxation on capital gains. NBOA believes that the capital gains relief incentives included in the bill will create a climate that will encourage investment; promote increased growth in the economy, jobs, and wages; and strengthen U.S. competitiveness.

Neutral Cost Recovery

The House Republican Contract with America includes a neutral cost recovery proposal. This proposal would increase depreciation deductions to approach the economic equivalent of expensing. Currently, the tax code does not allow businesses to recover fully (on an economic basis) the cost of investments in depreciable business property. The proposal would increase depreciation deductions to account for inflation and the time value of money. The neutral cost recovery provisions would generally apply to property placed in service after December 31, 1994.

Current law prohibits company owners from taking an immediate write-off for the investments they make in depreciable assets such as plant, equipment, and other assets. Consequently, they must spread the write-offs over longer periods. This practice hurts small business owners in several ways. It reduces the real present value of the write-offs since they do not account and compensate for the twin effects of inflation and the time value of money. By not allowing business owners to factor in the costs of inflation and the time value of money and to adjust their write-offs on depreciable property to reflect these costs, business owners are unable to recover the full costs of their investments.

Under the neutral cost recovery proposal in the Job Creation and Wage Enhancement Act, businesses would be allowed to recoup the cost of their investments. The plan would allow companies to adjust their depreciation write-offs yearly by applying a 3.5 percent discount rate and the rate of inflation. This would make the write-off amount equal to the full purchase price of an asset.

NBOA Position on Neutral Cost Recovery

The National Business Owners Association strongly supports the neutral cost recovery provisions contained in H.R. 9. This bill will give entrepreneurs a powerful new investment incentive, allowing them to recover the full value of an investment in new machinery, equipment or technology over the useful life of an asset. Moreover, these changes recognize the importance of capital to small business and its ability to invest for future growth. We believe further that this provision will exert a positive influence on investment and wages as it seeks to correct an inequity in the current tax code that harms small business. These changes will also help promote rapid economic growth by spurring increased investment. We believe that such growth will fuel business startup and expansion, as well as spark new job creation.

Increasing the Expensing Level for Small Business

The House Republican Contract with America also proposes an increase in the amount of property that a small business can "expense" or deduct in the year of purchase. Current law allows a small business (a business purchasing $200,000 or less of eligible property) to take an immediate deduction on the first $17,500 of property it acquires. Remaining property is generally subject to regular depreciation rules. The proposal would allow small businesses to fully deduct an additional $7,500 from each year's earnings for purchases of equipment and inventory up to $25,000, compared with $17,500 now. The provision would be in effect for taxable years beginning after December 31, 1995.

Expanded write-offs for investments in plant and equipment for small business are needed to ensure that small firms have access to capital to invest in growth and expansion. Entrepreneurs need to invest today for the future and long-term investment must be nurtured. Yet, the present tax treatment of investments in plant and equipment has not favored long-term investment as it should nor has it favored the investments of small business men and women who are driving our nation's growth.

NBOA Position on Increasing Expensing for Small Businesses

The National Business Owners Association strongly favors the proposal to increase the expensing amount for small businesses as contained in the Job Creation and Wage Enhancement Act.

This legislation provides an important investment incentive for small business owners, while enabling them to recover more of the cost of their investments. This, in turn, will increase the availability of additional capital for future investment.

Clarifying the Home Office Deduction

H.R. 9 would clarify the home office deduction by making two changes. First, an office in the home would qualify as a principal place of business if the office is the location where the taxpayer's essential administrative or management activities are conducted on a regular basis by the taxpayer and the office is necessary because the taxpayer has no other place to perform those activities. Second, qualifying home office expenses would also include those allocable to the storage of product samples. The changes to the home office deduction generally would be effective for taxable years beginning after 1995.

The home office deduction was restricted by a 1993 U.S. Supreme Court decision in *Commissioner v. Soliman*, when the court denied certain deductions and imposed two additional tests for determining eligibility for deductions. To qualify now, a business owner must: meet clients or customers in the home office; and second, earn the firm's revenue there as well. The *Soliman* decision penalizes many small business owners because they choose their homes as their business location rather than a store front, office building or industrial park. This ruling fails to recognize the fundamental realities of American business today, including its changing nature; how, when, and where business is conducted; as well as the needs of entrepreneurs who are leading our economy.

The bill would restore the deduction for home office expenses to pre-*Soliman* law. Taxpayers would not be required to meet the criteria determined by the Court. Rather, the bill allows a home office to meet the definition of a principal place of business if it is the location where essential administrative or management activities are conducted on a regular basis by the taxpayer. To avoid potential abuses, the bill would require that taxpayers have no other location for the performance of the administrative or management activities of the business.

The home may be the best incubator for fledgling businesses that are struggling to survive and succeed. Few new small business owners, if any, can afford the luxury of rented office space. That is because a major problem facing new enterprises is cash flow. Many entrepreneurs launch new firms on a shoestring budget, enduring long hours, limited resources, and lean or no profits before they become successful. For these business owners, the home office deduction can boost the chances that the company they have started and worked hard to build will be a success. That is why the loss of the deduction represents a major blow to those whose success often hangs in the balance and hinges on taking advantage of every break that can keep a company financially afloat and growing.

The *Soliman* decision ignores the changing face and needs of business. The advent of advanced and ever-improving computer and telecommunications technology has empowered millions to work from their homes. Entrepreneurs are no longer tied to an office or to a store front. Now, thanks to technology, they can work from their homes. Technology has changed the way we think, communicate, work, and do business – and where we do these things. New technologies are revolutionizing business and helping us realize huge improvements in productivity and service. As technology becomes cheaper due to innovation, more Americans can afford to work for themselves and from their homes. U.S. tax policy should not discriminate against home businesses because a taxpayer chooses to operate a business out of the home.

NBOA Position on Clarifying the Home Office Deduction

The National Business Owners Association strongly supports efforts to restore the home office deduction. Restoring the home office expense deduction could affect between 20 and 40 million Americans who work from their homes.

Increasing the Estate Tax Exemption

The Contract with America would raise the estate and gift tax exemption equivalent to $750,000. The current $600,000 exemption has not been increased in several years and has been eroded by inflation. The increase in the exemption would be phased-in. The exemption would be $700,000 for estates of persons dying, or for gifts made, in 1996. The exemption would be $725,000 in 1997 and $750,000 in 1998 or later. The $750,000 exemption amount would be indexed for inflation.

Estate taxes are hurting family-owned businesses, especially smaller firms. Funds that could be retained in a business to invest in growth and create jobs are going to pay taxes on the assets of the deceased owner or the owner who desires to exit his or her firm and hand over control to the next generation. The accounting firm of Arthur Andersen estimates that the transfer taxes on business assets above the current $600,000 exemption range from 38 percent to 60 percent, depending on amount. Surviving family members frequently must sell part of the company to pay the estate taxes. According to Mr. Drew Mendoza, program director of the Family Business Center at Loyola University-Chicago, meeting this tax burden forces many family businesses into sale or foreclosure. A

survey found that nine of 10 family successors' businesses failed shortly after the original owner's death, due to the difficulty of paying estate taxes. Seventy percent of all family businesses will not succeed to the second generation and only 13 percent will make it to the third generation.

According to a recent research study conducted for Massachusetts Mutual Life Insurance Company, 57 percent of owners say they intend to pass on their ownership positions to a close relative. This represents an eight percent drop-off from the 1993 study, when 65 percent of those surveyed said they intended to keep the business in the family. It is an alarming statistic, and points to a possible disturbing nationwide trend: we are losing family-owned businesses. Higher estate taxes may be the culprit or only a single factor contributing to the decline of America's family-owned businesses. These firms are important to our nation's economy. It is estimated that there are 10 million to 12 million family-owned businesses nationwide. These companies may account for as much as half our gross national product and 60 percent of all wages paid.

With all the daunting challenges and obstacles already facing small business owners, the tax code should not add to the burden of family business owners by making it more difficult for them to keep their companies in family hands. We need to preserve family businesses by removing obstacles -- such as higher estate taxes – that threaten their prospects for continued survival and success.

The last estate tax reform occurred in 1981, when the high inflation of the 1970s forced Congress to alter the existing law. The tax rate was reduced from 70 percent to 50 percent, the tax exemption was raised from $200,000 to $600,000, and further taxes were deferred on the portion of the estate the spouse inherited. These changes were only adequate for a short time. Small business owners say the current rate has not kept pace with the state of the economy and they need to be overhauled again.

NBOA Position on Raising the Current Estate and Gift Tax Exemption

The National Business Owners Association strongly supports raising the current estate and gift tax exemption to $750,000 and adjusting it for inflation. This change will help ease the burden of estate taxes for many small business owners, keep family firms financially stable, and preserve them for generations to come.

CONCLUSION

We appreciate this opportunity to offer our views on the tax and investment incentives contained in the Job Creation and Wage Enhancement Act. These incentives will set the stage for a new American era of economic growth led by small business owners. The real growth in all major economies worldwide is coming from smaller, more entrepreneurial companies. That is especially true of the U.S. economy. The importance of entrepreneurs and small business owners to the economy cannot be underestimated. They drive the American economy, fueling its growth, adding new jobs, and creating wealth.

Congress must help unleash the entrepreneurial spirit to spur economic growth and encourage individuals with promising ideas and the courage to take risks to start and expand businesses. Too often government creates obstacles to growth as it has with disincentives for savings and investment. Small business owners deserve policies that promote economic growth – policies that reward, not punish, risk-taking and hard work. The tax and investment incentives in the Contract with America are a bold and promising step in the right direction.

Mr. Chairman, we look forward to working with you and the Members of this Committee over the coming months to develop and enact the policies that will help America's nearly 22 million small business owners bring about a new American era of economic growth and prosperity.

TESTIMONY OF JOHN C. GOODMAN
NATIONAL CENTER FOR POLICY ANALYSIS

The Individual Retirement Account program, first established by the Pension Reform Act of 1974, was one of the most successful programs ever adopted. People could make tax-free contributions to an IRA and pay the taxes at the time of withdrawal. By 1984, 15.4 million taxpayers were depositing $35.8 billion per year in IRAs. Studies by Professors Steven Venti of Dartmouth, David Wise of Harvard, Glenn Hubbard of Columbia and Jonathan Skinner of the University of Virginia clearly showed that IRAs increased the rate of personal saving. Their studies showed that as much as 80 cents of each dollar deposited to IRAs represented new savings. If we assume that the average depositor was in the 35 percent income tax bracket, for each $1 increase in the federal deficit more than $2 of new savings was added to the credit market. Thus IRAs financed an increase in private investment which led to increased tax revenues that offset government deficits.

The Drop-off in IRA Contributions. The Tax Reform Act of 1986 removed many of those who had been making tax-free IRA contributions from eligibility. It limited the tax-free contribution to people with no employer-provided pension or to individuals with incomes of less than $25,000 and couples with incomes of less than $40,000. The 1986 act dramatically reduced marginal tax rates, making tax advantages of IRA contributions less attractive. As a result of these changes:

- The number of people making annual IRA contributions dropped from 15.5 million in 1986 to 6.4 million in 1988 — a decrease of almost 60 percent.

- The total amount contributed to IRAs each year dropped from $37.8 billion in 1986 to $12.0 billion in 1988 — a decrease of almost 70 percent.

The NCPA estimates that 45 to 50 percent of the decline in IRA participation was due to the income limits. The remaining drop in participation was due to the drop in marginal tax rates. In general:

- The average marginal tax rate for IRA contributors dropped from 27.1 percent in 1986 to 19.1 percent in 1988.

- As a result, the value of the tax advantage associated with IRA contributions fell by 35 to 40 percent.

Backended IRAs. The House Republicans' Contract With America proposes a new IRA — one that is "backended." Instead of making tax-free deposits and paying taxes when funds are withdrawn, with these accounts people would make aftertax deposits and tax-free withdrawals. Moreover, before age 59 1/2, funds could be withdrawn without penalty if used for the purchase of a first-owner occupied home, college education expenses, medical costs or insurance for long-term care. For two years, people holding traditional IRAs would have the option of cashing them out without penalty, paying taxes and transferring the funds to backended IRAs.

Why are backended IRAs attractive? If tax rates are the same over a person's life, paying taxes before making deposits or after making withdrawals are equally attractive — that is, the present values of front-ended and backended IRAs are the same. But tax rates will not remain constant. When IRAs were introduced, most American workers could expect to be in a lower tax bracket after they retired. Hence, it made sense to avoid taxes during the working years and defer them until retirement. With the passage of the Social Security benefit tax in 1983, an increase in 1993 in the amount of the benefit subject to tax and the reduction in marginal tax rates passed in 1981 and 1986, the traditional assumption is not necessarily true. Many workers who today are in the 15 percent income tax bracket will be in the 28 percent bracket by the time they retire. The Social Security benefit tax can further increase their marginal tax rate to 52 percent. The backended IRA addresses the problem of higher marginal tax rates for the elderly by providing for aftertax deposits during the working years and tax-free withdrawals later.

With backended IRAs there is no initial tax revenue loss. Revenue would increase in the short run because people who have IRAs now would transfer funds to the backended IRAs and pay regular taxes on the amount transferred. Critics argue that there would be long-run revenue losses from future tax-free withdrawals. However, Professor Martin Feldstein of Harvard has countered that the backended IRA increases long-term government revenue because, like a current IRA, it increases saving, which increases the size of the capital stock, which increases output and taxable income.

Another advantage to the backended IRA is its treatment of capital gains income. Under current law, assets held for many years are taxed on increases in value due to the effects of inflation alone. Because all income is tax free at withdrawal, capital gains in a backended IRA would not be taxed, making growth assets particularly attractive.

NCPA Senior Fellows Aldona Robbins and Gary Robbins have estimated the economic effects of the backended IRA proposal for TaxAction Analysis. They conclude that the measure would result in a reduction in the overall marginal tax rate on capital by 0.6 percent and a reduction in the aftertax cost of capital to investors of 0.5 percent. The Robbinses further estimate:

- By the year 2000, annual gross domestic product would be $18 billion higher than otherwise.

- The proposal would create 42,000 new jobs.

- The federal government would gain $58 billion in additional revenue between 1995 and 2000.

The proposed expansion of IRAs is good for everybody. It will provide the average American an incentive to save more. It will produce more money to finance capital investment, economic growth and jobs. And it will increase tax revenue, both because of the initial transfer of funds from existing IRAs to backended IRAs and because of the increased output of goods and services.

TESTIMONY OF THE
NATIONAL FEDERATION OF INDEPENDENT BUSINESS (NFIB)

The National Federation of Independent Business (NFIB) appreciates the opportunity to submit testimony on the issue of allowing a tax deduction for a home based business. NFIB is the nation's largest small business organization representing over 600,000 small business owners from all fifty states. The typical NFIB member has five employees and has $250,000 in gross annual sales. NFIB sets its public policy positions through regular polling of its membership.

A provision clarifying who is able to take a tax deduction for a home based office or business is one of the small business tax items included in the Contract with America.
The economic goals of the Contract with America -- less taxes, less spending, and less regulation -- are what small business owners have wanted for years, as shown over and over again in NFIB surveys. In 1986, small business owners identified their federal tax burden as the third biggest problem facing their businesses, according to a study done in that year by the NFIB Education Foundation entitled *Small Business Problems and Priorities*. Then, a follow up study published in 1992 showed federal taxation moving up to the second biggest problem faced by small employers, second only to the rising cost of health insurance. And in the most recent study completed by the NFIB Education Foundation in October of 1994, entitled *Small Business Economic Trends*, small business owners identified their tax burden as the number one problem facing their businesses.

Small business has a huge stake in the outcome of the debate on the tax elements of the Contract. It is equally true that America as a whole has a huge stake in how small business fares in whatever tax and economic legislation this Congress passes. Evidence continues to suggest clearly that small business plays a unique and rather remarkable role as a job creator and provider of personal opportunity, security and independence for millions of Americans. Consider the following:

Jobs. Since the early 1970s, small firms have created two of every three net new jobs in this country (created jobs minus lost jobs). A substantial majority of that job growth came in the very smallest firms -- those with fewer than five employees. The nation's small business job machine has shown a capacity to produce in either good or tough times. **From 1989 to 1991, a period of minimal economic growth, firms with fewer than 20 employees created virtually all net new jobs in the country. Firms of all other sizes lost employment during that period.**

Demographics. Almost all businesses are small businesses. There are approximately five million employers in the United States. About 99 percent of them are small employers. And almost all small businesses are very small -- so-called Mom-and-Pop, Main Street, family enterprises. More than half of businesses with employees employ fewer than five people. Almost 90 percent of employers employ fewer than 20. Small business as a whole employs more than half of the private sector workforce. **Most small firms are not set up as C corporations, but as proprietorships, partnerships, and subchapter S corporations.**

Values. Small business holds out to our citizens great hope. Small business offers a road map to the American dream that allows any American with a good idea and talent to follow it to economic freedom and security by starting their own business and working hard to make it a success.

It is this culture, these values, that primarily drive people to start a business -- not because they have money or want to make a lot of it. In a 1991 NFIB Education Foundation study entitled *New Business in America*, new business owners were asked why they went into business. Answers such as "Use my skills," "Control over my own life," and "Build for the family" were all cited twice as frequently by respondents than was "Earn Lots of Money." And having money to start with is not a distinguishing factor in wanting or being able to start a business and pursue the American dream. **More than half of all businesses begin with less than $20,000 in capital. One in four of *Inc.* magazine's 500 fastest growing companies in 1992 started with less than $5,000.**

None of this should lead you to believe that surviving as a small employer is easy. To the contrary, it is difficult. About half of all businesses do not survive beyond their first five years.

There are numerous reasons why businesses fail. One of them is government -- government taxes, government red tape, government regulations, and government paperwork. That is why what you do here in the first 100 days of the 104th Congress is so important. You have a unique challenge and opportunity -- an opportunity to free small business owners and entrepreneurs from the drag of government so they can do what they do best, create opportunity and wealth for the American people. The rest of this testimony will look at how one specific tax provision included in the Contract, clarifying who can take the home office tax deduction, will encourage further small business creation, growth, opportunity and jobs.

Background

Section 280A of the Internal Revenue Code requires those wishing to take the home office deduction to use a portion of their home exclusively for business purposes. In addition, the office must be the (1) principal place of business; (2) the place used by clients or customers; OR (3) a separate structure on the same property as the home. Most of the conflict between the Internal Revenue Service (IRS) and taxpayers have focused on what constitutes a "principal place of business".

Congress enacted section 280A in order to establish a less subjective, uniform standard for determining which offices qualify for the home office deduction. Despite this effort, different courts began establishing a variety of tests to determine whether an office was qualified. The phrase "principal place of business" was the basis for most of the variations between the tests. Some courts adopted a "focal point" test, which looked at where the income is generated and where services are provided. This test proved to be too narrow and so some courts adopted a "dominant portion of the work" test to replace it. This new test would only require that the business perform a dominant portion of the business's activities from the home office.

The U.S. Tax Court rejected the focal point test and the other tests and developed its own. Under the tax court test, the court would look at the facts and circumstances of each case and determine whether or not a home office was eligible for the deduction by exploring (1) if the office was essential to the business; (2) if the office was used for a substantial amount of time; and (3) if there were other locations where this work could be done. The U.S. Supreme Court eliminated this test in 1993 and created its own in the Soliman decision.

The Supreme Court's Decision

Commissioner v. Soliman involved an anesthesiologist who visited all his patients in the hospital and did all the paperwork at home. The Court found that he did not qualify for the home office deduction because he serviced his customers and spent most of his time at the hospital. The Court through its use of the plain English definition of the word "principal", held that the hospital was Mr. Soliman's principal place of business.

The Court decided that the IRS should determine a taxpayer's principal place of business by looking at all locations where a taxpayer does business. The principal place of business should be determined primarily by the importance of the activities performed at each location and how much time is spent at each location. Taxpayers can have only one principal place of business. Mr. Soliman spent most of his working hours at the hospital with patients. As a result, the court found the hospital to be the "principal" place he conducted business.

Most of the confusion over the home office deduction is caused by the phrase "principal place of business." This phrase was supposed to mean that the office played a significant role in the running of the business. The Supreme Court, however, read the statute literally and came to the conclusion that a taxpayer can only have one "principal" place of business and that "principal place" is determined by the importance of the activities performed at each location and how much time is spent at each location. In other words, this location must be where most of the business activity takes place. Taxpayers may have no principal place of business if these

Supreme Court tests are not met.

The Impact of *Soliman* on Small Businesses

What does Soliman mean to small business owners who had been taking a deduction for their home based office or business? Consider these examples of business owners who perform administrative and management activities essential to their business at home but under Soliman are unable to qualify for the home office deduction:

A general contractor who builds homes. At his home office this business owner pays the bills for his business, which includes the building materials he uses as well as other direct costs. He also keeps all his accounting and payroll records at his home, as well as other forms and records required by the government -- such as IRS 1099 forms and I-9 forms required by Department of Justice. He uses his home office for his business telephone that is needed to negotiate bids. Under Soliman this business owner would be unable to take the home office deduction because his greatest amount of time is spent at the work site building homes. His revenue source is the homes he builds and although he is required by the federal government to keep certain records, he has no where else to perform these administrative duties. He currently is not allowed a tax deduction for his home office.

A management consultant who conducts employee leadership seminars. This business owner also needs her home office to keep billing and accounting records. But in addition to those core administrative and management duties, she also needs a place to create, produce and store items for her seminars, such as handouts, training manuals, slides and videos. In order to produce these materials, she needs a place to read and research as well as a place to design her seminars and conduct other necessary technical preparation. She needs to be able to maintain a library and a safe place to keep her equipment -- like her computer and any video equipment she owns. Under the Soliman decision she would have difficulty taking a deduction because the majority of her time is spent on site in other locations giving the actual leadership seminars. Because her main revenue source is outside her home office, it is not considered a principal place of business and so her ability to qualify for a home office deduction could be questioned.

An interior designer who performs 95 percent of her work in other people's homes. This business owner, like the contractor and consultant, also needs a home office to perform essential business activities, such as bookkeeping, accounting and other necessary forms of record keeping. Additionally, she needs a place to store these various records. Although an interior designer may spend 95 percent of her time out of her home office, she still must have a place to keep the records of time spent with each client and collect and deposit revenues in order to pay necessary business expenses. Like the other two business owners, she is unable under Soliman to take a deduction for her home office because she spends the majority of her time at other locations and her primary revenue source is meeting with clients outside the home office.

A Solution to the Problem

Since much of the controversy over who can take this deduction centers on the reference in Section 280A of the Internal Revenue Code to the home office deduction being taken on a portion of a home that is the "principal place of business," the language in the Contract addresses this problem by re-defining principal place of business. The Job Creation and Wage Enhancement Act clearly defines "principal place of business" as (1) the location where the taxpayer's essential administrative or management activities are conducted on a regular and systematic basis; and (2) the office is necessary because the taxpayer has no other location to perform these administrative and management activities.

NFIB supports this proposal. It is a big step in the right direction. We have had some concern that it may leave too much subjectivity remaining on criteria for taking the deduction, but we have been pleased with the Ways and Means Committee staff's willingness to listen to these concerns and its willingness to further clarify Congress's intent with report language using specific examples of essential administrative and management activities such as bookkeeping, recordkeeping and storage of records.

Conclusion

This issue of who is eligible for the home office tax deduction is very important to continued small business creation and growth and to NFIB and its members. Home-based

businesses are the cradle of many successful enterprises both large and small. Home-based businesses will continue to increase in the information age, with fax machines and modems making it more feasible. In addition, a home-based business is an increasingly attractive option for two wage earner families in which one parent would like to be at home with the children. The home business path to independence and income should not be foreclosed because of the ongoing controversy over how and whether such a business deducts its expenses.

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Committee on Ways and Means
U.S. House of Representatives

Hearings on Savings and Investment

STATEMENT OF ALBERT HALE
PRESIDENT
THE NAVAJO NATION
ON

INDIAN RESERVATION INVESTMENT AND CAPITAL FORMATION

I am Albert Hale, President of America's largest Indian tribe, the Navajo Nation. The purpose of my Statement is to urge the Committee to include in its tax and job creation legislative package two vitally-needed measures to help induce private sector businesses to make investments on Indian reservations (the most disinvested geographic locations in America), and to facilitate the availability of capital toward that end.

Specifically, the Navajo Nation requests that the Committee adopt two complementary investment mechanisms that comprise a sensible, meaningful and necessary follow-up to the reservation-based "Indian Investment and Employment Tax Incentives" (i.e., accelerated depreciation for property on Indian reservations, and an Indian employment credit) established in the Omnibus Budget Reconciliation Act of 1993. First, the limited accelerated depreciation investment incentive must now be supplemented with a more powerful incentive that is already well-known to Congress -- the Indian Reservation Investment Tax Credit ("IRITC") that was previously: (i) enacted with bipartisan support in 1992 within a major tax bill (H.R. 11) that was subsequently vetoed, (ii) passed again by the Senate with bipartisan support in 1993 in its version of the Budget Reconciliation Act, but (iii) removed in conference in favor of the less-valuable accelerated depreciation incentive. Second, Indian tribal leaders should be provided the tools to attract and raise capital to facilitate those sought-after investments through expanded opportunities for tribes to issue bonds, the interest on which is exempt from federal taxation ("tax-exempt bonds").

I appreciate the opportunity to provide this Statement for the hearing record, and thank the Chairman and the Members of the Committee for their consideration of our position.

INTRODUCTION

Less than one month ago, thousands gathered in Window Rock, Arizona, the capital of the Navajo Nation, to join me on a special day -- my inauguration as President of the Navajo Nation. Our all-day ceremony was a joyous celebration, honoring our past and our sacred traditions, yet at the same time mindful of the enormous challenges in our future. Underlying the happiness, joy and unity of thousands of Navajo people that day was the stark reality of the challenges ahead.

Regrettably, the challenges of our future -- a new generation of Navajo leadership -- are in large measure the identical challenges that have confronted and defined the futures of generation after generation of our ancestors: devastating poverty, unconscionable unemployment, lack of infrastructure. Whether it is a "Contract With America" or a new covenant with the people, that contract will be illusory and the covenant will be broken unless dramatic action is taken now to improve the lives and living conditions on Indian reservations that are located in 32 different states across America.

Though the challenges are great, they in turn offer opportunities -- to this Committee and this Congress -- to provide the leadership that can help transform the present reality into a future of investment and jobs in Indian country.

BACKGROUND

Like some of the Members of this Committee, and so many of your colleagues in the 104th Congress, I share your elation at being newly-elected to my position. Like you, I am filled with the desire, and hope, that I can serve my constituency in a manner that will justify the trust they have placed in me. And, like you, I am fully aware that change is necessary, and that government's role in bringing about that change must be re-examined and re-shaped.

Unlike any of you, however, I have the unique responsibility for improving the lives and prospects of the poorest of America's poor. Across the Navajo Nation -- which is larger than the states of Connecticut, Delaware, Maryland, Massachusetts and Rhode Island combined -- our people live in conditions of economic deprivation virtually unknown in those states.

At a time when the average unemployment rate in America is 4%, the **unemployment rate in the Navajo Nation averages 38% to 50%**, depending on the season. Over 56% of the Navajo people live in poverty. Per capita income averages $4,106, less than 1/3 of that in the surrounding states. Only a very few Navajos enjoy certain "luxuries" that are taken for granted elsewhere in the United States -- 77% of Navajo homes lack plumbing, 72% lack kitchen facilities, and 76% lack telephone service. Though the Navajo Nation is slightly larger than West Virginia, our 2,000 miles of paved roads equate to barely 11% of West Virginia's 18,000 miles. Until recently, we had just three banking facilities within our entire 28,500 square mile area.

Ironically, the Navajo Nation is perceived as one of the more prosperous of Indian tribes. Tragically, these types of living conditions are mirrored at hundreds of other Indian reservations throughout the United States, with the nationwide Indian reservation unemployment rate averaging 56%. Not in the most destitute non-Indian rural areas, nor in the most decayed urban inner cites, nor in the Third World countries to which the United States generously provides foreign aid can the Members of this Committee observe chronic impoverishment and infrastructure shortfalls rivaling that found at Indian reservations in the states of:

Alabama	Iowa	Montana	Oregon
Alaska	Kansas	Nebraska	Rhode Island
Arizona	Louisiana	Nevada	South Dakota
California	Maine	New Mexico	Texas
Colorado	Massachusetts	New York	Utah
Connecticut	Michigan	North Carolina	Washington
Florida	Minnesota	North Dakota	Wisconsin
Idaho	Mississippi	Oklahoma	Wyoming

Listen to the words of several of your own colleagues, from both parties, who were among the bipartisan coalition that championed the Indian Investment and Employment Tax Incentives in 1993 (and who supported the more powerful IRITC):

Senator John McCain: "I challenge those Members who say they want to help the poor to remember the Indian people, perhaps the poorest members of our society."

Senator Pete Domenici: "American Indians are by far America's poorest ethnic group."

Senator Daniel Inouye: "The unemployment rate on the majority of Indian reservations is simply incomprehensible to the average American."

Representative Bill Richardson: "Nowhere -- I repeat nowhere -- in the United States can you find adverse economic conditions that rival those found consistently throughout Indian country."

And, as correctly summed-up by my predecessor, former President Peterson Zah:

> Stated simply, there is no single group of U.S. citizens that -- uniformly -- is more economically-deprived than American Indians living on reservations; there is no classifiable set of locations that -- uniformly -- is more deficient in infrastructure and job opportunities than Indian reservations.

INCENTIVES TO FACILITATE RESERVATION INVESTMENT AND CAPITAL FORMATION

The IRITC:

The IRITC is a powerful investment incentive for the private sector, and one that can truly influence business to consider Indian country for new or expanded investment. The Navajo Nation strongly recommends that, subject to a modification explained below, the Committee incorporate into its job creation legislation the identical IRITC that Congress enacted in 1992 in the vetoed H.R. 11, and that the Senate re-adopted in 1993 in its version of the Budget Reconciliation Act. See: (i) 1993 Senate-passed IRITC (139 CONG. REC. S8027-28 (daily ed. June 24, 1993)), (ii) excerpts from 1993 Budget Reconciliation Act Conference Report (H.R. REP. NO. 213, 103d Cong., 1st Sess. 718-23 (1993)), and (iii) excerpts from 1992 Conference Report on H.R. 11 (H.R. REP. NO. 1034, 102d Cong., 2d Sess. 45-49, 715-16, 721-23 (1992)) (submitted as exhibits).

Among the positive features of that twice-passed IRITC legislation are: (1) tax credits for Indian reservation personal property, new reservation construction property and, significantly, reservation infrastructure investment; (2) full credits available for qualified investments on all **reservations where Indian unemployment exceeds the national average by at least 300%**; (3) partial credits (1/2) on any reservations where Indian unemployment is between 150% and 300% of the national average; and (4) restrictions prohibiting availability of the credits for property used in connection with gaming activities. Significantly, the IRITC can encourage both small and large businesses, and promote both new investments and expansion of existing businesses.

The Navajo Nation recommends an important modification to the IRITC. The tax credit percentages previously acted upon by the Congress (i.e., 10% for reservation personal property, 15% for new construction property and 15% for infrastructure investment) should be made even more generous -- 20%, 25% and 25%, respectively. This is truly the type of powerful encouragement that will be required to help effectuate the reversal of decades of experience in which the private sector has virtually ignored Indian reservations as places to locate new investment and jobs.

Tribal Tax-Exempt Bond Financing: Although the Congress in recent years has cut back on the types/amount of tax-exempt bond financing that can be undertaken by state and local governments (including restrictions on issuance of private activity bonds), the limitations imposed on tribal issuance of tax-exempt bonds have been even more restrictive (in contrast to state and local governments) due to 1987 amendments to the Indian Tribal Governmental Tax Status Act of 1982. As a result, despite the fact that Indian reservations are the most disinvested, capital-poor locations anywhere in America, tax-exempt bond authority has had little, if any, positive impact in addressing those circumstances.

The 104th Congress should move dramatically not only to loosen those restrictions, but also to authorize expanded tribal tax-exempt bond issuance authority that can have an immediate effect in providing the capital -- for business formation and job creation -- that has been unavailable at Indian reservations historically. Toward that end, the Navajo Nation intends to forward shortly to the Committee legislative language that will allow this useful economic development tool to make a real difference on Indian reservations.

THIS INVESTMENT INCENTIVE AND CAPITAL FORMATION PACKAGE IS ESSENTIAL FOR INDIAN COUNTRY ECONOMIC DEVELOPMENT

While it would be convenient simply to dismiss these proposals by saying that it is too soon to create another set of federal tax incentives for Indian country, that response would be inappropriate, short-sighted and self-defeating. Indian country cannot afford to wait for ten years while Congress gauges the private sector's response to the accelerated depreciation incentive. To help resolve at last the extraordinary economic deprivation that has perpetually characterized Indian country and plagued the people who live there, nothing short of these meaningful and effective new incentives will suffice.

Indeed, the principal weakness of the Indian Investment and Employment Tax Incentives was the substitution, in conference, of the less-valuable accelerated depreciation incentive for the more-potent IRITC. That compromise resulted in an investment incentive that in all likelihood is not valuable enough, standing alone, to counter the inherent disincentives (primarily the lack of infrastructure) to Indian country investment. Adding a powerful new investment incentive to the existing accelerated depreciation incentive, however, will allow both to be used hand-in-hand as tools to attract the attention of a national business community that -- by reasons of unfamiliarity, misimpressions, misunderstanding or worse -- has been blind to the potential advantages of locating in Indian country. The IRITC will enhance the effectiveness of the accelerated depreciation incentive, not to mention the Indian employment credit, as an attractive draw to Indian country. (An added benefit is that the IRITC can be partially "paid for" to the extent of the savings from that portion of the value of property against which the credit is taken, and for which accelerated depreciation cannot be taken.)

One historic argument against an investment tax credit generally is that it provides benefits to investors for investments that would otherwise have been made even in the absence of the incentive. Of course, that argument fails miserably when applied to an IRITC targeted solely to Indian country and its 56% average unemployment rate.

As the Navajo Nation has repeatedly explained, Indian country is always at a significant disadvantage when competing -- even against the most financially-strapped non-Indian distressed communities -- for new private sector investment and jobs. This unlevel playing field that has perpetually confronted and confounded tribal economic development leaders is caused, most prominently, by the shocking lack of infrastructure that burdens reservation inhabitants everywhere. The increased non-wage business costs resulting from these unique infrastructure deficiencies can only be mitigated by availability of incentives that comprise or contain added benefits for Indian country in comparison to non-Indian areas (i.e., the so-called "Indian differential"). The proposed IRITC plainly meets this test.

That a powerful new incentive is needed cannot be subject to dispute. As explained above, the economic deprivation characteristic of Indian reservations and their inhabitants is unique within United States borders, and should be viewed -- with considerable alarm and discomfort -- as an embarrassment to all Americans. Rather than minimizing the scope of incentives targeted for encouragement of Indian country investment and jobs, a maximum, sustained effort should be directed -- not toward addressing, but actually to resolving -- this crisis for U.S. citizens living on reservations throughout America. The IRITC, when added to the accelerated depreciation incentive, can provide a powerful magnet to the private sector, and modification and enhancement of tribal authority to issue tax-exempt bonds can help bring about the capital formation to enhance the potential effectiveness of those investment (and the existing employment) incentives. NOW is the time to make the commitment to resolve the problem of Indian reservation unemployment and poverty.

Finally, the IRITC in particular is a perfect fit with the times. It is available directly to the private sector taxpayer, and is not dependent upon creation of a new government bureaucracy for implementation. Unlike appropriations, the IRITC can serve to leverage much higher amounts of private sector dollars flowing to reservations. Unlike the current expensing provisions under consideration (which are available only to small business), the IRITC can appeal to large and small business alike, and can serve to attract the focused attention of labor-intensive, factory-type facilities that to date have ignored Indian country. Unlike some other provisions currently on the table, the IRITC has twice enjoyed bipartisan support -- from the immediately preceding two prior Congresses. Today, the 104th Congress should at last make this twice-passed Indian country objective a reality, and should include expanded tax-exempt bond authority to enhance its potential.

CONCLUSION

Importantly, the IRITC is consistent with, and a tool that can effectively facilitate, "local empowerment." As I explained in my inaugural speech last month:

> The centerpiece of the Hale/Atcitty campaign, and now the Hale/Atcitty administration, is local empowerment. More than 52% of the Navajo voters endorsed local empowerment.
>
> * * *
>
> [L]et us release our people from the bondage of dependence by empowering them to decide for themselves and set the course and future for their communities and the Navajo Nation.

Mr. Chairman, nothing is more basic yet more essential to empowering people to lead successful, productive lives than having a job. Apart from the obvious economic benefits, having a job -- providing for a family and contributing to one's community -- empowers a person in untold psychological and spiritual ways that enrich and ennoble that person's life and the lives of their families.

If you are born an Indian, and you desire to remain on your reservation to live with your family and contribute to your community, you have less than a 50% chance of finding employment. This is a shameful, counterproductive set of circumstances that must be recognized immediately, addressed expeditiously, and resolved before the turn of the 20th century for the people who have inhabited this land for centuries past.

The IRITC and the enhanced tribal tax-exempt bond authority discussed herein properly look to the private sector to provide the investment dollars and job creation urgently needed throughout Indian country. These powerful incentives can work; half-way measures will not.

Passage of these measures can put this Committee in the forefront toward helping to correct the tragic circumstances of Indian reservation unemployment, poverty, infrastructure deficiencies and overall economic deprivation that scar the American landscape. On behalf of the Navajo Nation, I urge the Committee to make this issue one of your highest priorities as you mark-up the tax and job creation legislation.

February 2, 1995

* * *

February 3, 1995

HEARING BEFORE THE
HOUSE WAYS AND MEANS COMMITTEE
U.S. HOUSE OF REPRESENTATIVES

ON

THE PROPOSED NEUTRAL COST RECOVERY SYSTEM

WRITTEN STATEMENT
OF
PRICE WATERHOUSE LLP ON BEHALF OF A GROUP OF CLIENTS

Introduction

Price Waterhouse, on behalf of a group of companies from several industries, is pleased to submit this written statement concerning a proposal before the Congress to provide taxpayers with an alternative tax depreciation regime, called the Neutral Cost Recovery System (NCRS). NCRS is included as Title II of H.R. 9, the Job Creation and Wage Enhancement Act, and is a significant component of the "Contract with America."

Numerous commentators, including members of Congress, the Treasury Department, tax practitioner groups, trade associations, and others, have provided the Committee with their views on the political and policy ramifications of the proposal. The purpose of these comments is to address the basic technical issues of tax administration and compliance that we believe are of critical importance if a workable alternative cost recovery system is to be enacted.

Many commentators have suggested that the NCRS proposal is overly complex. Treasury Assistant Secretary for Tax Policy Les Samuels told the House Ways and Means Committee on January 10, 1995, for example, that the NCRS proposal would "add significant complexity to the tax system." Any depreciation proposal that provides taxpayers with an election to the current Modified Accelerated Cost Recovery System (MACRS) will inherently create additional calculations for taxpayers electing that system. It is our view that if the Committee determines to adopt the NCRS system, its complexity can be reduced and a workable system crafted that meets NCRS's stated goals.

NCRS as Introduced

The version of the NCRS included in H.R. 9 would permit taxpayers to elect, on an asset-by-asset basis, to apply a "neutral cost recovery system" to certain depreciable property. The goal of the NCRS proposal is to provide taxpayers with deductions, over the depreciable life of certain equipment, that approximate the asset's original cost in present-value terms. The proposal would be effective for property placed in service after 1994.

The section 168 depreciation schedule (MACRS) would be used as a base to calculate NCRS depreciation deductions, except that the 150-percent declining balance method would replace the 200-percent declining balance method. Depreciation deductions then would be increased to reflect (1) inflation occurring since the property was placed in service; and (2), in the case of property currently eligible for the 200-percent declining balance method (generally assets with MACRS regular tax lives of 10 years or less), an assumed 3.5-percent annual real rate of return. NCRS indexing for inflation would apply to "penalty"

categories under section 168(g), such as property used abroad and property used by tax-exempt entities. NCRS would not apply to intangibles or other costs not recovered under section 168 (such as costs recovered under the income forecast method).

A taxpayer would be allowed to exclude property from NCRS. The election would be irrevocable. If no election were made, NCRS would apply for both regular tax and AMT purposes. An election to use NCRS solely for AMT but not for regular tax would not be permitted.

As compared to an earlier draft of the NCRS legislative language released in September 1994, the version included in H.R. 9 incorporates provisions that, we believe, would go a long way towards enhancing the depreciation system. These positive changes included:

- **Basis adjustment** -- The introduced bill would not require a basis adjustment for the NCRS benefit. Thus, the basis of an asset subject to NCRS could not be reduced below zero.

- **Recapture** -- Similar to the resolution of the basis adjustment issue, the portion of depreciation expense attributable to the NCRS benefit would not be subject to recapture.

- **Effective date** -- The original draft provided that the proposal would be effective for taxable years beginning after December 31, 1994. The introduced bill clarifies that the proposal would be effective for property placed in service after December 31, 1994, regardless of the taxpayer's year-end.

- **Designating assets subject to NCRS** -- The introduced bill would permit NCRS to be elected on an asset-by-asset basis.

- **Anti-churning rules** -- The bill includes anti-churning rules that utilize the anti-churning language included in the 1981 Tax Act as part of the enactment of ACRS.

- **NCRS flow-through in entities such as partnerships and S Corporations** -- In order to avoid a deviation of inside and outside basis, the NCRS benefit would not reduce basis for a pass-through entity.

- **Calculation of NCRS** -- The bill would use the GDP deflator rather than the GNP deflator as part of the NCRS calculation.

- **No ACE adjustment created** -- The bill includes an amendment to section 56(g) to prevent the creation of a new AMT ACE adjustment.

- **Coordination with luxury automobile depreciation rules** -- Language was included to clarify that the section 280F depreciation rules for luxury automobiles will continue to apply for NCRS property, and that the excess depreciation over the section 280F limitation would be available in later years.

Further Changes, Clarifications are Necessary

We believe that additional modifications to the legislative language, as well as clarifying committee report language, would make NCRS more "user friendly" and better satisfy its stated goals. Areas where particular attention should be paid include the actual calculation of NCRS, the application of NCRS for taxpayers that use special methods of depreciation,

the application of the carryover basis rules, and the potential interaction of NCRS with other provisions of the Code.

- **Property depreciated using special methods**

Present law section 168(f)(1) provides that MACRS depreciation does not apply to property if the taxpayer has properly elected to depreciate the property using certain methods of depreciation, such as the income forecast method, the unit-of-production method, or any method not expressed in a term of years. In many cases, these methods can provide a superior measure of depreciation.

As currently drafted, the NCRS proposal would not apply for taxpayers using such methods of depreciation. The goal of the drafters to provide depreciation deductions that approximate the property's original cost in present-value terms should be extended to property where an election has been made under section 168(f)(1) to use a depreciation system that more closely approximates the economic depreciation of the property. Without this provision, property depreciated under section 168(f)(1) would be disadvantaged relative to property receiving the NCRS benefit. Loss of access to the NCRS concept should not be the price of adopting the alternative methods of cost recovery under section 168(f)(1).

- **Elective straight-line depreciation**

The Code allows taxpayers to elect the use of the straight-line method for property that would otherwise qualify for an accelerated (200 DB or 150 DB) depreciated method. However, section 168(k)(2)(B) of H.R. 9 would limit the neutral cost recovery ratio for such property to the change in the gross domestic product deflator, excluding the additional 3.5 percentage points per annum that would be allowed in the determinations of the ratio had the straight-line election not been made. The full amount of the ratio should be available in determining NCRS depreciation on property that would otherwise be eligible but for the straight-line election. This could be accomplished by excluding property subject to an election under section 168(b)(5) and 168(g)(7) from the special rule of section 168(k)(2)(B).

- **Carryover basis rules**

Property transferred in a non-recognition transaction described in sections 332, 351, 361, 371(a), 374(a), 721, or 731 (other than a section 708(b)(1)(B) transaction) takes with it a carryover basis. Thus, under the general MACRS rules, the transferee "steps into the shoes" of the transferor, and is treated as the transferor for purposes of computing the depreciation deduction with respect to so much of the basis in the hands of the transferee that does not exceed the adjusted basis in the hands of the transferor.

It would be appropriate to clarify the applicability of NCRS in transfers subject to section 168(i)(7). If NCRS applies to an asset in the hands of a transferor, that asset should retain its character as an NCRS asset to the extent the transferee "steps into the shoes" of the transferor. To the extent gain is recognized by the transferor, and the transferee is entitled to basis, NCRS should be available with respect to the additional basis.

- **Interaction with other code provisions**

There are several instances in which the NCRS legislative language should be clarified in order to ensure proper interaction with other Code provisions so that the intent of NCRS to provide a present-value equivalent of expensing is preserved.

First, the calculation of taxable income for limitation purposes should not include the NCRS benefit. In situations where taxable income limits the amount of an available deduction, the

NCRS benefit can be partially or completely eliminated through the operation of a taxable income limitation that includes the full amount of the depreciation deduction.

For example, percentage depletion under section 613 is limited to 50 percent (100 percent for oil and gas properties) of the taxable income from the mineral property. If taxable income from the property is reduced by the additional depreciation allowed as a result of the NCRS system (the NCRS benefit), the percentage depletion deduction will be reduced by one-half of the amount of the NCRS benefit in the case of most minerals, and by the full amount of the NCRS benefit in the case of oil and gas. Thus, an independent producer of oil and gas whose depletion deductions are limited by the taxable income of the property will receive no benefit from the NCRS system since every additional dollar of NCRS depreciation will reduce the depletion deduction by that same dollar. Similarly situated producers of other minerals would lose one-half of any additional NCRS depreciation.

A second issue arises in the application of the at-risk rules to activities that include NCRS depreciation. The additional NCRS depreciation deduction should not be taken into account in determining the amount a taxpayer is considered to have at-risk with regard to an activity. Otherwise, where the at-risk limitations limit the amount of deductions otherwise available, the additional NCRS depreciation deductions will have no effect. Similar to the application of the net income limitation, each dollar of additional NCRS depreciation would be eliminated through a reduction by the same dollar in the at-risk limitation.

A third issue is the calculation of the basis in the stock of a consolidated group member under section 1503(d). The bill should provide that additional NCRS depreciation will not reduce basis in such stock, just as the bill currently provides that the additional NCRS depreciation does not reduce the basis in a pass-through entity.

- **Availability of MACRS elections**

Under the general MACRS rules, assets are depreciated on an item-by-item basis. Taxpayers may elect to depreciate property using a general asset account. Under this method, a group of assets, identified by the taxpayer, are depreciated as one asset. Proceeds realized on the disposition of an asset from the group are included in income, without a reduction for the basis of the asset. Taxpayers are permitted to elect to depreciate property subject to MACRS using the straight-line method over either the recovery period or the class life of the asset, whether using term accounts or group accounts.

NCRS committee report language should specify that all elections available under MACRS are also available under NCRS. Thus, the election to apply general asset accounting to a specified group of assets would be available under NCRS. In addition, the designation of a class as subject to NCRS would be sufficient to designate all of the assets in that class as subject to the general asset account. However, an election to depreciate property using the straight-line method of accounting would subject the property to the limitations in proposed section 168(k)(2)(B).

- **NCRS calculation should be simplified**

H.R. 9 as introduced requires the calculation of a separate NCRS ratio for every calendar quarter in which property is placed in service. The NCRS calculation could be simplified by using a single NCRS ratio for all additions occurring during a year. Such a change could be accomplished with a minimal loss of accuracy and benefit to the taxpayer.

Under H.R. 9, the NCRS ratio is determined by comparing the GDP deflator for the end of the calendar quarter the property was placed in service with the GDP deflator for the corresponding calendar quarter of the current taxable year. Thus, a full year of inflation is accounted for in determining the NCRS depreciation deduction for the second year. One

would determine which 12 months of inflation to count by looking to the quarter the property is placed in service.

A simpler alternative would be to compare the GDP deflator for the mid-point (June 30th) of the calendar year the property was placed in service with the corresponding mid-point of the current calendar year. This would allow the same NCRS ratio to apply to all property placed in service during a calendar year and reduce by 75 percent the number of ratios required to be kept by most taxpayers. A full year of inflation adjustment would still be allowed for each year the property has been in service.

Such a method would permit the IRS to calculate and publish the ratio for any calendar year in time for inclusion in tax forms and instructions, in addition to simplifying taxpayer compliance.

Conclusion

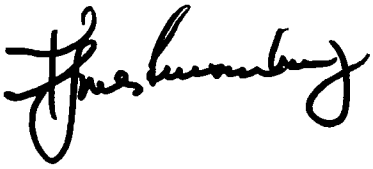
We appreciate the opportunity to comment on the basic technical and administrative aspects of the NCRS proposal. As the Committee continues its work on NCRS and other alternatives for improving capital cost recovery under the tax system, we look forward to the opportunity to continue this important dialogue.

This statement has been filed with the House Committee on Ways and Means on behalf of the following companies:

Anheuser-Busch Companies, Inc.
Caterpillar, Inc.
Dresser Industries
Goodyear Tire & Rubber Company
Praxair

Price Waterhouse LLP

Price Waterhouse LLP
February 3, 1995



Testimony of Congressman F. James Sensenbrenner
H.R. 89, "Family Farm Tax Relief and Savings Act of 1995"
Ways and Means Committee
January 31, 1995

I have introduced H.R. 89, the "Family Farm Tax Relief and Savings Act of 1995," to assist farmers in planning for retirement. This legislation would allow qualified farmers to rollover the gain from the sale of farm assets into an Individual Retirement Account.

Operating a farm is a unique and highly capital intensive business. Most American farmers must reinvest profits and excess capital into their farm in order to maintain productivity. The substantial capital commitment precludes many farmers from participating in traditional retirement accounts, such as an IRA or Keogh. For many farmers, the investments that are made in farm assets will be sold at a later date as the primary means of financing retirement.

The unpredictability of farm income also creates a serious problem for farmers planning for retirement. During difficult years, farmers may not have money to invest. By contrast, a very successful year may provide farmers with substantial profits that may be invested for retirement. However, current retirement savings accounts place a limit on the amount of money that may be invested with a tax advantage. These limits preclude farmers from maximizing their retirement savings when it becomes available.

H.R. 89 addresses the special retirement needs of farmers by allowing them to invest the gain of the sale of farm assets into an Asset Rollover Account (ARA). The ARA increases the amount of money that a qualified farmer may invest for retirement with deferred taxation similar to an Individual Retirement Account. By investing in an ARA, farmers may defer taxes on up to $500,000 in capital gains from the sale of farm assets for retirement. Annual contributions shall not exceed the year's qualified net farm capital gain or the number of years an individual has been farming multiplied by $10,000. The initial rollover of funds from a prior savings or retirement account into an ARA will not be subject to the annual limits.

For purposes of the ARA, a qualified farmer must have actively participated in the business of farming during the five years prior to the disposition of the farm assets. In addition, the farmer or spouse must have owned at least 50 percent of the farm during that time.

The ARA established by H.R. 89 accommodates the unique retirement needs of farmers. It allows them to make large investments for their retirement when money is available. This is usually after the sale of farm assets such as land and equipment that occupy the majority of a farmer's capital. This legislation gives farmers the opportunity to participate in the same tax deferred retirement investment used by millions of Americans in other professions.

In addition, this legislation will promote the continuance of family farming by eliminating the capital gains tax burden that often keeps a farmer from selling a farm to the next generation. Under current law, farmers have an incentive to maintain ownership of the farm until death, leaving their heirs with the tax burden of inheritance. H.R. 89 would encourage the sale of a farm upon retirement by allowing a farmer to defer the tax.

As the Members of the Ways and Means Committee consider the many worthwhile savings and investment provisions included in the American Dream Restoration Act, I hope that they will give special consideration to the savings and retirement needs of America's farmers. I encourage the members to incorporate H.R. 89, the "Family Farm Tax Relief and Savings Act of 1995," in their markup of the American Dream Restoration Act. I have requested an estimate of the revenue implications of H.R. 89 from the Joint Committee on Taxation. I will share that information with the Ways and Means Committee members when it becomes available.

Statement of
James L. Martin, Chairman
The 60/Plus Association
1655 N. Fort Myer Dr., #700
Arlington, VA 22209 (703) 351-5251

Committee on Ways and Means
United States House of Representatives

The Job Creation and Wage Enhancement Act (HR 9)
Estate Tax Reform and Senior citizens

February 1, 1995

INTRODUCTION

Mr. Chairman and Members of the Committee, my name is Jim Martin and I'm the Chairman of The 60/Plus Association. I'm here today to lend support to the Job Creation and Wage Enhancement Act (HR 9), especially the capital gains cuts, but specifically the Federal Estate and Gift Tax provisions contained therein.

Late last year when the details of the Contract with America were available, 60/Plus was extremely pleased to see the Estate Tax provisions calling for an increase by 1998 to $750,000 from the current $600,000 exemption, a figure that hasn't been raised in 14 years.

We at 60/Plus had, in fact, fought steadfastly for two years against a tax-and-spend philosophy which called for lowering, not raising, this exemption, to $200,000. The legislation, fortunately, has made no headway in either the House or the Senate.

While 60/Plus favors other legislative proposals that either double the $600,000 exemption to $1.2 million, or eliminate Estate Taxes altogether, we realize that "one small step for mankind" is better than no step at all.

And we appreciate the willingness of this Committee and particularly of this Chairman to commit to the task of achieving that first important step.

All seniors and their children and grandchildren applaud you for your efforts.

60/Plus is in its second year of active operation, with a membership of over 225,000. We publish a newsletter, the *Senior Voice*, which regularly features the popular "Lawmaker of the Month" column. Also, 60/Plus is the only conservative senior citizens group to publish a Rating System, scoring Members of Congress based on their pro-senior votes. If any Member of Congress scores 60 percent or better (60/Plus) on the Scorecard that Member receives the "GUARDIAN OF SENIORS' RIGHTS AWARD." In the 103rd Congress, 226 Members, Republicans and Democrats alike in the House and Senate, received our non-partisan award.

60/Plus is an anti-tax advocacy group dedicated to repealing the Federal Estate and Gift Tax, an unfair tax placed upon senior citizens and their heirs. Specifically, we're working with several Members of Congress as well as many small family-owned businesses, and others concerned that the Estate Tax, otherwise known as the "Death Tax," is unfair, burdensome and a job killer.

IN THE BEGINNING...

A little background on the Federal Estate and Gift Tax should be of some interest to you, because "temporary" levies all too often become permanent.

The first Federal Estate Tax was enacted in the 1860s, during the Civil War when money was needed to finance the war effort. Once its purpose was served, however, this temporary tax was repealed in 1870.

In 1898, yet-another temporary Estate Tax was approved. This Estate Tax was imposed to meet the budgetary needs caused by the outbreak of the Spanish-American War. Again, this literal temporary tax also was repealed in 1902 just four years after it was imposed.

The first Estate Tax to become permanent was enacted some 14 years after the repeal of the Spanish-American War temp-tax. This long-term Estate Tax was included in the Revenue Act of 1916, which saw the initiation of a permanent income tax. And estate planning hasn't been the same since.

SOCIAL CONSEQUENCES

60/Plus believes, as do most on this Committee, that when taxes are cut, government revenue *increases*. Why is this the case? Taxes alter how hard people work. Government revenue estimators continue to ignore the evidence that when taxes are raised, businesses don't hire, they fire. Government revenues decrease. However, when the tax burden is lifted, people invest, work harder and save more money. At the same time, businesses hire more people, invest more money, take more risks, expand operations and, thus, pay more taxes.

Expecting to raise $40 billion in new revenue, (by raising the top rate of tax by more than one third, from 31% to 42%), the Clinton tax increase will in our estimation have a devastating impact on revenue the government is counting on. One noted economist says the tax increase will yield only $10 billion, or only 25 percent of projections.

Another example given by Bruce Bartlett, former Executive Director of the Joint Economic Committee, shows a 1979 Joint Committee on Taxation (JCT) forecast of revenue gained by the Crude Oil Profit Tax. The JCT estimated raising $184.5 billion between 1980 and 1985. The tax raised only $77.7 billion, less than half of the government projections.

This gets back to the social consequences. Tax policy has consequences on everyday people and businesses. How they think, how they operate, and how they invest is oftentimes determined by Washington's taxes.

When taxes punish lifelong habits of thrift, when taxes discourage entrepreneurship, when taxes penalize families, when taxes are applied to already-taxed income, then they are wrong, immoral and, most of all, unfair. This is exactly the case with the most confiscatory tax of all, the Inheritance Tax and I might add, all Social Security taxes, the earnings limit placed on senior citizens.

Despite the fact that the $600,000 tax exemption has not been adjusted for inflation in recent years, and thus is being taxed even more heavily than it was a decade ago,

there are some lawmakers who believe the exemption is too generous. They want even more of our estates to go into federal hands.

A leader in this bid to cut even deeper into the estate you wish to pass along to your loved ones, or perhaps to some favored charitable institution, introduced a long-term health care bill which would not only ignore the lack of inflation adjustment, but would practically abandon any such adjustment. The proposal was to lower the $600,000 tax exemption to an unbelievably low rate of $200,000.

Under this scheme, some portion of your estate over $200,000 in value that you leave to your heirs would be taken from them and funneled into the federal coffers.

Our Honorary Chairman at 60/Plus, Former Rep. Roger Zion (R-Ind.), put it quite succinctly. The Indiana Republican said, "Imagine losing up to 55% of everything you've worked so hard to acquire to the government. It's even more frightening when you consider that you'll be taxed for dying on assets on which you've already paid a hefty tax."

Fortunately, several Members of Congress fought successfully to block passage of this rip-off.

SENIOR CITIZENS OVERWHELMINGLY SUPPORT REFORM

In a random sample of 7,359 respondents to the 60/Plus 1995 Seniors' Legislation Issues Survey, 60/Plus members overwhelmingly rejected the Federal Estate and Gift Tax.

Our members are telling us we're right on target in our efforts to get the federal government out of seniors' pocketbooks. Question 1 of the survey was, "The Federal Estate tax exemption on assets has been $600,000 since 1981. House Appropriations Committee Chairman Bob Livingston (R-La.) introduced legislation that would double the exemption to $1.2 million. Do you want Congress to increase the exemption? Seventy-seven percent of seniors said yes.

The second question was, "Besides the proposal to double the exemption, Rep. Chris Cox (R-Calif.) has also introduced legislation to repeal Federal Estate and Gift Taxes altogether. Do you agree with Rep. Cox's bill? Seventy-nine percent of senior citizens agree that the Federal Estate and Gift Tax should be done away with!

60/Plus reiterates its support for the Job Creation and Wage Enhancement Act (HR 9). We think it is a good first step forward, especially its eventual Estate Tax exemption increase to $750,000 from the current $600,000.

However, we will continue to advocate proposals that go even further. And, with that in mind, I submit for the record a recent column, "A 'Job-Robbing' Double Tax on Seniors and their Heirs," which was distributed to more than 200 seniors' publications nationally.

I look forward to working with the Committee on behalf of 60/Plus, which represents a rapidly growing seniors population who've already made sacrifices and contributions to the safety, prosperity and security of our nation.

Thank you.

New England Senior Beacon, Milford, NH

A "Job-Robbing" double tax on seniors and their heirs

By James L. Martin
Chairman, 60/PLUS

Most of you are probably familiar with the T.V. quiz show, "Jeopardy," where contestants are given an "answer" for which they must reply with the correct "question." Let's try our hand at a "Jeopardy" sample: The "answer" is: "The Inheritance Tax." The correct "questions": "What is the Grave-Robber Tax?"

Although the Inheritance Tax is called by several different names,—Estate, Gift, and Generation-Skipping Transfer Taxes—I prefer to call it as I see it, as the Grave-Robber Tax. It's a tax levied on estates that already have been subjected to virtually all other taxes as they were built over the years. Inheritance Taxes are double, even triple, taxation. Yet, the plain truth is: Inheritance Taxes, despite what their congressional advocates may claim, are a minimal source of revenue. In fact, they well may add to the federal financial problems by decreasing jobs, wages and output.

They account for an average of only about 1% of the total annual federal revenues year in and year out. Enormous amounts are spent in collecting and administering these taxes; and in lawyers' and accountants' time and expense as people try to avoid this punitive tax.

The facts show that Inheritance Taxes reduce the revenue from other taxes, by causing lower employment, lower wages, and lower production output. These taxes are revenue decreases, not revenue raisers.

In order to pay Inheritance Taxes, heirs must often sell the family business. Nine out of 10 cite the Inheritance Tax as the primary reason they must sell. Then, when the new owners frequently fail, jobs are lost.

The Inheritance Tax affects America's seniors, their heirs, and family-owned business of all sizes.

A joint study by the Center for the Study of Taxation and the Institute for Research on the Economics of Taxation shows that, if Inheritance Taxes had been eliminated in 1971, the following would have resulted by 1991: the nation's gross domestic product (GDP) would have been $46.3 billion higher than it was; 262,000 full-time jobs would have been created; and the stock of capital would have been $398.6 billion greater than the actual amounts for that year.

The study further projected the following would have occurred by the year 2000; the GDP would have been $79.22 billion higher; 228,000 more people would have been employed; and the amount of savings and capital would have been $630 billion higher than the amount projected under current tax law.

In the last session of Congress, Rep. Chris Cox (R-Calif.) introduced The Family Heritage Preservation Act (H.R. 2717) that would eliminate the federal estate and gift taxes and the tax on generation-skipping transfers.

Cox titled it the "Family Heritage Preservation Act" because of its focus on the social consequences of Inheritance Taxes.

Under the Inheritance Tax seniors, their heirs, and family-run small businesses are struck a devastating blow in the form of a 37% to 55% (Clinton raised it to 55%) tax on their after-tax savings. This is not just wrong, it's extremely unfair and ill-conceived.

Even though there is an exemption from this unfair tax on the first $600,000 of your estate, soon to be raised to $750,000 in the new Congress, 60/PLUS feels Inheritance Taxes must be totally repealed in the interests of fairness and for the good of society.

Inheritance Taxes discourage savings, discourage entrepreneurial enterprises, and penalize families. They are anti-family.

Their waste and economic inefficiency is apparent when you realize the thousands of lawyers and accountants who must be paid billions of dollars each year just to help individuals and family-owned businesses deal with the impending loss of their after-tax savings.

The Inheritance Tax caused businesses to close down, thus increasing unemployment, and they generally restrain businesses from operating and competing in an open marketplace.

And, for every "Rockerfeller" or other "wealthy" individual who some feel should have to "pay" this extra tax, we, at 60/PLUS, say two things: First, these individuals have already paid their taxes duly and properly; and second, for every "Rockefeller" hit by this double tax there are thousands of mom and pop-run businesses and small farms in each of the 50 states who are literally "run out of business" by this unjust tax.

Going back to our "Jeopardy" session, the answer is: "Repeal it." and the question? "What should we do about the Inheritance Tax?"

Editor's Note: The 60/PLUS Association is located in Arlington, Va., and is a two-year-old seniors advocacy group with a free enterprise, less government, less taxes approach to issues, with 225,000+ supporters nationally.

WRITTEN STATEMENT OF
THE SMALL BUSINESS COUNCIL OF AMERICA

BEFORE THE COMMITTEE ON WAYS AND MEANS
OF THE UNITED STATES HOUSE OF REPRESENTATIVES

ON ESTATE, GIFT AND GENERATION-SKIPPING TAX REFORM

JANUARY 31, 1995

SBCA is a national nonprofit organization which represents the interests of privately-held and family-owned businesses on federal tax, health care and employee benefit matters. The SBCA, through its members, represents well over 20,000 enterprises in retail, manufacturing and service industries, which enterprises represent or sponsor over two hundred thousand qualified retirement and welfare plans, and employ over 1,500,000 employees.

The time has come for Congress to repeal the estate, gift and generation-skipping taxes.

An estate tax due nine months after death is imposed on the transfer to children or other heirs of the taxable estate of every decedent who is a citizen or resident of the United States ($600,000 of assets are exempt). The graduated estate tax rates begin effectively at 37% and increase to a maximum rate of 55% (see Exhibit "A" for how the tax is calculated). Taxes on bequests to spouses may be deferred until the last-to-die of husband and wife.

A gift tax is levied on taxable gifts (excluding $10,000 per donee per year) as a back-stop to the estate taxes. The graduate rates are the same. (The $600,000 exempt amount may be used during life for gifts or at death.)

An extra, flat 55% generation-skipping tax is imposed on gifts or bequests to grandchildren ($1,000,000 is exempt).

The 1986 White House Conference on Small Business recommended eliminating estate and gift taxes on the transfer of small business assets to family members. Legislation has been introduced in prior years to accomplish this (Exhibit "B" attached).

With a new entrepreneurial voter wave shifting control of both the House and Senate to Republicans, it is time to repeal these transfer taxes. President Clinton has expressed the desire to retain and increase jobs. Repeal would do this!

- Only 30% of family business make it through the second generation. Seventy percent (70%) do not. Only 13% make it through

the third generation. Eighty-seven (87%) do not. The primary cause of the demise of family businesses, after the death of the founder and the founder's spouse, is the 55% estate tax. It is hard for the successful business to afford enough life insurance. (Premiums are not deductible and deplete working capital.)

- A recent study by Prince and Associates (research company) for National Life of Vermont reviewed the history of 749 family businesses which failed within three years after the death of the founder. The Prince study reinforced and supported the conclusion of the deadly effect of estate taxes. The businesses could not continue as a result of the tax drain on working capital needed to effectively compete and cover errors in judgment made by new and younger management. Jobs were lost in the communities.

- The estate tax took its present form primarily in the early 30's. The express purpose was to "break-up wealth". Is this consistent with a free enterprise economic system and a very competitive world economy? In 1992, the estate, gift and generation-skipping taxes accounted for only 1.1% of revenue. The expense of administering this system probably offset 75% or more of the revenue.

- The transfer tax provisions represent 82 pages of the Internal Revenue Code and 289 pages of Regulations issued by the Internal Revenue. The transfer tax system forces many estates, the Internal Revenue Service, and the Department of Justice to expend funds in court. The number of transfer tax cases now total 10,247 representing some 13,050 pages of the Commerce Clearing House Tax Publication.

- Australia repealed their estate and gift tax laws in the mid-1970's. It was felt that these transfer taxes were an inhibitor on the growth of family businesses. The legislative body of Australia sought more jobs which they believed would come if family businesses grew larger and were not caused to sell, downsize, or liquidate at the death of the founder to pay estate taxes.

The President has expressed concern about children inheriting appreciated assets from deceased parents and selling them without paying income taxes on the profits. This is the result of the step-up in basis to the value as shown in the estate tax return. If the transfer tax laws were repealed, there would be no step-up in basis. At the time assets were sold, gain would be taxed and funds available to pay the tax. The fair market value of assets sold would be fixed. To make this law equitable with existing law, there would be a step-up in basis for the first $600,000 of assets.

- If you factor the significant expense in collecting these taxes and the income tax when assets were sold, the repeal may be revenue neutral.

- Combined income and estate taxes frequently consume 75% or better of retirement plan accounts at death (see chart attached as Exhibit "C").

Even if transfer taxes cannot be repealed there are a number of steps Congress could take **right now** which would substantially alleviate the problems faced by small business owners. **A major first step is that taken in the Contract With America - increase the $600,000 deduction limit to $750,000. This is a major improvement over the present system and one that would be appreciated by small business owners across the country. We submit that this increase, however, should be indexed with the cost of living so that it remains a meaningful number.** Some commentators suggest that if the $600,000 had been indexed, it would be in the million dollar range now. That would make a significant difference. **Here are some other changes that would help small business owners:**

- **Eliminate the extraordinarily complex generation-skipping tax or increase the exemption from $1,000,000 to $5,000,000;**

- **Change the so-called 5-5 power to a 5-10 power to keep it in line with other areas of the transfer tax law;**

- **Reduce the estate tax rates - they are all too high, but 55% is just way too high. One way to accomplish this is to expand the estate tax brackets to take into account inflation since the brackets were established.**

Some of our most wealthy citizens have elected to give up their citizenship, become citizens of foreign countries, and avoid the 55% transfer taxes. The cover story of Forbes, November 21, 1994 was devoted to "Expatriation -- As the Ultimate Estate Planning Technique." What a loss of available capital!

This statement was largely prepared by Harold I. Apolinsky, Past Chair of the Small Business Council of America (SBCA) and currently Vice President of Legislation. He is a practicing tax attorney (over 30 years) who specializes in estate planning and probate. For over 18 years, he has taught estate planning and estate, gift and generation-skipping taxation to law school seniors at both the University of Alabama School of Law in Tuscaloosa, Alabama and the Cumberland School of Law in Birmingham, Alabama. This testimony is contrary to the best interest of the author's tax practice, his teaching, and his firm (they have 6 lawyers out of 94 doing estate planning, administration and probate) to urge repeal of these transfer taxes. He strongly believes, however, that it is the right thing to do to help grow family businesses, provide jobs and encourage the entrepreneurial spirit needed for small businesses to become large businesses.

EXHIBIT "A"

CALCULATION OF ESTATE TAXES

A. Gross Estate (fair market value at death of all assets, including real estate, stock, cash, life insurance, retirement accounts, etc.).

B. Deductions:

1. Debts and expenses.

2. Marital (assets left to spouse if citizen).

3. Charitable.

C. Taxable Estate.

D. Add Prior Taxable Gifts.

E. Total transfer to heirs (life and death).

F. Apply Rates: 18% to 55%.

G. Less credit ($192,800)*

H. Net tax (effective 37% to 55% [plus 5% for larger estates] due 9 months after death.

* *This is tax on $600,000 taxable estate.*

EXHIBIT "B"

PERTINENT LEGISLATION

A. Legislation was introduced in July 1993 (H.R. 2717) to repeal estate, gift and generation-skipping taxes.

B. Legislation was also introduced but not enacted in the 102nd Congress which would have allowed heirs of small business owners to defer the estate tax owed on a farm or business until it was sold outside the family. In order to take advantage of this deferral, the following requirements would have to be met:

(1) The business must be worth less than $50 million.

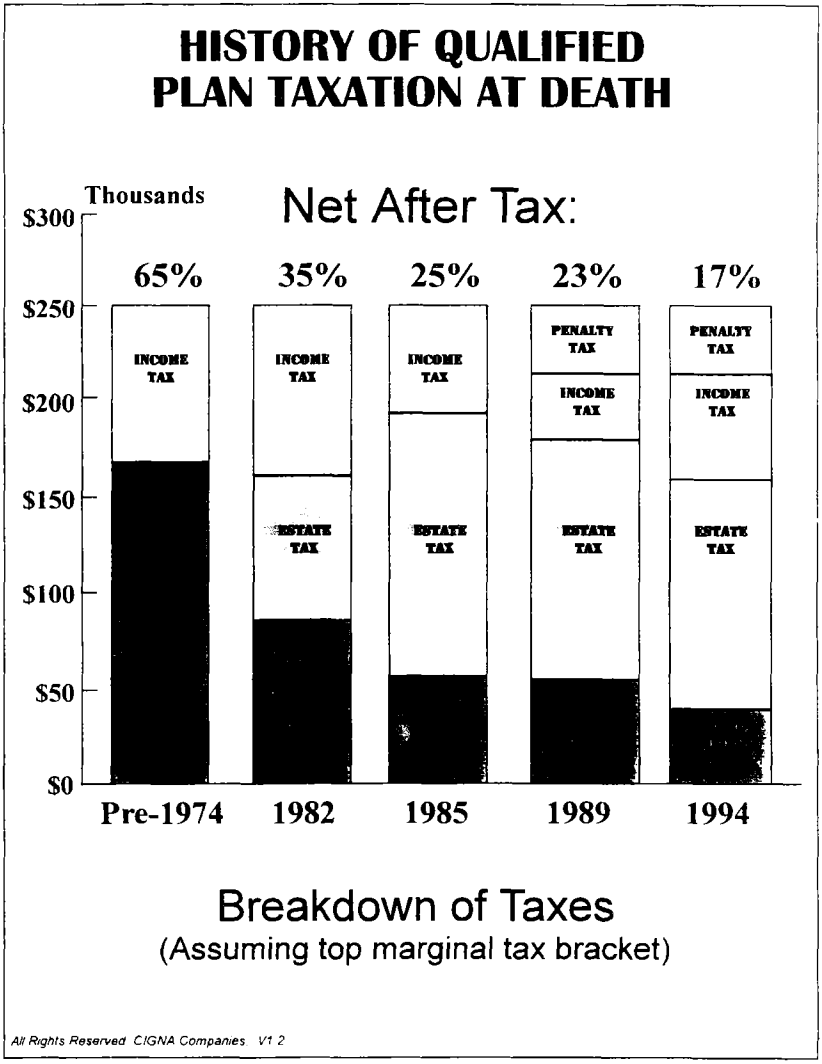
(2) The business must comprise at least 40 percent of the decedent's estate.

(3) The person inheriting the business must have actively participated in the running of the business prior to the owner's death.

C. A provision in separate legislation also introduced in the 102nd Congress would have reduced the amount exempt from estate and gift taxes from $600,000 to $200,000. This provision of the bill was subsequently withdrawn.

D. Legislation introduced in the 103rd Congress included bills that would increase the estate and gift tax exemption to $770,000 plus cost-of-living adjustments (H.R. 567), $850,000 plus cost-of-living adjustments (H.R. 1475), $1 million (S. 531) and $1.2 million (H.R. 1110).

EXHIBIT "C"



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STATEMENT
of
TELEPHONE AND DATA SYSTEMS, INC.
before the
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
regarding the
NEUTRAL COST RECOVERY SYSTEM
proposal of the
JOB CREATION AND WAGE ENHANCEMENT ACT OF 1995 (H.R. 9)
February 3, 1995

This statement is being submitted by Ross J. McVey, Assistant Controller, Telephone and Data Systems, Inc., P. O. Box 628010, Middleton, Wisconsin 53562-8010 (608-828-8314). Telephone and Data Systems, Inc. ("TDS"), is pleased to have this opportunity to submit this statement to the Committee on Ways and Means concerning select tax provisions contained in the Contract With America (the "Contract"). TDS is one of the largest independent communications providers in America, employing over 4,700 people in 45 states through its telephone, cellular, and paging operations. The communications industry has and will continue to play a major role in the economy of this country. This is a highly capital-intensive industry, one which consistently advocates federal tax policies that lower the cost of capital and provide needed incentives to implement new technologies.

TDS supports the underlying precepts of the Contract, those being the lessening of the role of government through lower taxes, less spending, and the promotion of jobs and the economy through capital formation. To that end, we have focused our comments on the following two Contract proposals within the Committee's jurisdiction which are of primary importance to TDS, its employees, and its customers: The Neutral Cost Recovery System and the Capital Gains Exclusion.

TDS is aware that the United States Telephone Association ("USTA"), an organization of which it is a member, is filing similar comments on these topics. We have participated in the development of those thoughts and are in full agreement with them.

NEUTRAL COST RECOVERY

The Neutral Cost Recovery System ("NCRS") contained in the Contract contains many positive aspects that will help achieve the desired goal of capital formation. The increase of depreciation deductions to reflect the effects of inflation and the time value of money coupled with not reducing the tax basis of the subject property by the indexed factors will depreciate the property in a manner that more accurately reflects a company's true economic investment.

TDS supports the extension of NCRS to the depreciation component of the alternative minimum tax ("AMT"). The failure to do so would destroy the parallel nature of the regular and AMT tax systems and would accelerate the cash flow requirements of AMT taxpayers, offsetting the incentives of NCRS.

For taxpayers subject to regulation, such as our telephone operations, the benefits of NCRS must be normalized. This is especially true due to the back-loaded benefits of NCRS. Otherwise, the intended benefits may not accrue to the taxpayer. Rather, regulators may pass the benefits on to ratepayers immediately rather than over the life of the property.

A concern of TDS with NCRS, as presently structured, is that the provisions do not evenly apply to certain industries and property. The proposal's 3.5 percent time-value-of-money adjustment would only apply to property with a class life of 10 years or less. This could have the effect of discouraging investment in long-lived property, which can account for up to 35 percent of the annual investment made by TDS and other telephone companies. Failure to include long-lived property, as eligible for the 3.5 percent adjustment, could also cause some unintended distortions in competitive behavior.

As noted above, a significant portion of TDS's investment is in long-lived property. The different treatment accorded long-lived property is unequitable in that many of the current and future competitors of telephone companies are permitted to recover their investments in the same type of property over seven years versus the 15 years required for telephone companies.

With regard to applying the provisions, we support the flexibility of allowing the NCRS election to be made on a property-by-property basis. We do feel the election to utilize NCRS should be affirmative, rather than requiring an election to decline, as currently drafted. Additionally, the requirement of applying the indexes on a quarterly basis will add cost and time to comply with these rules. The use of an annual index would provide for ease in compliance and still achieve the objectives of the legislation.

CAPITAL GAINS

TDS is a strong proponent of the proposed 50 percent exclusion of capital gains, as well as the indexing of capital gains for inflation. Investors and businesses should be taxed only on real economic gains resulting from their capital assets and not on inflationary gains. The proposed exclusion and inflation adjustment allow investors to retain more of their investment, lowering the cost of such capital. This affect of both provisions is multiplied in that they would encourage greater investment in the new technologies needed to allow our economy to compete in today's global markets.

The concern over the requirement of using a quarterly index as stated above for NCRS is applicable here also. This provision would be burdensome for the typical investor.

FEDERAL REGULATIONS

We would like to express and encourage caution in considering the impact of a proposed moratorium on federal regulations. Specifically, we would ask that, in the event this is considered, there be an exemption for tax regulations published by the Treasury Department. These regulations are needed to provide taxpayers a semblance of confidence in dealing with the complexities of the tax law. A moratorium would likely have the effect of increasing individual letter rulings, taxing an already overburdened Treasury staff.

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We would like to congratulate the authors of the Contract for their boldness and vision in seeing the true needs of this economy, and the need to spur capital investment. TDS, as a communications player on the "Information Superhighway", realizes the need for the investment upgrades, and would encourage your efforts in proposing tax legislation to that end.

Thank you for this opportunity to present testimony. We would be pleased to discuss these items with members and committee staffs at their convenience.

STATEMENT OF W.M. GRIFFIN
VICE PRESIDENT, GOVERNMENTAL AFFAIRS
TEXAS UTILITIES CO.

Texas Utilities Company ("Company") submits this written statement to the House Committee on Ways and Means in support of the provisions of the Neutral Cost Recovery System ("NCRS") of H.R. 9, the Job Creation and Wage Enhancement Act, and in support of proposals to modify the alternative minimum tax ("AMT").

The Company is a diversified holding company. The Company has a wholly-owned subsidiary, Texas Utilities Electric Company ("TU Electric"), which is engaged in the operation of an electric public utility system involving the generation, transmission, distribution and sale of electric energy in Texas.

BACKGROUND

The Company supports the NCRS for the reasons set forth in the testimony before this Committee by John McCallum on behalf of the Potomac Electric Power Company and the Edison Electric Institute on January 26, 1995. However, as discussed in the testimony of numerous witnesses, including Mr. McCallum and Paul R. Huard on behalf of the National Association of Manufacturers, the Company believes that the Committee should consider legislation to remedy some of the inequities and unfair policy inherent in the current structure of the AMT.

PROPOSAL

Under current law, AMT liability is a credit that generally may be carried forward to reduce regular tax liability, but not to reduce AMT liability. The Company believes that, in order to promote both fundamental fairness and national economic policy objectives, Congress should modify the AMT to permit a taxpayer to utilize its total accumulated AMT credit carryforwards to reduce its AMT liability. The amount of accumulated AMT credits as of December 31, 1994 would be usable against AMT liability ratably over five years (i.e., 20 percent of the total amount would be usable against AMT for each of the years 1995 through 1999). For any taxable year after 1994, a similar 5-year amortization convention would be applicable. In any year in which there is regular tax liability, the accumulated AMT credits also would be usable as under current law.

In addition, the Company believes that the Committee should consider conforming the AMT depreciation rules to the regular tax depreciation rules on a prospective basis.

REASONS FOR THE CHANGE

1. Purpose of the AMT

The current AMT was originally enacted as part of the Tax Reform Act of 1986 to ensure that taxpayers having economic profit reported taxable income and paid Federal income tax. The AMT is a comprehensive, separate tax system, but parallel to the regular tax system. It was designed to ensure that profitable taxpayers do not minimize (or avoid altogether) Federal income tax by employing legitimate tax rules.

2. Unfair Impact of the Current AMT

In practice, the AMT has served to discriminate against taxpayers in capital-intensive industries. This discrimination results primarily because the depreciation rules used in computing the AMT are considerably less favorable than the depreciation rules used for regular tax purposes. In other words, the AMT depreciable lives are longer, and the AMT depreciation methods are less accelerated, when compared to the regular tax depreciable lives and

depreciation methods. Thus, in practice, the AMT, as applied to capital-intensive taxpayers serves as depreciation "penalty."

Congress has already recognized the inequity of the AMT as it applies to capital-intensive industries. In the Revenue Reconciliation Act of 1993, Congress amended the provisions governing the AMT to eliminate the depreciation component of the adjustment for current earnings (the "ACE adjustment"). While this change has had the effect of partially reducing the unfair impact of the AMT upon capital-intensive taxpayers, the relief that the amendment provides is limited because it applies only to property placed in service after December 31, 1993. Thus, the amendment does not serve to relieve the problem for taxpayers that made substantial capital investments that were placed in service on or before December 31, 1993.

The inequity of the current system is demonstrated by the experience of the Company in recent years. The Company has been in an AMT position for every taxable year since the enactment of the AMT effective for the 1987 taxable year. During 1987 through 1989, the construction of TU Electric's two-unit Comanche Peak nuclear plant (which has a tax depreciable basis of more than $8 billion) was in progress. During those years, the AMT was computed in part by making a positive adjustment for book untaxed reported profits (the "BURP adjustment"). In computing the BURP adjustment for those years, the Company was required to include in income the allowance for funds used during construction ("AFUDC"). The AFUDC represents a non-cash accounting entry which reflects the capital carrying costs for regulatory purposes incurred during large construction projects. Thus, from 1987 through 1989 (the most costly construction period in the Company's history), the Company was required to pay enormous amounts of AMT with respect to the non-cash book income represented by the AFUDC.

Effective for the 1990 taxable year, the BURP adjustment was replaced with the ACE adjustment. The ACE adjustment required an even less favorable depreciation adjustment than that required for general AMT purposes. TU Electric placed Unit 1 of the Comanche Peak station in service in 1990 and Unit 2 in service in 1993. The total tax depreciable basis of the two units exceeds $8 billion. That substantial investment resulted in an extremely large ACE adjustment by virtue of the ACE depreciation of the $8 billion investment on a straight-line basis over 20 years and a consequent extremely large annual AMT liability.

The foregoing scenario has resulted in the Company's having $450 million in accumulated AMT credit carryforwards. The Company projects that, under current law, it will be unable to use these credits for at least 10 years. This represents a prepayment of taxes in the amount of $450 million, or essentially an interest-free loan by the Company to the government in that amount. The Company, having made this interest-free loan to the government consequently has been obliged to use borrowed funds to finance its operations.

3. Policy Implications of Current Law

Many capital-intensive taxpayers such as the Company have been placed in the position of long-term AMT status with the resulting long-term interest-free loans to the government. Current law should be changed to permit these taxpayers to use the funds that they have essentially loaned to the government to finance their own operations and thereby to contribute to economic growth and job creation and to promote the ability of domestic corporations to compete in the international economy.

Surely, the current scenario is not what Congress intended when it enacted the AMT. The Company has made a legitimate $8 billion investment with the attendant job creation and contribution to the economy and has faced a steep Federal

income tax penalty for doing so, a penalty that, under current law, will extend over nearly 20 years.

SUMMARY

The effect of the AMT upon the Company and other capital-intensive taxpayers has been to increase their cost of capital in the increasingly competitive domestic and international economies. The AMT therefore discourages taxpayers from making capital investments. By permitting a five-year amortization of accrued AMT credits and by conforming the AMT depreciation rules to the regular tax depreciation rules on a prospective basis as the Company proposes, Congress would take a significant step to alleviating the inequity imposed on taxpayers such as the Company whose only "fault" was substantial capital investment.

TESTIMONY OF THE UNITED STATES TELEPHONE ASSOCIATION

The United States Telephone Association ("USTA") is pleased to have this opportunity to submit testimony to the Committee on Ways and Means concerning select tax provisions contained in the "Job Creation and Wage Enhancement Act of 1995," H.R. 9. USTA is the primary trade association of local telephone companies serving more than 99 percent of the access lines in the United States and represents over 1100 members ranging in size from the regional Bell companies to the smallest of independents.

USTA supports the important underlying principle of the Contract with America -- a lessening of the role of government in the day-to-day functioning of our nation through lower taxes, less spending, fewer government regulations and a reemphasis on the importance of capital formation. With over $280 billion invested in plant and equipment and more than 530,000 employees, the local exchange industry is both capital and labor intensive. Thus, USTA has a strong interest in any proposal that seeks to lower the cost of capital to U.S. businesses and thereby encourage job creation and investment. We also endorse efforts to achieve tax relief within the overall framework of spending restraint.

We have limited our testimony to the following four Contract proposals within the Committee's jurisdiction which are of primary importance to USTA member companies: the Neutral Cost Recovery System, the new capital gains exclusion and inflation indexation concept, the initiative to increase the estate and gift tax exclusion, and the provision that would impose a moratorium on federal regulations.

Neutral Cost Recovery

As a representative of a highly capital-intensive industry, USTA has consistently advocated federal tax policies that lower the cost of capital. The Neutral Cost Recovery System ("NCRS") in the Contract is an acknowledgement that the cost of capital is too high, and it constitutes an important conceptual step toward lowering that cost. We believe that there are positive aspects to NCRS as presently structured, but we also have concerns about this approach which are detailed below.

On the positive side, under the proposal, depreciation deductions would be increased to reflect the effects of inflation and, for certain property, the time value of money. Importantly, the tax basis of NCRS property would not be decreased by these indexation factors. This is essential to the integrity of the proposal for without this provision the proposal would not achieve its stated goal of depreciating property in a manner designed to more accurately reflect a company's true economic investment.

USTA also supports the application of NCRS to the depreciation component of the alternative minimum tax ("AMT"). If NCRS did not apply for AMT purposes, the stimulative effect of NCRS would be severely diluted for the many taxpayers subject to the AMT, including some USTA members. If the incentive effect of NCRS is to be achieved, it must be applied to taxpayers in the AMT situation.

Another important consideration is the need for normalization in order for public utilities to realize the benefits of tax provisions that affect capital costs. Recognizing this, Congress has reaffirmed the concepts of normalization whenever capital formation incentives have been enacted. The NCRS system should be no exception. Without normalization protection, NCRS could actually increase the cost of capital for utility taxpayers.

The timing aspects of NCRS depreciation are protected by existing normalization provisions. However, the benefits of depreciation indexing ["indexing benefits"] are not so protected. Further, existing law might not protect against ratemaking treatments that impute elections into, or out of, NCRS. USTA strongly urges the incorporation of normalization provisions into the NCRS system. These provisions should insure that a minimum level of NCRS benefits accrues to the utility investor. To do this, the provisions must establish a ceiling on the amount of indexing benefits that may be used to reduce tax expense for the purposes of establishing cost of service for ratemaking purposes. Further, the provisions

should require that each taxpayer's election of NCRS (or MACRS) must be respected for purposes of computing adjustments to deferred tax reserves under Section 168(f)(9).

USTA believes that NCRS, as presently structured, would not adequately or evenly apply to certain industries and certain types of property, potentially causing unintended distortions in competitive behavior. USTA is concerned that the proposal's annual 3.5 percent time-value-of-money adjustment would apply only to property currently amortizable under the 200 percent declining balance depreciation method (generally property with a class life of 10 years or less). Failure to allow a time-value-of-money adjustment for longer-lived assets would produce an inaccurate measure of the taxpayer's investment in such property. Further, it could have the unintended effect of discouraging investment in long-life property, which would adversely impact companies that have a high percentage of such property. Because up to 40 percent of the property of USTA members is classified as having a class life of 15 years or more, the investment incentives of NCRS would be diluted as applied to many USTA members. This effect is particularly problematic given that, under current law, competitors of USTA members, such as cable companies, are permitted to depreciate over 7 years the same type of property that USTA members are required to depreciate over 15 years. As a result, these competitors may be entitled to greater benefits under NCRS than USTA members, exacerbating the existing tax depreciation advantage they now enjoy. As technology continues to drive change in the fast-evolving telecommunications industry, this advantage could be significant in the marketplace.

The competing demands for scarce resources will cause companies in our industry to assess very cautiously the impact of electing NCRS. Despite the indexing allowances, the slower declining balance method would actually reduce a taxpayer's depreciation deductions (for 10 year or shorter-life property) relative to present law during the first several years after an asset acquisition is made, with the tax cost being recouped in later years. In fact, the need for cash flow in an increasingly competitive environment may itself be a disincentive to electing NCRS.

In order to receive the benefit of NCRS taxpayers would have to use the asset for most if not all of its class life. Because the rapid pace of technological change in our industry often produces earlier-than-planned-for obsolescence, the back-loaded benefits of NCRS could produce a tension between the need to invest in new technology and the desire to retain existing property to fully realize NCRS tax benefits. This phenomenon could actually discourage investment in new technology. Although the NCRS benefit is elective, and taxpayers could choose not to use NCRS if rapid obsolescence is expected, it is not always possible to know in advance how quickly assets will become obsolete.

USTA also is deeply concerned that a severe out-year increase in the federal budget deficit could prompt a future Congress to recoup the benefits of NCRS (not necessarily by changes in depreciation) to the detriment of companies that paid higher taxes in early years under NCRS (as a result of the switch to the 150 percent declining balance method). This result, of course, would defeat the purpose of the Contract.

USTA also would like to offer two technical suggestions for making compliance with NCRS less burdensome for companies and possibly for the IRS. First, because NCRS would require companies to apply indexation ratios on a quarterly basis, companies must make multiple, complex and time-consuming depreciation calculations each year. These calculations are especially burdensome for smaller companies that have limited access to the special computer resources needed to make these calculations. The added cost and complexity of these multiple calculations could be reduced while the incentive benefits of NCRS are maintained by permitting companies to apply annual rather than quarterly NCRS indexation ratios. Second, while USTA agrees that NCRS should apply on flexible terms -- on a property by property basis -- it believes that taxpayers should be required to affirmatively elect, rather than decline, NCRS given that the new provisions represent significant changes to the present system -- changes that some taxpayers may not be prepared (or want) to undertake. Requiring an affirmative NCRS election would prevent unwary taxpayers from having NCRS and its additional record-keeping provisions applied to their property -- an irrevocable election under the proposal.

Capital Gains

USTA strongly supports the Contract's proposed exclusion of 50 percent of capital gains from adjusted gross income as well as the indexing of capital gains for inflation. Capital investment, especially investment in our nation's technological infrastructure, must play a critical role in rebuilding our economy. The proposed capital gains exclusion and inflation adjustment would allow investors to retain more of the gains resulting from prudent capital investment, thereby lowering the cost of capital. This would, in turn, permit greater investment in the new technologies needed to compete in today's markets.

USTA has long been concerned that, under current law, capital gains resulting from inflation signify no real increase in the value of a capital asset, yet produce income that is taxable at the same rates as ordinary corporate profits. This policy compounds the problem of inflation and distorts investment behavior in the marketplace. Investors and businesses should be taxed only on real gains resulting from their capital assets and not on inflationary gains.

Consistent with our comment on the complexity of NCRS quarterly basis adjustments, we would urge Congress to simplify, to the extent possible, calculations imposed on taxpayers in this area.

Increase in the Estate and Gift Tax Exclusion

USTA also supports the proposed increase in the estate and gift tax exclusion from $600,000 to $750,000. Congress has not increased the exclusion since 1981 when the $600,000 exclusion was implemented over a 6 year phase-in period that ended in 1987 when the $600,000 threshold was reached. There has been substantial inflation over the period since then, eroding the real value of the exclusion and resulting in a de facto increase in estate and gift taxes. Increasing the exclusion to $750,000 is long overdue. For many of our smaller companies, this exclusion can mean the difference between retaining a family-owned and operated business and being forced to sell to satisfy estate taxes. We believe that indexing the exclusion permanently is consistent with other Contract tax proposals and an important improvement over current law, and we applaud its inclusion.

Moratorium on Federal Regulations

USTA would like to request that Congress not extend the proposed general moratorium on regulations to those tax regulations published by the Treasury Department. Such regulations provide needed guidance and certainty to taxpayers dealing with the Internal Revenue Code and, unlike most regulations, are generally encouraged by U.S. companies. Extending the moratorium to Treasury regulations would create uncertainty and prevent economically advantageous financial transactions from taking place. It would put undue pressure on the system of obtaining private letter rulings in the absence of timely regulations of general application. It also would limit the ability of the Treasury to fight abusive transactions -- something that clearly is in the public interest. We therefore agree with the Treasury Department that income tax regulations should be exempted from the moratorium.

* * * *

In conclusion, the authors of the Contract should be praised for placing emphasis on the need to lower the cost of capital for U.S. businesses. Given the increasingly global competition we face, this is an essential policy imperative. And while USTA would like to restate its support for the Contract's objective of reducing the role of government in our lives through tax relief and regulatory reform, we also endorse the Contract's objective to obtain significant spending reductions.

Thank you for this opportunity to present testimony. We would be pleased to discuss these views with members and committee staffs at their convenience.

PRESIDENT'S FISCAL YEAR 1996 BUDGET

HEARINGS

BEFORE THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

FEBRUARY 7, 8, AND 9, 1995

Serial 104–25

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PRESIDENT'S FISCAL YEAR 1996 BUDGET

TUESDAY, FEBRUARY 7, 1995

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, D.C.

The committee met, pursuant to notice, at 10:55 a.m., in room 1100, Longworth House Office Building, Hon. Bill Archer (chairman of the committee) presiding.

[The advisories announcing the hearings follow:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE
January 30, 1995
No. FC-5

CONTACT: (202) 225-1721

ARCHER ANNOUNCES HEARINGS ON PRESIDENT'S FISCAL YEAR 1996 BUDGET

Congressman Bill Archer (R-TX), Chairman of the Committee on Ways and Means, today announced that the Committee will hold hearings on President Clinton's fiscal year 1996 budget proposals that are under the jurisdiction of the Committee. The Committee will receive testimony from Administration witnesses and the Director of the Congressional Budget Office. **The hearings will take place on Tuesday, February 7, Wednesday, February 8, and Thursday, February 9, 1995, in the main committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m.**

In view of the limited time available to hear witnesses, oral testimony at this hearing will be from Administration witnesses only. However, any individual or organization may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing.

BACKGROUND:

On February 6, President Clinton will submit his fiscal year 1996 budget to the Congress. As previously mentioned in his State of the Union address, the President is proposing several tax initiatives. In addition, the welfare reform proposal advanced by the Administration affects several different areas of the budget, including Aid to Families with Dependent Children, which provides cash welfare payments to eligible beneficiaries and is solely within the jurisdiction of the Committee on Ways and Means. The Committee will also hear testimony on the general economic trends outlined in the budget and the spending, revenue and deficit projections in fiscal years 1996-2000. In addition, the Director of the Congressional Budget Office will present the economic and budget outlook as contained in CBO's February report.

In announcing the hearings, Chairman Archer stated: "In his State of the Union message, the President said he was interested in working with Congress in our effort to create a smaller, less costly government. The fiscal year 1996 budget will give us the details on how the President intends to achieve his policies, and ways in which we can work together to take government in the direction the public wants."

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit at least six (6) copies of their statement by the close of business, Friday, February 17, 1995, to Phillip D. Moseley, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 300 additional copies for this purpose to the Ways and Means Committee, room 1102 Longworth Building House Office Building, at least one hour before the hearing begins.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. A witness appearing at a public hearing, or submitting a statement for the record of a public hearing, or submitting written comments in response to a published request for comments by the Committee, must include on his statement or submission a list of all clients, persons, or organizations on whose behalf the witness appears.

4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and the public during the course of a public hearing may be submitted in other forms.

Note: All Committee advisories and news releases are now available over the Internet at GOPHER.HOUSE.GOV, under 'HOUSE COMMITTEE INFORMATION'.

*****

NOTICE -- CHANGE IN TIME

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE
February 2, 1995
No. FC-5-Revised

CONTACT: (202) 225-1721

TIME CHANGE FOR FULL COMMITTEE HEARING ON TUESDAY ON -PRESIDENT'S FISCAL YEAR 1996 BUDGET-

Congressman Bill Archer (R-TX), Chairman of the Committee on Ways and Means, today announced that the full Committee hearing on President Clinton's fiscal year 1996 budget proposals that are under the jurisdiction of the Committee previously scheduled for Tuesday, February 7, 1995, at 10:00 a.m., in the main Committee hearing room, 1100 Longworth House Office Building, **will begin instead at 10:30 a.m.**

All other details for the hearing remain the same. (See full Committee press release No. FC-5, dated January 30, 1995.)

******

Chairman ARCHER. Let me announce to the members of the committee that I am informed that Secretary Rubin is on his way over here from the Senate side. It is my intention to wait another 10 minutes, until 11 o'clock. He was due here at 10:30, and we are glad to accommodate the Secretary up to one-half hour. But at that point, I will recess the committee.

[Pause.]

Chairman ARCHER. I would like to ask all of our guests to take their seats so we can proceed with our hearing this morning.

Secretary Rubin, we welcome you to take a seat there at the witness table.

Secretary RUBIN. Thank you, Mr. Chairman.

Chairman ARCHER. We are pleased to welcome you to the committee. It is your first appearance here as Secretary.

Today is the first of 3 days of hearings on the President's budget. We will be hearing only from Secretary Rubin today. Tomorrow we will be hearing in the morning from the Secretary of HHS, Donna Shalala. Then we will finish this series of hearings on Thursday with the Director of OMB, Alice Rivlin, and the CBO Director, Robert Reischauer.

We have already completed our public hearings on the provisions of the Contract With America, hearing from a variety of witnesses, and today we are going to take time out from that schedule to listen to the administration and their views on the recently submitted budget.

Mr. Secretary, I can tell you from the start there are many things about this budget that we can agree on. You want to provide tax relief for the middle class, and so do we. You want to ensure that that is offset by spending reductions so that it is deficit neutral, and so do we. Very importantly, you want to make sure it is a policy that the Treasury can administer, and we agree with that.

In the end, it is the taxpayers who will judge our work, and there is nothing to be gained and everything to be lost by failing to work together. I am committed to working with the President and his Cabinet not only on tax relief but on welfare, health reform, and deficit reduction. I urge all of my colleagues to do the same and to start in a real spirit of cooperation by giving careful attention to the President's proposals.

Now for a brief opening statement, I yield to my friend, Sam Gibbons.

Mr. GIBBONS. Thank you.

Mr. Secretary, I think you can be very grateful to Chairman Archer for his courtesies. We are not usually this friendly to people who get stuck over in the House of Lords as long as you apparently did this morning. But I can think of other chairs of this committee who would have adjourned the meeting and said come see us in June or July.

I want to personally commend you, though, for the fine job that you have done in the administration. You are one of, if not, its principal adviser on economic policy, and I am pleased that the economy is in as good a shape as it is in. We are approaching full employment. We are approaching full use of industrial capacity. The business climate in general is considered to be very good in the United States as a whole.

This new budget moves in the right direction. It does reduce spending by $144 billion over a 5-year period. I think those figures are real. They are not phony. I commend you for that.

As I have said to you in the past, though, I really do not support talking about tax cuts now. I think it is the wrong economic thing to do. I know how it titillates every Member of Congress to be able to talk about tax cuts. It just makes us feel real good to be able to talk about that. But I think our emphasis should be, as painful as it is, on budget deficit reduction. I think that is the most important thing that this Congress and this administration should be doing.

I want to thank you and commend you again for the distinguished public career that you have had and what you have done for our economy, and I welcome you here. I hope this will be the first of many very informative discussions we have with you.

Chairman ARCHER. Without objection, any other opening statements by individual members of the committee may be inserted in writing in the record at this point.

[The opening statement of Mr. Ramstad follows:]

OPENING STATEMENT OF HON. JIM RAMSTAD

Mr. Chairman, I appreciate the opportunity to speak with Secretary Rubin about President Clinton's 1996 budget.

I must say I am disappointed in the President's newly released budget. President Clinton missed a golden opportunity for significant bipartisan deficit reduction.

Under the President's budget, the already massive budget deficit actually will increase over the next 2 years. While it's unfortunate the President has abandoned his campaign promise to halve the deficit by 1996, it's intolerable that this administration's deficits are increasing to such sky-high levels.

Unlike the President's budget, Republicans in the House will make a serious effort to control the growth of spending, which is driving up the deficit.

While I appreciate the administration's support for the Contract With America's family tax cut concept, the proposal to increase taxes on families once their children reach age 13 makes no sense. I've yet to hear one parent tell me that rearing teenagers is less expensive than rearing younger children.

Mr. Chairman, thanks again for calling this hearing. I look forward to hearing Secretary Rubin's testimony and to exploring in greater depth this important issue.

Chairman ARCHER. Mr. Secretary, again, welcome to the committee. We are pleased to receive your testimony, and you may proceed.

STATEMENT OF HON. ROBERT E. RUBIN, SECRETARY, U.S. DEPARTMENT OF THE TREASURY

Secretary RUBIN. Mr. Chairman, thank you very much.

First, let me apologize for being late, and thank you for your courtesy. I was, as you know, testifying at the Senate Budget Committee. While that had been arranged so that it would end in time to get me here on time, it turned out that that was not quite as easy to do once there as we had hoped it would be. So, again, I thank you for your courtesy, and I am very, very pleased to be here.

Chairman Archer, Representative Gibbons, members of the committee, I am very pleased to appear before you to present the President's budget for fiscal year 1966—1996, rather. [Laughter.]

Well, 1966 was an interesting year, too, but we are going to focus on 1996 in this particular budget.

Mr. GIBBONS. In 1966, the whole budget was $100 billion.

Secretary RUBIN. I actually remember 1966 fairly well. It was a good year. It was the year I started working, so I have some recollection of it. In any event, we will focus on 1996.

Let me say, Mr. Chairman, I am doing something that not many Treasury Secretaries get to do, which is to present a budget that continues a process of cutting begun at the start of this administration and that cuts taxes and increases public investments, both in ways designed to increase future productivity. That is the underlying philosophy of this budget: continuing the deficit reduction process and at the same time cutting taxes in ways that will help the middle class and at the same time provide incentives for saving, education, and other activity that will contribute to future productivity and also increase public investment.

OMB Director Rivlin will testify Thursday and provide details on the spending side of the budget. President Clinton, from the very beginning of this administration, has had a broad-based economic strategy to stimulate and then protect the recovery, to position the country for the long term, and to increase the incomes of working Americans. This strategy consists of fiscal discipline, private and public investment to increase long-run productivity, opening markets, reforming government and reforming regulation, and achieving health care and welfare reform.

The threshold issue we faced and the first issue that we dealt with when the President came into office was to bring the deficit under control after a long period of large and increasing deficits and at a time when we were facing projections for large and increasing deficits going forward. Working with Congress, we enacted a powerful deficit reduction program. As a result, the deficit has come down from $290 billion in 1992 to what we now project is $193 billion this year; or, to use a starker and, I think, more meaningful contrast, the deficit was on a track toward $400 billion in 1998 based on the programs that were in place at the end of the prior administration, and it is now projected, based on the deficit reduction that has been accomplished by this administration with Congress, to be $196 billion for that same year, 1998.

The deficit as a percentage of GDP, gross domestic product, goes from 4.9 percent in 1992 to a projected 2.7 percent for this year and a projected 2.11 percent of GDP in the year 2000, and we have a chart that shows that reduction.

I think, Mr. Chairman, and I think most observers of deficits in the economy believe that the most important measure of the deficit is the deficit as a percentage of the total income of the country, just as it would be for a private entity. How large is your borrowing relative to your income?

As our chart shows, we started with a deficit as a percentage of GDP at 4.9 percent. We wind up at the end of 10 years with the policies contained in this budget at 1.6 percent of GDP.

Fiscal discipline has been reestablished after a long period of ballooning deficits. The deficit has been reduced by more than one-half, both in absolute terms and as a percentage of GDP.

I worked in financial markets for 26 years, and I have absolutely no doubt that our aggressive deficit reduction program enacted by Congress was, in large measure, responsible for the decline in in-

terest rates in 1993, which in turn was key to jump starting the economy in that same year.

Rates have now increased, reflecting growth, but the deficit premium, the critical impediment to growth, is in my judgment in very large measure gone. The increase in rates now is reflecting growth and is what you would expect to have.

We now have a strong investment-led recovery that is creating jobs. Business investment in machinery and equipment has increased dramatically and, as a percentage of GDP, is at an all-time high, as shown in the next chart. That is an enormous plus for future productivity.

The economy has created 5.7 million jobs, 5.3 million in the private sector. The unemployment rate has declined from 7.1 to 5.7 percent. With all the strength of the current recovery, the increases in the CPI, Consumer Price Index, still remain under 3 percent per annum for each of the last 3 years. This is an administration that is very focused on and watchful with respect to inflation.

In the long term, however, the success of our economy will depend on productivity growth. Productivity growth has been extremely slow for a generation, and this has contributed to slow growth in workers' incomes. Slow growth in average wages has been accompanied by an unequal distribution of income gains.

In the past 15 years, those with incomes in the lowest fifth of American households have seen their real incomes fall. Those in the top fifth have seen their real incomes rise, and the middle has stood still.

This budget emphasizes a three-part strategy to promote growth and improve the incomes of working Americans: one, maintaining fiscal discipline; two, providing tax relief for the middle class, tax relief that is targeted to also promote individual activity that will increase future productivity; and, three, increasing public investment in workers through education and training.

First, maintaining fiscal discipline. On a 10-year basis, as I mentioned a moment ago, our budget projects a reduction in the ratio of the deficit to the total economy, the deficit-GDP ratio, to 1.6 percent.

We continue reducing the deficit while lowering taxes at the same time by making substantial spending cuts in three areas. Restructuring government saves $26 billion, savings that come largely from five agencies—Transportation, Energy, Housing and Urban Development, the General Services Administration, and the Office of Personnel Management. We save $80 billion by further lowering the discretionary caps in 1996–98 and by extending the discretionary caps for 2 years beyond their scheduled expiration to the years 1999 and 2000. There is $32 billion in savings that comes primarily from the mandatory side of the budget through continuing some existing health care savings and various other items. A remaining $5 billion of deficit reduction comes primarily from lower debt service as a result of our success in lowering the deficit.

When you put all of these cuts together, they total $144 billion between 1996 and the year 2000. The President has proposed using $63 billion of these savings to provide tax relief to middle-income families as part of his Middle-Class Bill of Rights.

While the deficit is projected to continue to fall as a percentage of the economy for the next 10 years, eventually the deficit will turn up. The problems are an increasingly aging population and rapidly rising health care costs. If we want to maintain fiscal discipline over the long run, which our administration considers to be absolutely crucial, we must reform the health care system as soon as possible, and we look forward to working with Congress on that objective.

Before I leave our deficit reduction, let me make two additional points.

Under President Clinton—and chart 4 I think will show this—for the first time since the sixties, expenditures on government programs are less than the taxes paid by the American people. In other words, our deficit results from the burden of paying interest on the debt accumulated primarily by the deficits of the eighties.

The second general point I would like to make is that it is our belief, expressed many times in various forums, that the way to achieve deficit reduction is through deliberate and thoughtful policy choices, not through a balanced budget amendment.

Now let me turn to the question of providing tax relief for middle-income Americans.

On December 15, 1994, President Clinton announced his Middle-Class Bill of Rights. A middle-class tax cut has been an explicit goal of this President from the beginning. Many working American families have lagged behind, even in the past 2 years, despite our rapid rate of economic growth. Not only do these tax cuts provide immediate relief to middle-class families, but, very importantly, these tax cuts also serve a critical economic purpose by helping these families save and invest to become more productive and enjoy higher future standards of living.

We have targeted tax cuts squarely at the middle class. Eighty-six percent of the benefits of these proposals will go to families with incomes between $20,000 and $100,000. Let me briefly touch on the three components of the Middle-Class Bill of Rights.

First, the $500 child tax credit for children under 13. This credit is designed to help younger families, where economic pressure often tends to be greatest, to provide better child care, after-school activity, and the other requisites for good child rearing. This credit would reduce the Federal income tax burden of a typical two-child family with an income of $50,000 by almost 21 percent once the credit is fully phased in. This is an important investment in children, the future of our country.

Second, a $10,000 deduction for post-secondary education and training expenses. This deduction can be used by all members of the family, including spouses and children, and will help middle-income families better obtain the education and skills that will equip them to succeed at work in a modern economy. Again, people investing in themselves.

Third, expansion of individual retirement accounts. This program will substantially increase the availability of individual retirement accounts by raising the income ceiling to $100,000 for joint filers and $70,000 for individuals. Under the President's plan, the flexibility of the individual retirement accounts is greatly enhanced, which we believe will increase use and, thereby, savings. An indi-

vidual can either deduct the amount deposited up front or forego this deduction in favor of tax-free withdrawal of all accumulated earnings after 5 years. Also, an individual may save for a broader range of purposes. Penalty-free withdrawals may be made at any time for specific purposes such as education, a first home, or certain medical expenses.

The point, Mr. Chairman, is to take the IRA and make it a more flexible savings instrument and thereby, hopefully, greatly increase its use and increase savings and the savings rate in this country, which will be a critical determinant of our future economic growth.

Finally, on the subject of taxes, one of the administration's priorities is to implement fully the Internal Revenue Service's Tax Systems Modernization plan to reduce the administrative burden on businesses and individuals and to raise compliance.

Public investing in the future: The President's public investment program, critical to future productivity, is many faceted. In this budget, it focuses on his GI bill for America's workers, which consolidates and streamlines a patchwork of some 70 job training programs to provide skill grants to lower income and displaced workers.

Mr. Chairman, to conclude, this budget is the next step in carrying forward the President's economic strategy designed to raise living standards for all Americans. A great deal has been accomplished in the last 2 years in putting in place the President's comprehensive economic strategy, and the results speak for themselves. But much remains to be done if this country is going to be effectively and properly positioned for long-term economic health. We enormously welcome the opportunity to work with you in the spirit that you expressed in your opening remarks on a bipartisan basis to continue moving forward.

Thank you, Mr. Chairman.

[The prepared statement and attachments follow:]

STATEMENT OF ROBERT E. RUBIN
SECRETARY OF THE TREASURY
BEFORE THE HOUSE WAYS AND MEANS COMMITTEE

Mr. Chairman and Members of the Committee:

I am pleased to appear before you today to present the President's proposed Budget for the 1996 Fiscal Year. I've been in office less than a month, but I am doing something not many Treasury Secretaries get to do: presenting a budget that cuts the deficit and cuts taxes. I am also doing something that you would have to go back 16 Treasury Secretaries to sometime in the Truman Administration to find: announcing that our budget deficit will decline for three years in a row.

As Treasury Secretary, my testimony will focus on broad policy issues and on the revenue proposals set forth in our budget. OMB Director Alice Rivlin will testify before you Thursday. She will provide greater detail on the program side.

Every Administration's agenda is contained in its proposed budgets. President Clinton, from the beginning of this Administration, has had a broad-based economic strategy to stimulate and then protect the recovery, to position the country for the long-term, and to increase the incomes of working Americans.

Prior to joining Treasury, I assisted the President in setting our overall policies. I know how deeply he feels about continuing to move forward on his full economic strategy, which includes fiscal discipline, boosting both private and public investment to increase long-run productivity, opening markets, reforming government and regulation, and achieving health care and welfare reform.

This morning, I would like to summarize briefly what we have achieved, where we are now, and where we are headed, with special attention to the President's proposed Middle-Class Bill of Rights.

What Have We Achieved to Date?

When the President came into office, the economy may have been in recovery, but the recovery was weak and uncertain. Employment growth, in particular, had lagged far behind normal expectations. Large federal budget deficits, which were increasing rapidly as a percent of GDP even as the economy was recovering, created an unstable economic environment. Escalating structural deficits were a clear signal that the chances of an eventual severe financial crisis were on the rise. Prudent business people were reluctant to hire or to invest in this unstable environment. As a result, Americans were experiencing a jobless recovery.

Thus, the first necessary economic move was to bring the deficit under control. Working with Congress, we enacted a powerful deficit reduction program. The $505 billion deficit reduction package was achieved largely through spending cuts of $255 billion over five years, including freezing discretionary spending at 1993 levels, and raising income tax rates on only the 1.2 percent of Americans with highest incomes.

We also introduced plans to reduce the size of government. The President's Reinventing Government initiative called for reducing the federal work force by 272,900 over five years, bringing government employment back to levels not seen since John Kennedy was President.

At the same time that we were cutting spending and government employment, we were able to reduce taxes for millions of lower- and moderate-income working individuals and families, and to offer tax relief for small businesses.

The net effect of our plan was to bring the deficit down: from $290 billion in 1992 to what we now project as $193 billion this year, the deficit as a share of GDP went from 4.9 percent in 1992 to a projected 2.7 percent for 1995.

I worked in financial markets for 26 years, and I have no doubt that our aggressive deficit reduction program was, in large measure, responsible for the decline in interest rates which in turn was key to jump-starting the economy in 1993. Deficit reduction also reduced uncertainty about our fiscal future and restored confidence conducive to investment.

In addition to addressing the deficit problem, we also made sure that American businesses had access to the credit they needed. When President Clinton took office, small- and medium-sized businesses were facing a "credit crunch." In response, President Clinton announced a program of regulatory and administrative changes to reduce impediments and increase the availability of credit.

The combination of these policies, a sound fiscal environment and increased availability of credit, has paid off. We now have a strong investment-led recovery that is creating jobs. The first chart at the end of this statement shows that business investment in equipment has increased dramatically under the Clinton Administration. As a percent of real GDP, business equipment investment is at an all-time high.

Most important, as we have cut the deficit and reduced federal employment, the economy has created 5.7 million jobs, putting an end to the jobless recovery. Note that 5.3 million, or 93 percent, of these jobs were created in the private-sector (see attached chart). At the same time, the unemployment rate has declined from 7.1 percent to 5.7 percent. Some say that all these new jobs are in low-paying industries, but that view is incorrect. Over the past year, the number of jobs in construction, which pays 30 percent more than the average wage, has surged by some 325,000. The decline in manufacturing jobs has turned around: factory employment is up 290,000. The high-paying wholesale trade and transportation and public utilities industries provided an additional 295,000 jobs.

All this investment and employment growth has occurred in an environment of low inflation--an absolutely critical objective of this Administration. Even with the strength of the current recovery, inflation has remained under control. The increase in the consumer price index has come in under 3.0 percent for each of the last three years. We see virtually no evidence of cost-push inflation pressure from wages. Growth of the employment cost index--the most reliable measure of labor costs--was lower in 1994 than it had been in 1993.

We have also established the basis for growth of future wages and living standards through our trade liberalization policies. We worked hard to enact NAFTA and GATT because we believe American workers will benefit. In an increasingly integrated world, we are going to have to look outward rather than inward if we are going to stay on top. Moreover, jobs in export industries are more productive than average and pay about 10 to 20 percent more than average. That means shifting the composition of GDP toward more exports automatically shifts the economy toward better paying jobs.

Where Are We Now?

As successful as economic performance has been in the last two years, getting the economy moving and creating jobs in the short term was only part of the challenge. In the longer run, the key test of this Administration will be whether it has succeeded in raising productivity growth--because that is the only way to create higher wages and

higher standards of living.

I want to emphasize that productivity growth is not an academic abstraction. In the final analysis, increases in workers' incomes cannot be sustained without increases in productivity--in the amount produced per hour worked. Productivity growth has been extremely slow over the past twenty years. And slow productivity growth has meant slow growth in workers' incomes.

This slow growth in average wages has been accompanied by an unequal distribution of income gains. As you can see from the attached chart, in the past fifteen years, those with incomes in the lowest fifth of American households have seen their real incomes fall below the levels attained by their counterparts in 1980; those in the top fifth have seen their incomes rise by 21 percent; and the middle has stood still.

The unequal distribution of income gains over the past fifteen years has put very real pressures on middle-class families. Their standards of living have failed to match their legitimate expectations. Dealing with this problem is at the heart of the President's budget and his Middle-Class Bill of Rights.

Where Do We Go from Here?

This budget emphasizes a three part strategy to promote growth and improve middle-class incomes: 1) maintaining long-term fiscal discipline, 2) providing tax relief for the middle class, and 3) increasing investment in workers through education and training, as well as in machines and buildings. This is the approach that the President has outlined in his budget.

Maintaining Fiscal Discipline

This Administration fought hard to break the back of the cycle of ever-increasing deficits. But it is not enough to reduce the deficit for three years in a row. We are concerned both about the pattern of projected deficits over the next five years and also about the pattern after the turn of the century.

For the next five years, this budget maintains the progress on deficit reduction made in OBRA '93. As I said earlier, our projections show the budget deficit dropping in 1995 for the third straight year, this time to $193 billion. After 1995, the deficit, measured in dollar terms, fluctuates in a narrow range before falling back to $194 billion in 2000.

More important than stabilizing the deficit in dollar terms is reducing the deficit as a share of GDP. Between 1995 and 2000, the deficit-to-GDP ratio falls from 2.7 percent to 2.1 percent. We haven't seen numbers in that range since 1979.

Further, the attached chart shows that the deficit as a share of GDP has been cut in half from what was projected before passage of the 1993 deficit reduction package, fulfilling the President's promise.

This year, we continue our deficit reduction efforts and lower taxes by making substantial cuts in spending. Budget cuts come from three areas. Restructuring government saves about $26 billion. Most of that $26 billion is the result of fundamental changes in five agencies--the Departments of Transportation (DOT), Energy (DOE), and Housing and Urban Development (HUD), the General Services Administration (GSA), and the Office of Personnel Management (OPM). Additional efforts are aimed at terminating certain agencies and programs and restructuring others. In addition, we propose to turn over to the private sector or to state governments activities that they are well positioned to carry out themselves.

We have already had real success in this area. The President's reinventing

government initiative has already reduced the federal work force by 102,500 positions. Currently, the federal work force as a share of total employment is at its lowest point since the 1930's. In addition, Congress has enacted $63 billion of the $108 billion in reinventing government savings proposed by the Administration. The goal is to make government even smaller and to make it work better for all Americans.

In addition, further lowering of discretionary spending caps from 1996 through 1998 and extending them for two years beyond their scheduled expiration in 1998 produces an additional $80 billion in savings. The budget contains specific proposals to achieve these savings. The net result of extending the caps and making the cuts will be to keep discretionary spending virtually constant in nominal dollars from 1996 through 2000.

Finally, $32 billion in savings comes primarily from the mandatory side of the budget through continuing some existing health care savings, imposing user fees for the lucrative electro-magnetic spectrum, accelerating student loan savings, and reducing certain agricultural programs. The remaining $5 billion of deficit reduction comes primarily from lower debt service, as a result of our success in lowering the deficit.

Together, our program cuts and projected debt service reductions save $144 billion between 1996 and 2000. The President has proposed using $63 billion of these savings to provide tax relief to middle-income families as part of his Middle-Class Bill of Rights. The remaining $81 billion is for deficit reduction.

If our proposed policies are continued beyond the year 2000, we now project that the fiscal year 2005 deficit will be only 1.6 percent of GDP. This good news comes from two developments. First, for the ten-year period from fiscal year 1995 to fiscal year 2005, the President's budget proposals produce substantial deficit reduction. Second, our new budget baseline projects lower spending for Medicare and Medicaid, based on the latest growth rate estimates from the actuaries at the Health Care Financing Administration.

Administration estimates of deficits in the out-years are noticeably lower than estimates that have been recently produced by the Congressional Budget Office. There are several reasons for this.

First, CBO's baseline, by convention, does not include any deficit reduction proposals. The President's budget proposes substantial deficit reduction over the next ten years.

Second, the Administration's baseline estimates include recent revisions to projected costs of Federal health care programs made by the actuaries at the Health Care Financing Administration. I do not believe that the latest CBO estimates incorporate the full revisions from the actuaries.

Third, over the long term, the Administration has a slightly more optimistic rate of growth for productivity--by one or two tenths of one-percent--than does CBO. By 2005, even very small differences in projected growth rates materially affect deficit projections.

In other words, there are straightforward explanations of the differences between our numbers and CBO's, and we are very comfortable with all our projections.

While we are confident that the deficit outlook for the next ten years is good, all observers agree that the deficit will eventually turn upward. The problems are an increasingly aging population and rapidly rising health care costs. We cannot do anything about the projected demographic shifts, but we need to do something about health care as soon as possible. If we want to maintain fiscal discipline over the long run, we must reform health care.

Before we leave our deficit discussion, let me make two additional points. First, let me refer you to an enlightening chart. This chart shows the difference between program expenditures and revenues for the Clinton Administration and for each of the last eight Administrations. Under President Clinton--for the first time since the 1960s--expenditures on government programs are less than the taxes paid by the American people. We have a deficit solely because of the burden of paying interest on the debt run up largely as a result of the deficits of the 1980s--not because we're overspending today.

The second general point I'd like to make is that I believe the way to achieve deficit reduction is through deliberate and thoughtful policy choices, not through a balanced budget amendment that greatly increases macroeconomic risk in our economy and involves spending cuts that have not been specified at the time the decision on a balanced budget amendment is made.

Providing Tax Relief for Middle-Income Americans

Let me now turn to the centerpiece of the President's budget. On December 15, 1994, President Clinton announced in an Oval Office address his "Middle-Class Bill of Rights." A major piece of his initiative is providing tax relief for middle-income families.

A middle-class tax cut has always been a goal of this Administration. In 1993, however, the Administration faced a deficit crisis larger than had been predicted at the start of 1992. Bringing the deficit under control, and directing tax relief to lower and moderate income Americans were our first priorities.

Due to strong, effective leadership and tough choices, the deficit reduction program has been even more of a success than expected. However, incomes of many working American families have lagged behind--even in the last two years, when growth in the economy has been brisk.

The President's tax cuts will not only provide immediate relief to financially-strapped middle-income families but also will help these families save and invest so that they will become more productive and enjoy higher future standards of living. Individual tax relief coupled with savings and investment will boost American productivity, providing the foundation for sustained increases in real incomes.

The Administration's tax cut is targeted squarely at middle-income families. The attached chart illustrates that a full 86 percent of the benefits of this tax cut will go to families with incomes between $20,000 and $100,000.

The tax cuts in the President's Middle-Class Bill of Rights have three elements, aimed at strengthening families, promoting education, and encouraging savings.

$500 Child Tax Credit: This credit is designed to help younger families, where economic pressure often tends to be greatest, to better provide child care, after-school activity, and the other requisites for good child rearing. This is an investment in children--the future of our country. A $500 (when fully phased in) non-refundable credit will be allowed for each dependent child under 13. Between 1996 and 1998, the maximum credit would be $300. This credit would reduce the federal income tax burden of a typical two-child family with an income of $50,000 by 21 percent. The credit will be phased out for taxpayers with initial Adjusted Gross Incomes (AGI) between $60,000 and $75,000. No credit will be available to taxpayers with AGI in excess of $75,000.

Deduction for Post-Secondary Education Expenses: This deduction can be used for education and training expenses for all members of the family, including spouses and children, and should better enable middle-income families to obtain the education and skills that will equip them to function effectively in a modern economy. This deduction is used in determining a taxpayers AGI (that is, taken above the line) and is, therefore,

available to those who do not itemize their deductions as well as to those who do itemize. The maximum allowable deduction would be phased out ratably for taxpayers filing a joint filers with AGI (before the deduction) between $100,000 and $120,000 ($70,000-$90,000 for individuals). The maximum deduction would be $5,000 in 1996-1998 and $10,000 thereafter.

This proposed tax deduction of up to $10,000 in tuition and fees can be taken for study at any college, university, or vocational program eligible for federal assistance.

Expansion of Individual Retirement Accounts: This program will substantially increase the availability of individual retirement accounts by raising the income ceiling to $100,000 for joint filers and to $70,000 for individuals. Today, only couples with AGI up to $40,000 and individuals with AGI up to $25,000 can make fully deductible contributions. Moreover, the flexibility of the individual retirement account has been greatly enhanced: an individual can either deduct the amount deposited up front, or forego this deduction in favor of tax-free withdrawal of all accumulated earnings after five years. The President's proposal would allow penalty-free withdrawals immediately for specified purposes such as education, first homes, long-term unemployment, or certain medical expenses.

Other Revenue Proposals

In addition to the President's proposed middle-class tax cuts, the budget contains certain other provisions that affect revenues. An Appendix to my testimony provides further details. But let me note that we are proposing two additional empowerment zones, thus enlarging empowerment zone tax incentives; reducing a tax on vaccine manufacturers; denying the Earned Income Tax Credit (EITC) to undocumented workers, and to those with significant unearned income; changing the tax treatment of those who renounce their citizenship or use foreign trusts to shelter income; and supporting the extension of the taxes that finance the "Superfund" that cleans up hazardous waste sites.

Also, on the subject of taxes, one of the Administration's priorities is to fully implement the Internal Revenue Service's Tax Systems Modernization (TSM) plan to reduce the administrative burden on businesses and individuals and to raise compliance.

Investing for the Future

Fiscal discipline and middle class tax relief are necessary elements of any coherent economic strategy. Yet, by themselves, they are not enough to ensure higher standards of living for all Americans.

Additional investment in the skills and capabilities of America's workers and in physical capital have always been an integral part of the President's agenda. Today's investments will translate into stronger productivity growth and higher living standards for years to come. Boosting public investment is an important step towards a rising standard of living for all Americans.

Let me focus on three areas: investment in human capital; investment in science and technology; and investment in infrastructure.

Human Capital: The President has consistently emphasized the importance of "lifelong learning" in an economy which favors the highest skilled workers. The budget proposes $47.3 billion in 1996 for investment in education and training. This represents a $5.4 billion increase, or 13 percent, over 1993 levels. Working with Congress, the Administration has already launched legislation from expansion of the Head Start program to cutting the cost of higher-education loans for students.

This year, the President will focus on better opportunities for adults already in the

work force. The President's proposal--the "G.I. Bill for America's Workers"--will consolidate and streamline a patchwork of some 70 job training programs. The "G.I. Bill" will offer dislocated and low-income workers "skill grants" through which they can make their own choices about the training they need to find new and better jobs.

Two other Presidential initiatives also deserve mention here.

Welfare reform fits into the over-arching strategy of raising economic growth. The current welfare system costs taxpayers a great deal of money and actually discourages work by participants. This Administration wants to work with Congress to make welfare a temporary safety net only, through time limits and through making work pay. If we succeed, we will both raise the standard of living of participants and lower the tax burden on average Americans.

Similarly, health care reform is not only essential to maintaining long-term fiscal stability, but also important for the take-home wages of the average American. If employees' health insurance costs keep rising, workers' wages won't. Health care cost containment will pay off in higher wages as well as in a more stable fiscal environment.

Science and Technology: We know that the rates of return for R&D are high in the private sector. Industry R&D may have accounted for as much as a quarter of overall productivity growth in recent decades. Commercial firms cannot reap the entire rewards of basic research, however, because other firms easily learn and use the knowledge generated. Despite high rates of return, the private sector does too little basic research to meet all of society's needs.

Thus, the federal government plays an important role in promoting and investing in R&D. Federal spending accounts for nearly 40 percent of the nation's R&D spending. This budget proposes $69.4 billion in 1996 for research and development--an increase of $3.74 billion in nondefense R&D over 1993.

Through the President's National Science and Technology Council, the Administration seeks to support the best possible science on a tight budget. The science and technology program pursues advances in health, business, the environment, information technology, national security, and basic science itself.

In addition, because of the importance of R&E to the nation's economy, we support the extension of the R&E tax credit on a revenue neutral basis, and we will work with Congress to pay for it.

Infrastructure: Infrastructure is one area where the government must play an important role--the private sector could not profitably run many of our nation's roads and bridges or the treatment plants needed to provide clean water. The budget proposes $58.8 billion for 1996 for infrastructure investment--up $8.6 billion from 1993.

While infrastructure spending can be among the most effective ways to boost productivity, projects must be chosen carefully. The Administration proposes to restructure the Transportation Department, consolidating its infrastructure activities into a single transportation block grant. Local governments will have more flexibility to direct resources to areas which best address community needs. Our goal is more and better infrastructure, at less cost and with less red tape.

Conclusion

In conclusion, let me make three points:

First, you can read the priorities of this Administration in its budget. This President is committed to raising standards of living for all Americans, and the policy objectives pursued through the budget--deficit reduction; the middle-class tax cuts; public

investments in workers, in knowledge, and in infrastructure; Reinventing Government--are all aimed at attaining that goal.

Second, this budget maintains the ground won in the struggle to reduce the deficit in 1993. We project that, with the deficit-reduction policies in the budget, the federal deficit will remain below $200 billion in nine of the next ten years, and will shrink to 1.6 percent of GDP in fiscal 2005. We as a country simply cannot afford to return to the days of rising, uncontrolled deficits of the 1980s or early 1990s. This budget will keep us on a sound trajectory that reduces the deficit.

We do this by taking step-by-step reductions in spending programs and in cutting the size of government itself. Reinventing government not only saves money, but also makes government efficient. As a result of the Administration's actions to date, we are reducing the deficit and do not need a balanced budget amendment to enforce fiscal discipline. This is the right way to cut the deficit.

Third, we take a crucial step toward addressing the economic concerns of working families by cutting their taxes. Our proposals are targeted to the people who need them the most when they need them the most. These cuts will help families with young children, people who are paying for education, and those who want to save for the future.

This budget builds upon what has been achieved. It is the next step in the logical sequence of policies designed to raise the living standard for all Americans. It reinforces fiscal restraint. It provides tax relief to millions of Americans who have seen their incomes stagnate for a generation. And it invests in education, infrastructure, and technology.

Much has been accomplished in the past two years, but much remains to be done. I look forward to working with you on a bi-partisan basis to continue moving forward.

APPENDIX: OTHER REVENUE PROVISIONS

Additional Empowerment Zones. The Secretary of Housing and Urban Development would be authorized to designate two urban empowerment zones in addition to the six urban and three rural zones designated on December 21, 1994. This would have the effect of extending the empowerment zone tax incentives to these additional areas. Other current-law limitations, such as those regarding population, size, poverty, and application requirements, would be applicable to these areas.

Reduce Vaccine Excise Tax. Under current law, a manufacturer's tax is levied on vaccines used to prevent diphtheria, pertussis, tetanus, measles, mumps, rubella or polio. These taxes are deposited in the Vaccine Injury Compensation Trust Fund and provide a source of revenue to compensate individuals who sustain certain injuries or to families of individuals who die following administration of these vaccines. Because of large balances in the trust fund, the Administration proposes a reduction in revenues from these taxes. The decrease will allow continued program compensation while lowering the costs of vaccines to both public and private purchasers.

Earned Income Tax Credit

EITC denied to undocumented workers. Under this compliance proposal, only individuals who are authorized to work in the United States would be eligible for the earned income tax credit (EITC). When claiming the EITC, taxpayers would be required to provide a valid social security number for themselves, their spouses, and their qualifying children. Only social security numbers that are valid for employment purposes in the U.S. would enable the individual to claim the EITC. In addition, the proposal

would modify the IRS procedure for processing returns with erroneous or missing taxpayer identification numbers so as to reduce improperly claimed credits. These proposals would be effective in 1996.

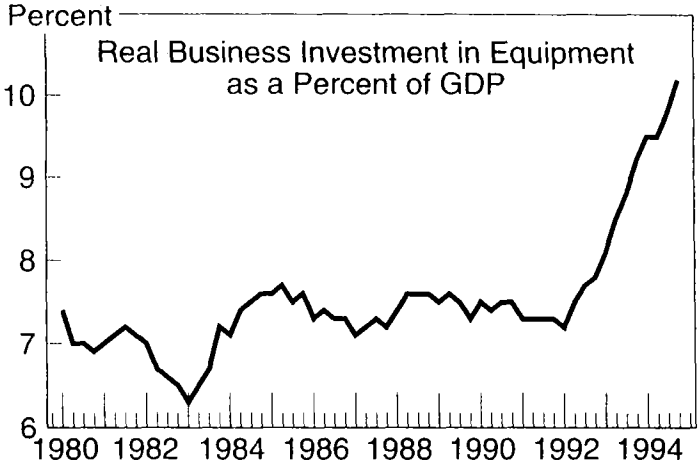
EITC denied if interest and dividends exceed $2,500. Under current law, an individual must have earned income in order to be eligible for the EITC. Because the EITC is designed to benefit low-income workers, the amount of the credit should decrease as the taxpayer's income increases. A taxpayer with relatively low earned income, however, may be eligible for the EITC even though he or she has significant interest and dividend income from investment assets. Under this proposal, taxpayers would not be eligible to receive the EITC if their combined interest and dividend income for the year exceeds $2,500. This proposal would be effective in 1996.

Tax responsibilities of Americans who renounce citizenship. The proposal would tax the untaxed gains of U.S. taxpayers who renounce citizenship. The tax would also apply to aliens who have been lawful permanent residents for at least ten years and then cease to be subject to U.S. tax. This tax is intended to apply only where very substantial gains are involved and, thus, an exemption is provided for up to $600,000 of gain. U.S. real estate and pension assets would also be exempt.

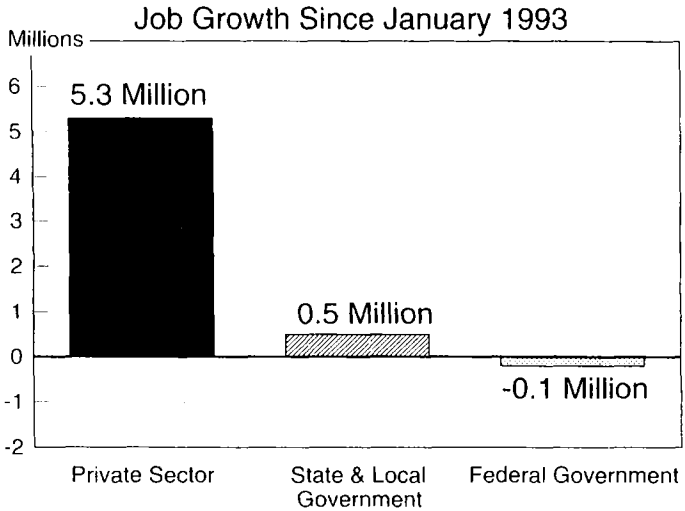
Foreign Trusts. The foreign trust proposal is designed to increase compliance for taxing two categories of people. First, U.S. persons sometimes transfer their assets to foreign trusts and rarely pay tax on the trust income. The proposal would impose enhanced information reporting requirements (with penalties for failure to comply) on U.S. persons who transfer assets to foreign trusts. The second category of taxpayers are U.S. persons who are members of wealthy foreign families. Foreign families often establish foreign trusts for the benefit of U.S. family members. Under current law, the United States treats such trust assets as owned by the foreign family, and any distribution of income earned by the trust to the U.S. beneficiary is treated as a nontaxable gift to the U.S. person. The proposal would tax this trust income.

Extension of Superfund Tax. Four different taxes are imposed under present law to fund the Hazardous Substance Superfund (Superfund) program including a corporate environmental income tax equal to 0.12 percent of the amount of modified alternative minimum taxable income in excess of $2 million, and excise taxes on domestic or imported crude oil or refined products, certain hazardous chemicals, and certain imported substances. These taxes are scheduled to expire generally after December 31, 1995. The Administration supports the extension of the corporate environmental income tax through taxable years beginning before January 1, 2001, and the Superfund excise taxes through December 31, 2000.

Business Investment Has Surged

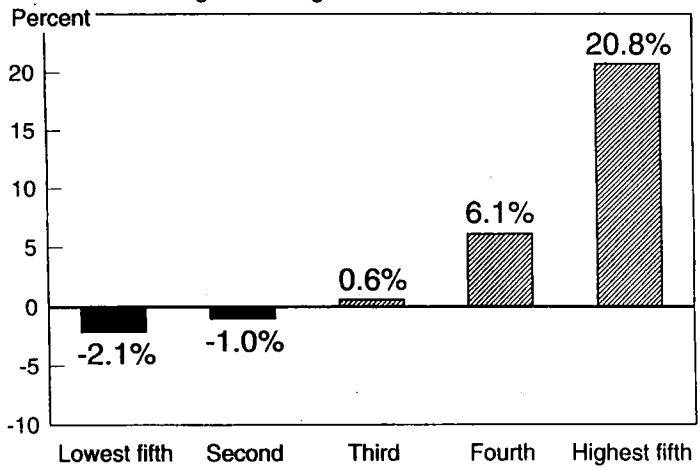


93 Percent of the 5.7 Million New Jobs Have Been in the Private Sector

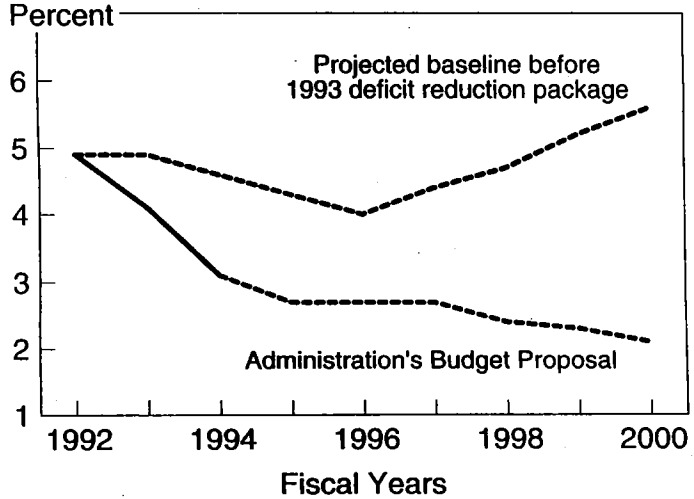


Middle Class Incomes Were Stagnant, 1980-93

Change in Average Real Household Income

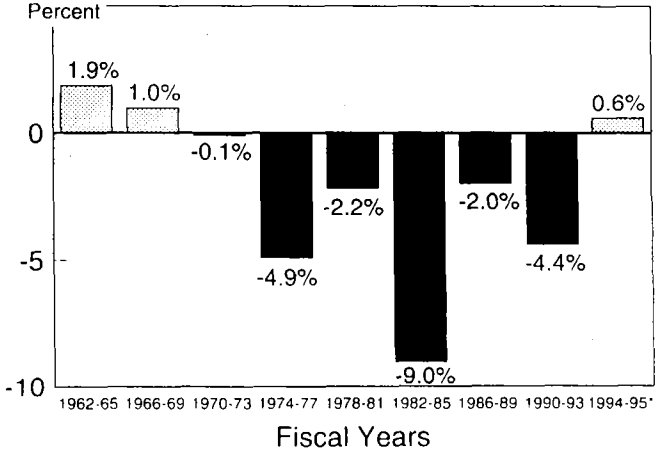


The Deficit Has Been Cut in Half as a Share of GDP



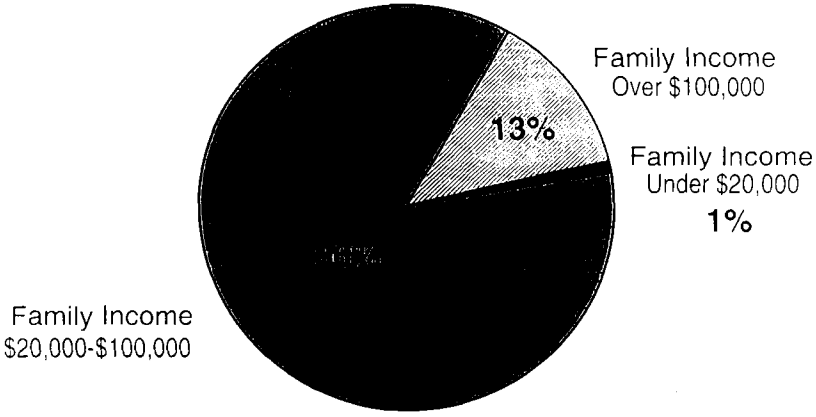
Spending on Government Programs Is Less than Taxes for the First Time Since the 1960's

Revenues Minus Program Spending as a Share of GDP



*Fiscal year 1994 and projection for fiscal year 1995.

Tax Cut Targeted to Middle-Income Families



Chairman ARCHER. Thank you, Mr. Secretary, and thank you for your very cogent testimony to the committee.

If I may ask you a question that is on the minds of average Americans that I have been hearing from, does the administration for which you work believe that we should have a balanced budget at the Federal level? That is simply a yes or no answer. You do not have to expound on it.

Secretary RUBIN. Let me express it, if I may, this way, Mr. Chairman, because I actually think it is a rather complicated question.

Chairman ARCHER. But it isn't complicated. Either we pay our bills currently or we don't, and the question is: Do you believe we should do that?

Secretary RUBIN. The President has said on many occasions that he believes that we should move toward a balanced budget, but we should do it in a careful and deliberate fashion and make sensible decisions each year that are appropriate in the context of the economic circumstances of that year.

Chairman ARCHER. OK. At what time does the President believe we should achieve the balanced budget?

Secretary RUBIN. The President believes very strongly, and I think rightly, that there should not be an arbitrary time; because once you have an arbitrary time, you have no way of knowing what the economic circumstances will be during your approach toward that arbitrary period, and you may be reducing the deficit at precisely the wrong time.

If, for example, we went into a recession and at the same time you continued to reduce the deficit, what you could do is turn a recession into something far more serious. That is really precisely the point. One should not have an arbitrary time. One should have a goal, and the goal should be to work toward a balanced budget in the context of the circumstances of every given year when the decisions have to be made.

Chairman ARCHER. Well, if the economy is doing as well as your charts say—and it is doing well based on what we hear from economists across the country—is not now the time when we should be able to pay our bills? We are not in a recession.

Secretary RUBIN. Mr. Chairman, it is our view—we would agree with you that this is a time when we should continue on the deficit reduction track. We began, as you well remember, in 1993. As I said in my opening statement, we inherited a situation that was viewed in the financial markets, and I think rightly so, as a fiscal morass, a fiscal mess. I think there was a prevailing sense of pessimism about fiscal order in this country. We put in place, with Congress, a very powerful deficit reduction program. This budget carries that program forward. Toward that end, we made $144 billion of cuts, and I will tell you, they came very painfully. If you do not believe me, ask the Secretaries who had to make those cuts.

We have used more than half of it for deficit reduction, and we have used some of it for tax cuts. That is what gets you on the path—well, the chart is not up there now, but that is what gets you on the path toward a 1.6-percent deficit-GDP ratio.

In our judgment, the next major step is to go at the item in the budget that really is driving the deficit, and that is health care expenditures.

Chairman ARCHER. But we still are not paying our bills this year, and we are at the height of a very successful economic recovery.

Secretary RUBIN. Mr. Chairman——

Chairman ARCHER. The American people, I think, have the right to ask: If we cannot pay our bills now, when will we pay our bills?

Secretary RUBIN. Mr. Chairman, I think your question is a good question. This is the kind of debate that we think should be undertaken with respect to economic policy. It is our judgment that you need to reduce the deficit in a powerful and aggressive but, nevertheless, a carefully balanced way. Because if you reduce it too rapidly, what you will do is have a negative macroeconomic effect on the economy, slow down growth, and possibly even push it into a recession. So it is for that reason that we have advocated being very focused on the deficit, but doing it appropriately over time.

Chairman ARCHER. But it seems to me the difficulty doing it over time is that as you project forward, most of your spending savings are going to be in outyears, that you may face the very thing you are talking about, which is an economy that is not as strong as it is now. The American people wonder why we are not doing more right now while we have a strong economy, and they also wonder, along the lines of your testimony, that the major problem in not getting to a balanced budget today is the interest charges for accumulated debt that was run up in previous administrations. Yet, as I understand your budget, you continue deficits year after year after year in your own projections of over $200 billion a year, which I believe you would agree is going to compound the debt and create more interest charges on future generations.

Secretary RUBIN. Mr. Chairman, conceptually, maybe the way to put it is this: What we have tried to do is design a program that will bring the deficit down as a percentage of the economy, very much as you would in looking at any sort of entity—how large is its borrowing relative to the size of its income?—and also begin to bring the debt down as a percentage of the total economy. That is what our program is designed to do.

It is our view that if you go too fast with respect to deficit reduction, you begin to run macroeconomic risks. On the other hand, we also believe that you should move as rapidly as you can because we agree with you that deficit reduction and getting the deficit down as a percentage of the total economy and getting the debt down as a percentage of the total economy are very important objectives for the long-term economic health of this country.

Now, we could have a debate—and it is a good, healthy debate—about exactly how rapid that process should be. I think we have done an enormous amount in the time that we have been in office, and we did it from the base of having inherited a very difficult and, I think, long-run untenable situation.

Chairman ARCHER. Well, I do not want to get back into who did what over the last 15 years, because we could be forever debating that, but we are where we are, and we have to move forward in

a way that I believe tells the American people we are serious about getting to a balanced budget.

That is the one thing that troubles me about the budget you are submitting to us today. You are making projections over 10 years that still show deficits that do not go down but go up. If we cannot do it in a 10-year period, I think the American people can properly ask when. The answer is, if it is simply that we want the deficit to relate to the GDP growth rather than a balanced budget, I do not think the American people will buy it.

I may be wrong, but I have used up all my time, Mr. Secretary. So I am going to yield to my colleague, Sam Gibbons, for inquiry.

Mr. GIBBONS. Well, thank you, Mr. Chairman. I know the Secretary's time is limited. I know we are running late. The Secretary has been very generous with me in our discussions, and so I am going to yield back the balance of my time and let other people have a chance to question.

Chairman ARCHER. Mr. Crane.

Mr. CRANE. Thank you.

Mr. Secretary, since only one-third of married couples have children under age 13, and since the cost of bringing kids up escalates as they get older, I am curious why you came up with that cutoff age with respect to the tax credit for children at 13.

Secretary RUBIN. Mr. Crane, that is a good question. What we spent a lot of time doing was trying to figure out how to make our limited resources, because it is the President's view that every tax cut must be fully paid for and without any budget gimmicks, how do we make our limited resources most effective. The judgment that we reached was that it is younger families who have the most difficulty in terms of their incomes, and it is also young children who provide the greatest problem in terms of many kinds of expenses. I mentioned child care, after-school activity, and things of that sort.

So the idea was to focus the money on the people that we thought needed it the most and toward children at the age where we thought the greatest benefit could be obtained by enabling families to invest more in their uprearing.

I might add, incidentally, as kids get older and they get toward post-secondary school age, our education tax credit kicks in so that there is available help with respect to future training and schooling.

It is basically a question of targeting limited resources to the place where we thought it was most needed and would be most important to the future of our country in terms of investing in children.

Mr. CRANE. Another question is the education expense deduction which is limited to $5,000 in 1996, 1997, 1998, and then goes to $10,000.

What was the rationale behind postponing the elevation to $10,000 until 1999?

Secretary RUBIN. The President felt that an education and training tax deduction was a way to provide people with an incentive to do the things that will make them more productive, which is obviously good for the economy. Once again, you have the question of taking limited resources because he absolutely refused to have

any tax cut that was not paid for; and, he wanted to accomplish deficit reduction at the same time that we had a tax cut. So we took our limited resources and we applied them in the manner that seemed most sensible, and to us that seemed to be to have 3 years of phase-in at $5,000 and then go to $10,000.

Mr. CRANE. A final question has to do with the proposal for border services user fees. I am curious as to why it is called a user fee.

Secretary RUBIN. It is called a user fee because it is going to be raised from people who legally, legitimately cross borders, and then the funds will be used predominantly for providing services to those people, for example, the border checkpoints and the various kinds of activities that Customs and others have to undertake to deal with legitimate crossings across borders.

Mr. CRANE. Well, frequent crossers are going to get a discount?

Secretary RUBIN. There is a frequent-crosser discount, yes.

Mr. CRANE. Aren't they using the border crossings like anybody else?

Secretary RUBIN. They are, yes, they are, and it is a good point. We actually discussed that. I think there was a balance struck, and the idea was that if people go back and forth a great deal, it would impose too much of a burden on those people. So the thought was to provide a discount, but that is a matter one could debate and have a different judgment on.

Mr. CRANE. I am just curious why it isn't referred to as a tax rather than a user fee, then, when you are making those kinds of arbitrary distinctions.

Secretary RUBIN. Oh, because I think that a user fee is a phrase in wide use to apply to a fee that is charged to people for a service that they are using as opposed to a general tax that is used for general purposes.

Mr. CRANE. These fees are designed to stem illegal border crossings and fight drug trafficking?

Secretary RUBIN. No. These fees are really designed to deal with the kinds of checkings and activities that are involved in legal, legitimate border crossings at both our northern and southern borders.

Mr. CRANE. They are not currently funded?

Secretary RUBIN. They are currently funded, but the idea here was to have them funded by the people who use the services.

Mr. CRANE. Thank you, Mr. Secretary.

Chairman ARCHER. Mr. Thomas.

Mr. THOMAS. Thank you very much.

Mr. Secretary, Sam Gibbons was very generous in the comments to you about this committee in the House versus committees in the Senate. I guess I would just ask you to go back and review article I, section 7 when you need help in terms of who is there constitutionally and what needs to be done.

We normally meet at 10 o'clock. We adjusted it to 10:30, and we basically waited until 11 o'clock. I would urge you to focus on the constitutional relationships.

In your statement, you talked about health care being significant in terms of controlling the deficit, and just prior to this, you men-

tioned that health reform or the failure to deal with health reform will drive the deficit.

What kind of health reform do you have in this budget?

Secretary RUBIN. Let me respond to both aspects of what you said, Mr. Thomas, because I agree with you. We had intended to be here at 10:30, and I do apologize for not being here. That was something that was unavoidable. But I do apologize.

Mr. THOMAS. Well, it is avoidable if you do not schedule it that way in the first place. So it is avoidable.

Secretary RUBIN. Well, let me apologize again. We did our best, and——

Mr. MCDERMOTT. Would the gentleman yield?

Secretary RUBIN. We are very pleased to be with you.

Mr. THOMAS. Thank you.

Mr. MCDERMOTT. Would the gentleman yield? I don't think you need to badger the witness when he was testifying in the Senate at the Senate Budget Committee.

Mr. THOMAS. I am suggesting, perhaps, that article I, section 7, that says that all revenue bills originate in the House of Representatives ought to enter into consideration of when you schedule committees, I would tell the gentleman from Washington, so that we don't get this dilemma that we have been presented with. That is all.

The gentleman will continue.

Secretary RUBIN. OK. In the spirit of being very pleased to be with you, let me respond to your health care question. [Laughter.]

Health care reform is not dealt with in the budget, and it is an extremely good question, and let me tell you why. We spent 2 years working on health care reform. We made an enormous and highly public effort to get health care reform. We did it because the President had the very strongly held view that, No. 1, all Americans should have health care coverage, and, No. 2, health care cost constraint was an absolute requisite for future economic growth.

We were unsuccessful in Congress. The judgment we made toward the end of last year and I guess the beginning of this year, but particularly toward the end of last year, was that in order to move forward toward the very same objectives that the President has advocated so vigorously over the last 2 years, what we should do is go through a different process, and that this time we should work with Congress in a partnership to try to accomplish these purposes.

When we sat down with the budget, it was our view that if we put a health care program in the budget, we would be getting ahead of Congress, and we would be undermining precisely what we were trying to accomplish.

Mr. THOMAS. Well, I appreciate the answer, but as you know, in 1993 the budget contained, in terms of the agreement, about a $56 billion cut in Medicare over 5 years. This budget contains about a $9.9 billion cut in Medicare, basically extending items to produce about a $65 billion cut over 7 years. You are quite right. The President's plan last year proposed a $124 billion cut in Medicare over 5 years.

In terms of your approaches in previous years, you focused on significant reductions in the Medicare program. In partnership

with Congress, your choice now was to really offer nothing. Normally in partnerships you tend to work together to try to resolve problems. From my understanding of what you have said is that without a proposal from the President to reduce Medicare in this budget, it will force Congress to propose any changes?

So it is not a political document at all. You agree that we have to do something with Medicare, and reductions are part of the program. Is that what I understood you to say?

Secretary RUBIN. No. I think, Mr. Thomas, that my point was what we do in this budget is we extend some existing savings. We would not refer to those and I don't think they would be fairly characterized as Medicare cuts.

What I then said was that we believe very strongly that we need to move ahead on health care reform, we need to move ahead on reducing health care expenditures, but that the only way to do that, without having all sorts of adverse effects, is to do it in the context of health care reform. I think our last 2 years have proven that for us to get out ahead of Congress is not the way to accomplish health care reform——

Mr. THOMAS. I understand that——

Secretary RUBIN. —so we come to you with our hands out in partnership.

Mr. THOMAS. So that part of a plan which is a reduction in Medicare won't be used as a political tool to show that Congress wants to reduce Medicare and this administration does not, based upon your past offerings of significant reductions in Medicare. Is that correct?

Secretary RUBIN. No. I think that a more accurate characterization would be to say that we had last year a health care reform program in the context of which Federal health care expenditures would be brought down, enormous improvements and savings would be accomplished. That did not work, and we want to now go back and work with Congress on the question of health care reform to accomplish both universal coverage and cost containment.

Mr. THOMAS. Finally, then, even though you argue that health care reform is a necessity to help solve the deficit problem, you have offered no new ideas, not in partnership, but you are going to let Congress lead and you will follow.

Secretary RUBIN. No. I don't think that is an accurate characterization of where we are. We have put forward a budget which continues a powerful deficit reduction program begun in 1993——

Mr. THOMAS. No, no. On Medicare. On Medicare. My time has expired. On Medicare, do you have any ideas in the budget on Medicare?

Secretary RUBIN. I will get to health care. The percentage GDP figures were on the chart that now doesn't seem to be there. What we have said is we are not looking for Congress to lead. We are looking to work together with Congress. When we tried to lead, we led with our chin and we got socked. So the answer to that was let's not do that again, let's work in partnership with people for whom we have enormous respect, the Congress of the United States. That is what we are prepared to do.

Chairman ARCHER. The gentleman's time has expired.

Mr. Rangel.

Mr. RANGEL. Thank you, Mr. Chairman.

Mr. Secretary, it is difficult for us to give an analysis of your budget when we have absolutely nothing to work with, with the majority. I mean, they will be bringing us a balanced budget, and they will make certain that it is paid for by spending cuts. But we haven't the slightest idea where those cuts are coming from.

Now, it seems to me with this budget that you are saying that if you remove the payment of interest on our debt, then our spending would be less than the revenues we are raising.

Secretary RUBIN. That is right, Mr. Rangel. Had it not been for the interest on the debt, the vast preponderance of which was incurred during the eighties, we would be in a budget surplus position.

Mr. RANGEL. I think that everyone would admit that one of the most dramatic drives of our President and the administration has been to reduce the deficit that prior administrations have created.

Secretary RUBIN. I think that we have had an enormous accomplishment, beginning in 1993, in turning what I think could be fairly characterized as a fiscal mess into fiscal order.

Mr. RANGEL. So that when the administration decided to give a tax cut to middle-income families, it had to weigh that against continuing that policy of reducing the debt directly as opposed to a percentage of the——

Secretary RUBIN. No. There I would make a slightly different comment, if I may, Mr. Rangel. The judgment the President made was that there are many purposes that need to be achieved in an economic program if you are going to maximize economic growth and the wages of working Americans, and that the way to do that in this budget was to both continue the deficit reduction process and at the same time offer a tax cut.

Mr. RANGEL. Well, the tax cut costs about $63 billion.

Secretary RUBIN. Correct.

Mr. RANGEL. In the range of the people that would be the beneficiaries of it, do you have the average amount that a family will receive as a result of this middle-income family tax cut?

Secretary RUBIN. I don't, and in some measure it would depend, Mr. Rangel, on what they did. But I can tell you this: About 86 percent of the total tax cut package is aimed toward middle-income families, and I think—yes, we do have a chart that shows that. Families between $20,000 and $100,000 will receive——

Mr. RANGEL. That is a great breakout. But could you give me a guesstimate about what the average family will receive that is in the large size of that pie?

Secretary RUBIN. Well, I can tell you this: From the child tax credit alone, a typical family of four with an income of $50,000 will have their taxes decreased by about 20 percent. That is from that one tax credit. That is from one of the three components alone.

Mr. RANGEL. Well, I think that most of us who would prefer to have the deficit cut even deeper believe that the President's proposal on tax cuts is not going to have any direct impact on the economy, and it is not sufficient enough for the taxpayer to say thank you and that basically it is a campaign promise that he made and he wants to keep it.

Secretary RUBIN. No, I don't think I agree with that, Mr. Rangel. I think that for the families that avail themselves of these programs, I think that they will have a significant tax benefit. As I said, the child tax credit alone will be a 21-percent tax reduction for the average family of $50,000 with two kids.

But, more importantly, I think that what the President is doing is very important in terms of our future productivity and our future economic growth, because what he is doing is he is creating incentives for people to do things for themselves that will make them more productive and more effective in the modern economy.

It is really, I think, a very, very important set of incentives for people to do what is in their own interest and in the interest of the Nation.

Mr. RANGEL. Well, Mr. Secretary, I support the President's budget and want you to know that it is very easy for people like me to do this when we have this Contract With America hanging behind us. Thank you for your contribution.

Chairman ARCHER. Mr. Bunning.

Mr. BUNNING. Thank you, Mr. Chairman.

Secretary Rubin, there are so many questions, and I have so little time.

The budget for the current fiscal year is approximately $1.5 trillion. The President's proposal for spending is $1.612 trillion for fiscal 1996. The administration talks about the tough choices and how you had to make them to reduce the deficit.

Please explain to me and to the rest of the people how an increase of over $100 billion is a cut.

Secretary RUBIN. Mr. Bunning, I think you have to break the budget into pieces, and——

Mr. BUNNING. I do not want to do that. I want you to explain, answer the question.

Secretary RUBIN. I am in the process of explaining it, but I think to explain it, you have to break it into pieces.

On the discretionary side, we will have lower discretionary spending in each of the years of this budget than we had in 1995, which means not only is it lower in absolute terms, just absolute nominal terms, but if you adjust it for inflation, it obviously is a lot lower as time goes on; $100 today is not worth the same thing as what $100 will be 5 years from now. That was an enormously difficult accomplishment, and if you don't credit that, my suggestion, as I think I said before, is speak to the Secretaries who are now struggling with the need to accomplish what I have just said.

Now, spending keeps going up, because even if you get this piece under control—and getting this piece under control is a herculean task, and I think we have done an enormously effective job in doing it—you still have to deal with the question of health care expenditures. That gets us back to the very same point that Mr. Thomas and I were speaking about, and it is why I think the chairman's opening remarks are so welcome. It is absolutely essential that the administration and Congress join together to deal with Federal health care expenditures in the context of health care reform.

Mr. BUNNING. That is how you explain an increase of over $100 billion in spending, as a cut?

Secretary RUBIN. That is the analysis of our present budget situation. That is exactly right, Mr. Bunning. This is not a simple matter. The budget is a very complicated matter.

Mr. BUNNING. Sitting on the Budget Committee and sitting on this committee, we are very familiar with how tough it is going to be to get to 2002 and to balance the Federal budget, which we have made a commitment to do.

Let me ask you another question. If we run approximately $200 billion deficits in this range of 5 years—in other words, we are going to add $1 trillion to the debt—keeping in mind that the interest on the debt is approximately 16 percent of budget outlays presently, how long will it take for the interest on the debt to become the largest portion of our budget pie?

Secretary RUBIN. Actually, if we can stick with the deficit path that we outlined on the chart over here, where the deficit continues to fall as a percentage of GDP from the roughly 2.7 percent of our projection for the next year on down to 1.6 percent, what will happen is the debt will become a smaller and smaller percentage of GDP, and as a consequence, interest will become a smaller and smaller percent of GDP——

Mr. BUNNING. I didn't ask that question. I asked the question of how much—what percentage of the budget, not what percentage of GDP, what percentage of the Federal budget will be interest on the debt?

Secretary RUBIN. Well, if you can continue to bring the debt down as a percentage of GDP, then it seems to me over time what you will be able to do is start to bring interest down as a percentage of the total budget.

Mr. BUNNING. Doesn't it depend on how the interest rates are controlled and what interest rates we are paying?

Secretary RUBIN. Well, obviously, that comment assumes all other things being equal. Now, in terms of what interest rates are going to do—that is a very good point. In terms of what interest rates are going to do, if you stay on the path that we have suggested and if the deficit really does fall to 1.6 percent of GDP, I believe that you will have a very healthy interest rate environment.

I just came back from a G–7 finance ministers meeting this weekend in Toronto, and it was very interesting. We are viewed—and I think rightly so—as having gone from a fiscal morass to fiscal health.

Mr. BUNNING. I have one other question. I noticed in the budget that we just received there is no replacement for the $20 billion that the Federal Government has used out of the ESF, Exchange Stabilization Fund, to bail out the Mexican peso. Would that be something that you intended to do down the road? Or when are you going to charge off the $20 billion? We would like to hear the answer on that.

Secretary RUBIN. As we discussed, I think, in an earlier session, the Exchange Stabilization Fund is independent of the budget, and nothing that we are doing in Mexico, as a consequence, with the Exchange Stabilization Fund will result in any effect on the current budget.

Mr. BUNNING. In other words, you are not going to—you will not be required to replace that money?

Secretary RUBIN. The Exchange Stabilization Fund has been used with some frequency over time, and it has never had any budgetary effect. That is correct.

Mr. BUNNING. That is like our contribution to the IMF not having any effect, when it does.

Secretary RUBIN. Well, but once you have made the contribution to the IMF and it is in the IMF, then it does not affect the budget. Similarly here, what you have is a fund of money——

Mr. BUNNING. I asked a question about replacing the money.

Secretary RUBIN. We do not believe, Mr. Bunning, that what we are doing with respect to Mexico will create a situation in which we will be short of funds to accomplish the necessary purposes with respect to the dollar.

Let me say we were very, very, very careful, before proceeding with this proposal with regard to Mexico, to make sure that we had adequate funds in the ESF to continue doing what was necessary, if it does become necessary, with respect to the dollar.

Chairman ARCHER. The gentleman's time has expired. The chair is going to have to strictly use the time rules, because the Secretary, I believe, has to leave at 12:30. Is that correct?

Secretary RUBIN. It is, Mr. Chairman. But since I arrived a little bit late, what we are trying to do is postpone where we are going. We would really be very happy to stay with you.

Chairman ARCHER. I want as many members as possible to have the opportunity to inquire.

Mr. Jacobs.

Mr. JACOBS. Thank you, Mr. Chairman.

I want to begin with a public service announcement to all C–SPAN junkies. You probably heard the term "dynamic scoring," and it has just been discovered that Mae West, in one of her old movies, has defined that. She played the part of a teacher of elementary school children, and she took up math and said the following: "One and one is two. Two and two is four. Four and four is ten—if you know how to work it." So that explains dynamic scoring.

I want to say to the Secretary that I am one member——

Chairman ARCHER. Will the gentleman suspend for a moment? With all due respect to my good friend from Indiana, it is not in accordance with the House rules to speak to the television cameras or to the television audience, and I would ask all members hereafter to confine their remarks to the witness and to the members of the committee.

Mr. JACOBS. Thank you very much, Mr. Chairman. I withdraw the target and reincorporate my reference to the words. This is unfortunate because I was about to say that I am one member of the minority who agrees implicitly with our Republican chairman's questions concerning if not now, when, on balancing the budget. I have always believed that balancing the Federal budget would be about like the old Russian foreign trade policy: they exported the things they needed, and they imported the things they needed worse. If we would all give that some exercise, we might better define the distinction between need and want.

I have a nephew who has never wanted a Dairy Queen. He has always needed one. I think that we should all give some attention to that example.

In that spirit, Mr. Secretary, I only want to ask you about the child tax credit, whether it is the majority's or the administration's proposal. Does the Treasury Department have any calculations using the probability of—that may be dynamic scoring, too—the life span and the probability of the average income over that life span, how much each one of these children will end up paying in taxes, reflecting interest on the additional debt for the $500 credit for each one of them, depending on the age, 3, 5, 10, or whatever it is?

Secretary RUBIN. That is a very interesting question. The answer to your question is no, but analytically, that is a very interesting way to look at it. We have implicitly made a judgment. That is actually a very interesting way to frame that. We have implicitly made a judgment that the investment in the children today is worth more to those children than the savings that they would realize as a consequence of that much additional deficit reduction now over the course of their lives. That is how you framed the question. We have obviously implicitly made a judgment on that comparison of now and then, but we do not have numbers.

Mr. JACOBS. I understand.

Secretary RUBIN. But that is the right analytic framework, I think.

Mr. JACOBS. I understand your response and would accept it in the case of educationally disadvantaged children, where basic education is simply absent in the usually one-parent home and multichild home. I don't know that I could accept it in terms of people such as members of this committee. My wife and I have 5- and 3-year-old sons—the first time I was ever a father. No matter what our income is, we have a gift from God, the accident of having been born, each of us, in families where articulate English was spoken and where social grace was understood.

If you concentrated your help among those children who do not have that and, therefore, are condemned to a lifetime of ignorance because they cannot acquire the necessary linguistic skills, I would be applauding, even if the C–SPAN audience saw me doing it.

Secretary RUBIN. Mr. Jacobs, you actually, I think, would not qualify for our child care credit—not in any qualitative sense, but on an income basis, because we phase out——

Mr. JACOBS. I think that is true, but I did a little personal reference because somebody in my family, like my wife, might be watching this, and I just wanted to mention that. Probably not, Mr. Chairman, but maybe.

No, I am talking about the people who do qualify, obviously, for what you have proposed. I say if you would winnow the credit down to the children where it would make a difference in future income, then I would say that the credit is an investment and not, shall we say, a method of acquiring votes.

Chairman ARCHER. The gentleman's time has expired.

Mr. Houghton.

Mr. HOUGHTON. Thank you, Mr. Chairman.

Mr. Secretary, good to have you here. Mr. Secretary, just on a personal note, I came down here in January 1987, and I was convinced that it was sort of a stupid idea to have a law to defend you against yourself, because I thought we could balance the budget. But somehow we did not have the spine to do it, and so, therefore, reluctantly, I have joined the army of people who think that a balanced budget amendment is a good idea.

Now, I can understand your position that maybe a date certain isn't a magical figure. The thing that bothers me, however, is that the sustaining trends to get where we want to go—and this is incorporated in this year 2002—are not there. So we not only don't have a specific date, but we do not have a sustaining trend. According to your own testimony that what you expect is under a budget $200 billion in deficit of 9 of the next 10 years, that sort of bothers me. It is the trend that is important.

Secretary RUBIN. Mr. Houghton, we would agree with that analysis. I think where we would disagree, perhaps, is on the question of whether or not that trend is attainable without a balanced budget amendment.

Again, I would refer you to the chart that is on that easel. If the policy choices that we have made—and they are very tough policy choices—on the cutting of spending are implemented, then we will be on a path toward a balanced budget.

Now, if you add on top of that a program to deal with the entitlement that is really driving the deficit, which are the health care expenditures, I think that you will then find yourself on an even more effective deficit reduction path.

So I think it is within our ability to do this, and to do it without what we think are the very serious risks involved in a balanced budget amendment.

Mr. HOUGHTON. I know there are risks, and I think it is within our ability. But so far we really haven't been able to manifest that.

Since 1992, the last 2 years, the reason the deficit has gone down principally is because of the revenue increase, because, actually, spending has gone up during that period of time.

Secretary RUBIN. Well, I think you have really had two types of spending, and I think you have to look at them separately, Mr. Houghton. On the discretionary side, we really have gotten control of the budget, and that was an enormous accomplishment done at great cost. On the entitlement side, you are correct, and that is, once again, what drives us back to the need for health care reform.

I think if we are serious about the long-term deficit—and this administration, it seems to me, has manifested its seriousness at, in some ways, maybe great cost to itself. But we really have taken—I have said this before, but it is true—we have taken a fiscal morass and put ourselves in a position now where we are perceived, both in the markets and abroad, as being in a position of fiscal discipline.

If we are serious about going forward, I think we have to do two things: No. 1, go on the path on the discretionary side, which is outlined in this budget; and, No. 2, deal with health care reform.

Mr. HOUGHTON. Well, I think the fact that you are Secretary of the Treasury means an awful lot to the rest of the world. You create a great sense of leadership and stability.

However, when you take a look at what you said in terms of reducing spending, spending will not be reduced. If it is reduced, I don't see it in these figures, which, for 9 out of the 10 years, don't show any improvement.

Secretary RUBIN. Well, I don't mean to repeat myself, but spending on the entitlements side, you are right, has continued to go up, and it is going up at a rapid rate, and it will get worse because of demographics. It all drives us back to the same issue the President talked so much about in the last couple years—health care reform.

On the discretionary side, Mr. Houghton, I think we really have gotten this under control. We stabilize; we even bring it down some. At the same time, the economy is growing.

Mr. HOUGHTON. But, Mr. Secretary, the discretionary is only one part of it. Actually, it is one-third of the overall budget. Therefore, maybe a draconian move to have a date certain to force that trend line down in all spending is not such a bad idea.

Secretary RUBIN. Well, there I think is where the disagreement lies. It is our view that the hazards involved in an arbitrary date vastly exceed the benefits, and we think it far better and more sensible to engage in a deliberate and thoughtful process.

Mr. HOUGHTON. Thank you very much.

Chairman ARCHER. The gentleman's time has expired.

Mr. Shaw.

Mr. SHAW. Thank you, Mr. Chairman.

I would like to join my colleagues in welcoming you to this committee.

Secretary RUBIN. Thank you.

Mr. SHAW. In your testimony and according to your graph, you show that the deficit as a percentage of the GNP, gross national product, has gone down. I believe historically you will find that any year in which you have a substantial growth in gross national product because of increased revenue to the Federal Government and decreased expenditure in many programs, you will find that same phenomenon usually does exist in those particular years. Do you disagree with that?

Secretary RUBIN. Well, I think there have been times in the eighties where defense and other expenditures went up even though there was a growing economy. So I think actually that probably is—I would have to look back at the eighties, but I think that probably is not correct.

Mr. SHAW. Well, I——

Secretary RUBIN. I am not sure. We can look back at the eighties together at some point.

Mr. SHAW. I disagree with you, but a strong gross national product certainly favors revenue to the Federal Government, and it certainly favors decreased cost.

Secretary RUBIN. That is absolutely correct, and what this budget and I believe this administration has accomplished since we took office is to combine a period of economic growth with a period of real constraint on spending on the discretionary side. That is how we have accomplished the deficit reduction, and I think a very powerful deficit reduction, that has taken place and reversed the pro-

jections which really, I think, were quite alarming with respect to deficits that we inherited.

Mr. SHAW. In the area of welfare reform, how did you address that in the budget? I don't think that the President presently has a welfare reform bill. He had one last year. How did you handle that?

Secretary RUBIN. Welfare reform is not in the budget for the same reason that health care reform is not in the budget. It is a very complex area. It is an area on which we did put forth a bill last year. The bill was unsuccessful. The President made the judgment that the best way to proceed on welfare reform, which, as you know, has been a very high priority of his from the very beginning of this administration, is to work with Congress and, as the chairman said in his opening remarks, work with this committee to accomplish a very important purpose.

Toward that end, he had a conference a week or two ago—I have forgotten exactly when it was—to try to develop consensus around ideas in this area.

Mr. SHAW. Thank you. Thank you, Mr. Chairman.

Chairman ARCHER. Mrs. Kennelly.

Mrs. KENNELLY. Thank you, Mr. Chairman.

Mr. Secretary, as I travel around my district, one of the most attractive things that has been talked about this year is the tax deduction for education. Interestingly enough, I have been asked this question twice, and I thought it would be a good idea to ask you.

Evidently, the deduction is per family, not per child. It starts at $5,000 and eventually reaches a $10,000 deduction for tuition, not room and board.

Mr. Secretary, what happens if an individual has a family, divorces and has another family? This seems to happen. Evidently, this is a question in my district, so I am sure it is a question around the country. Would that individual be able to apply for two deductions, or would he have to allocate one?

Secretary RUBIN. That is an interesting question. Assistant Secretary Samuels, who is the Secretary for tax matters, says each family gets $10,000.

Mrs. KENNELLY. Well, that is going to relieve some people's minds. Thank you, Mr. Secretary.

Let me just go into another subject that I have had interest in over the years, and that is the EITC, earned income tax credit. I notice in the President's budget that he is suggesting that the Social Security numbers of those applying for the earned income tax credit be checked. Having been involved in this program for a number of years and having been very pleased when the President increased the EITC in his original budget, are we doublechecking this Social Security number because you found that we are dealing with fraud? If so, how much? Roughly, how much?

Secretary RUBIN. The President, as you know and as you said, has been a very strong advocate of the earned income tax credit, and it is part of this program of making sure that work pays for people as opposed to welfare. Really, in a sense, you could argue it is the first step in welfare reform.

The problem that we have run into—and the Treasury announced this some months ago; I have forgotten when it was—was

that there is a fraud problem with respect to the EITC, and it is one that needs to be dealt with. What this program was designed to do was to be part of that process.

There is a process going on in Treasury right now to determine exactly what the specifics of the problem are, and at an appropriate time, we will have a public discussion of that. But I think at the present moment, probably the best thing to say is that we identified a problem, discussed it publicly, and this is part of the approach to dealing with that problem.

Mrs. KENNELLY. Well, I was pleased to see you doing this, because I think this is a very good program. It keeps people off welfare. It keeps them in the working world. So I am glad you are doing this.

Tomorrow we are going to mark up a small piece of legislation having to do with the individual deduction for health insurance for the self-employed. One of the ways we are looking at paying for it is another piece of your budget, and I find this very interesting. It is for people who get interest and dividends above $2,500 a year; they will no longer be eligible for the earned income tax credit.

Now, Mr. Rubin, granted, we do have fraud in certain areas. Granted, things happen. Everybody isn't up front about some things that they do. But may I ask you, what percentage—do we really have a problem with the earned income tax credit and $2,500 of interest and dividends?

Secretary RUBIN. Let me tell you what the theory is, and it is a good question. The theory is that the EITC really should be reserved for low-income people and that if they have assets sufficient to generate $2,500 of unearned income, then they ought not to qualify for it. It is a very, very small percentage. Don't hold me to this, but I think it is something like 2 percent of the total number of EITC recipients.

Mrs. KENNELLY. Well, I thank you for that answer. I was afraid almost to ask the question, because I really think this is a good program. You are trying to do the right thing by doublechecking the Social Security numbers, but I would hate to think tomorrow in the markup when we start talking about interest and dividend that we would think this is a serious problem. It is 2 percent of those claiming——

Secretary RUBIN. I believe that number is correct. Let me just check.

Yes, Secretary Samuels confirms that it is correct.

Mrs. KENNELLY. Well, I salute the administration for finding the 2 percent.

Thank you.

Secretary RUBIN. OK.

Chairman ARCHER. Mr. Herger.

Mr. HERGER. Thank you, Mr. Chairman.

Mr. Secretary, if you could tell me, is the goal of the President to come up with a balanced budget?

Secretary RUBIN. The President generally tends to express it this way. He believes very strongly in fiscal discipline, which is why we did what we did in 1993, perhaps at considerable political cost to himself, and that his objective going forward is to work toward a balanced budget, and that is the point we have been discussing a

little bit here today, the chart that is still up there, plus the health care reform.

So the object is to work toward a balanced budget. I don't think there is any magic—I will speak for myself, but I know it is his view as well. There is no magic in exact balance. What there is enormous magic in is continuing to get the deficit down as a percentage of the total economy. That is the track we are on, and the next step is health care reform.

Mr. HERGER. The goal is not per se to come up with a balanced budget, but to work toward a balanced budget? I want to make sure I understand.

Secretary RUBIN. The goal is to have fiscal order, to continue to bring the deficit down as a percentage of GDP, and to work toward a balanced budget.

Mr. HERGER. Now, again, looking at the budget, it would appear that it is in the vicinity over the next 5 years of very close to $200 billion per year deficit spending. Is that correct, over the next 5 years?

Secretary RUBIN. What these projections show is that the deficit stays constant while GDP continues to increase, which, if you were running a private enterprise, is precisely what you would want to have happen so that your borrowing becomes a smaller and smaller and smaller percentage of your total income.

Now, if we can get health care reform effectively put in place, then you will see the deficit come down in absolute terms as well as a percentage of GDP.

Mr. HERGER. But in answer to my question, over the next 5 years the deficit will remain in the vicinity of $200 billion per year? That is what your numbers would indicate?

Secretary RUBIN. Yes, the percent——

Mr. HERGER. Which amounts to an additional $1 trillion, right, $1 trillion more debt in 5 years than we have now, which in turn is that much more interest on $1 trillion. Is that correct?

Secretary RUBIN. What you will find, as I said a moment ago, is that over the next 5 years the deficit in absolute terms stays, roughly speaking, constant while the economy continues to grow. Under those circumstances, I think what you will find is that the debt begins to come down as a percentage of GDP, which is a very healthy fiscal position for a country to be in.

Mr. HERGER. OK. That is not quite the question.

Secretary RUBIN. An enormous, just an enormous contrast to what happened during the eighties.

Mr. HERGER. But, yes or no, our debt will be increasing by almost $1 trillion over the next 5 years by your budget?

Secretary RUBIN. Well, my answer would be exactly the same as it just was, that we will have begun——

Mr. HERGER. The answer is yes; is that right? We will have $1 trillion more debt 5 years from now than we do now by the President's proposed budget, yes or no?

Secretary RUBIN. If we go ahead with the President's budget, which we obviously strongly believe we should, we will continue to address what we think is a very important problem, which is starting to get the debt down as a percentage of GDP, getting the deficit down as a percentage of GDP, and continuing the fiscal order in

this country which is recognized both in international financial markets and in the international—what I call the community of international finance ministers.

Mr. HERGER. Well, those people I represent find it very difficult to understand how an additional $1 trillion debt over 5 years is working toward a balanced budget, as you mentioned was the goal, even though not a balanced budget but working toward it.

Let me move on to another question, again, that was alluded to in some previous questions. The concern we have is just how serious is the President? I have a concern that the President and the administration are not very serious at all. We were talking about discretionary spending. We have pretty well stated that we are not touching, we are not working on our entitlements, which is really the area that is escalating in the President's budget. I believe you did mention that we were working on discretionary spending. But isn't it true that the administration cuts in discretionary spending are really within the areas of defense and really not nondefense?

Secretary RUBIN. We have a total discretionary budget. It consists of defense and nondefense. Defense goes down somewhat, and the nondefense piece goes up somewhat. But the fact is that if you put the two together on the discretionary line, what we have done is presented a budget where discretionary stays below the 1995 level for 5 years in a row. I would guess—and I don't know this because I haven't done this—that you would have a very, very hard time finding an equivalent period back a long way in American history.

Now our challenge is to get a hold of health care entitlements, and the way to do that is in the context of health care reform.

We can do this. We have presented a budget which really provides a way to continue moving dramatically toward a balanced budget if we could just add to our budget the health care reform effort.

Mr. HERGER. Well, I am not sure if you answered the questions I asked, but, anyway, I do thank you.

Chairman ARCHER. The gentleman's time has expired.

I couldn't help but think, Mr. Secretary, as you struggle with trying to answer these balanced budget questions, that, in fact, you are saying we will get to a balanced budget all in good time, all in good time, but not in my lifetime.

Secretary RUBIN. Well, could I characterize it a little bit differently?

Chairman ARCHER. Well, you have already couched it, I think, several times.

Secretary RUBIN. I have already done it. OK.

Chairman ARCHER. Mr. McCrery will inquire.

Mr. MCCRERY. Thank you, Mr. Chairman.

Mr. Secretary, you seem, at least to me, to be sending conflicting signals somewhat. On the one hand, you say we have a great budget here, and we ought to stick to it. Then on the other hand, you say, but we do need health care reform and welfare reform. You don't really want to stick with this budget for 5 years, do you?

Secretary RUBIN. What we would like to do is stick with this budget for 5 years, and then add to it two more programs: one, health care reform, and the other, welfare reform.

Mr. McCrery. OK. So you don't really want to stick with this budget. You want to have this budget, and then you want to do health care reform and welfare reform to bring the deficit down further. Is that correct?

Secretary Rubin. Well, you can use the words "stick with" any way you want, but we believe very strongly that this budget is a multifaceted response to the very complex problems of our economy. It gets us on a good path with respect to the deficit, and now we want to do two more things, the two that you have just mentioned.

Mr. McCrery. Right. So you would like to do more than is in the budget that you are presenting us today over the next 5 years?

Secretary Rubin. Yes. We have a very ambitious attitude toward economic issues; therefore, we have an ambitious budget, and, therefore, we have the ambition of going further with respect to health care and welfare reform.

Mr. McCrery. Well, I am glad that you have got that straight, because we want to do more than is in the President's budget to get toward a balanced budget. Some of us want to get to a balanced budget.

The bottom line is, though, you surely agree that we cannot achieve a balanced budget or even get close to a balanced budget unless we reduce the growth of the Medicare program and the Medicaid program.

Secretary Rubin. It is the President's expressed view, which he has talked about enormously in the last 2 years, that health care expenditures, Federal health care expenditures, have to be dealt with, but in the context of health care reform.

Mr. McCrery. Thank you.

Some of us are concerned—and maybe you can put me at greater ease than I am, but some of us are concerned that our vision into the future stops short of a real problem. When we are talking 5 years or even 10 years, we are not really looking at the long-term economic health of this country, because around the year 2015, 2016, 2017, we are going to have a dramatic turnaround in the income and outgo of the Social Security system.

It seems to me that if we don't get to a balanced budget some time fairly soon, and maybe even run a little surplus to buy back some of the publicly held debt to put us in a better position, financial position to deal with that turnaround in the second decade of the 21st century, then we are going to be depending on the rest of the world, basically, to finance our needs. That would put us in a not very desirable position.

Do you disagree with that assessment?

Secretary Rubin. Well, the President is very much focused on the long term. There was a very interesting article about 1 year ago in the New York Times that said a lot of the things the President is doing, and doing at tremendous political cost to himself, are things that will not pay off until well after his 8 years in office.

On the question of Social Security specifically, the projection, if I remember correctly, is exactly what you said. Somewhere around 2015 or thereabouts the balance changes, and then by 2030 you really run into the problem of not having enough funds. Clearly,

that is an issue—although it is well off in time—that is going to have to be dealt with at some point.

It is our view, and I think rightly, that that is going to have to be dealt with on a bipartisan basis after extensive public debate. It is, however, a fair bit out in time, and our suggestion would be that the much more immediate question on the entitlement side is health care and health care reform, which is why the President took the enormous political risk he took last year in that arena.

Mr. MCCRERY. Well, I was not talking about changing Social Security, although that is something future Congresses can address. We are all agreed we are not going to touch Social Security, so leave that aside. I am just talking about the economic consequences of the turnaround in the trust fund. Right now we are using $60 or $70 billion a year from the trust fund to pay for ongoing operations of Government, to put it simply. Around the year 2015, 2016 or so, that is not going to be available to us, and, in fact, we are going to be paying out more from the Social Security trust fund than we are paying in.

We are going to have trust fund balances sufficient to pay those, but, still, the operational side of government is not going to be in as nearly good a position as it is even today with our deficit.

Secretary RUBIN. Which is precisely why we feel—and I have a feeling we maybe share a view on this—that we have got to continue to get this deficit down and get to work on health care reform and do it as quickly as possible.

Mr. MCCRERY. Well, I agree, and I commend you for your efforts. I just hope that you will work with us to go further faster, because some of us think that if we don't do something soon, we are going to create an even bigger problem very early in the next century. We need to do something more dramatic than you propose in the next 5 years.

Secretary RUBIN. Let me say in the spirit of the chairman's opening remarks, we are very much looking forward to working with this committee on the whole range of issues that really are going to affect the future of this country.

Mr. MCCRERY. Thank you.

Chairman ARCHER. Mr. Levin.

Mr. LEVIN. Thank you, Mr. Chairman.

Someone said earlier that there was no spine in this institution. I think you have reason to have some pride in what was done the last years, and there were some with spines here. Something was done. But now sinners are preachers around here.

Let me ask you, in terms of percentage of GDP, it was 5.4 percent in 1985, a time of relative prosperity, reduced to 2.7 percent now, and projected to be 2.1 percent.

In 1 minute—pretend you are on television—explain to——

Secretary RUBIN. I am not allowed to do that.

Mr. LEVIN. I said "pretend."

Secretary RUBIN. Oh, pretend. OK.

Mr. LEVIN. Explain the significance of percentage of GDP represented by the debt. Really, in 1 minute, try to say it simply, because it is said that you cannot get that across.

Secretary RUBIN. To put it in maybe the simplest terms that I can think of, at least, if you have an individual with an income of

$100,000 and that individual borrows $1,000, that is a very prudent thing. It will not interfere with other activities the individual wants to undertake, and it doesn't in any way threaten the financial future of the individual.

If a person with an income of $5,000 borrows $1,000, they are in a horrendously different position, and I think that is probably an analogy that maybe is helpful when you think about the country as a whole.

Mr. LEVIN. Now let me ask you a question that manifests my concern about the level of the debt. I want to ask you a pointed question. The tax cut represents about $15 billion on the average in the next years. It also goes up the last years, like every other tax cut proposed around here. So, again, briefly, why is it more important to spend that $15 billion a year in a middle-class—that is the middle-class tax part of it—rather than reserving that or allocating it specifically for this vital goal of deficit reduction?

Secretary RUBIN. Mr. Levin, I think that is exactly the kind of policy debate that we should have in this country as we look at this budget. It was the President's judgment, I think very rightly, that the additional $63 billion of deficit reduction would have less beneficial impact than would a program that would have some offsetting effect on the declining real wages that too many middle-income Americans have had, and very importantly, that would give people incentive to save and to invest in themselves, their children, in education, and training. So the judgment is: Which of those two programs is better for this economy over the long run? The judgment he made was that the system of incentives and tax decreases that we put in place is the better use of that money. But that is a very good public debate to have.

Mr. LEVIN. Better for the middle-class families that the tax cut is aimed at, right? You can even narrow it down. For the typical middle-class taxpayer, which is better: to use that $15 billion—I use that because it goes up each year—for middle-class tax relief or to reduce the deficit? For the typical family in my district, that becomes the issue with the importance that is given to deficit reduction. In 1994, I proudly said I helped to reduce the rate of increase in the deficit. Now I have got to answer the question: Which is more important for these middle-income families?

Secretary RUBIN. I think what I would recommend, at least, or suggest is that the philosophy of this budget is we are doing both. We are continuing the process of deficit reduction that began in 1993, and we are also making a judgment with respect to the $63 billion that you are talking about, that for middle-income families, they over time will become more productive and benefit more economically and, therefore, the Nation will benefit more economically by spending the money in the way that we are on these incentives for education, for training, for child care and so forth, than by an addition to the deficit reduction of that amount of money.

Mr. LEVIN. Thank you.

Chairman ARCHER. Mr. Hancock.

Mr. HANCOCK. Thank you, Mr. Chairman.

The President's budget has a projected 5.5-percent increase for this next fiscal year. The projection for GDP increase is what?

Secretary RUBIN. For which year are you talking about now?

Mr. HANCOCK. For this next fiscal year.

Secretary RUBIN. For 1996 we are projecting a 2.5-percent increase in real gross domestic product.

Mr. HANCOCK. A 2.5-percent increase in GDP and a 5.5-percent increase in the budget. It seems to me that a few years ago there was an effort started here on the Hill to control the increase rather than looking at GDP and what have you, but to control the increase to around 4 percent. In fact, I think it was called the 4-percent solution, then the 2-percent solution.

My question to you, Mr. Secretary, is: How can we continue—I mean, regardless of what we do, if we project the gross domestic product to increase 2.5 percent, and then we submit a 5.5-percent increase in the budget—I mean, we cannot keep doing that.

Secretary RUBIN. Well, what we need to do—and I believe this budget does do it, and that really was the purpose of this chart, to show that if you implement a budget that is designed the way this budget is, it will get at exactly the question you are raising, which is bringing the deficit down as a percentage of GDP—in nominal terms. So if you are stating that is your objective, we would be in absolute agreement with that.

Mr. HANCOCK. But I still think that we need—are going to have to take bigger steps in this next fiscal year's budget than what has been presented. I think some way we have to get it back in line with the people's ability to pay. That is why some of us supported on the balanced budget amendment a percentage limit of GDP as an expense, as part of the balanced budget amendment.

Secretary RUBIN. You used a very interesting expression, and it is probably one I should have used in response to Mr. Levin's question. It is ability to pay that maybe explains best why deficit as a percentage of GDP is really, I think, the most economically sensible way to look at the deficit. Your ability to pay for any given amount of deficit, or if you are an individual, any given amount of personal debt, is obviously greater the greater your income. So what we have tried to do—not tried, I believe what we have done is to put in place a budget which will continue to bring down this deficit-GDP ratio; in other words, continue to improve the ability of the Nation to pay for the deficit in any given year.

Mr. HANCOCK. The fact remains that people pay the total cost of government. That comes out of personal income. That is the only place it can come from. Yet we don't really have any studies on that because we don't have any figures on what total personal income is less Government transfer payments. Government transfer payments build up the totals of personal income, but we don't even know for sure what those figures are. That is one of the things that I would like to see us in some way start looking at.

Secretary RUBIN. Well, I think we can give you in writing a submission on personal income and transfer payments. I think we can actually be of some help to you in that respect.

Mr. HANCOCK. I would like to have that information.

Thank you, Mr. Chairman.

[The following was subsequently received:]

The attached table provides detail on the composition of personal income for the latest three years. The great bulk of the transfer payment component of personal income represents transfer payments by government, both Federal and state and local. Such government transfer payments represented 16.5 percent of total personal income in 1994.

The figures are taken from the National Income and Product Accounts for the United States. The figures are printed in various issues of the Survey of Current Business published by the Commerce Department.

COMPOSITION OF PERSONAL INCOME IN RECENT YEARS

	Billions of dollars			Percent of Total		
	1992	1993	1994	1992	1993	1994
Personal income total	$5,154.3	$5,375.1	$5,701.7	100.0	100.0	100.0
Wage and salary disbursements	2,974.8	3,080.8	3,279.0	57.7	57.3	57.5
Other labor income	328.7	355.3	381.0	6.4	6.6	6.7
Proprietors' income with inventory valuation and capital consumption adjustments	418.7	441.6	473.7	8.1	8.2	8.3
Rental income of persons with capital consumption adjustment	(5.5)	24.1	27.7	(0.1)	0.4	0.5
Personal dividend income	161.0	181.3	194.3	3.1	3.4	3.4
Personal interest income	665.2	637.9	664.0	12.9	11.9	11.6
Transfer payments to persons	860.2	915.4	963.4	16.7	17.0	16.9
Old-age, survivors, disability, and health insurance benefits	414.0	444.4	473.5	8.0	8.3	8.3
Unemployment insurance benefits	38.9	33.9	23.3	0.8	0.6	0.4
Veterans benefits	19.3	20.1	20.1	0.4	0.4	0.4
Government employees retirement benefits	109.9	118.7	126.9	2.1	2.2	2.2
Other transfer payments						
Aid to families with dependent children	23.3	23.9	24.2	0.5	0.4	0.4
Other	254.9	274.4	295.3	4.9	5.1	5.2
Less: Personal contributions for social insurance	248.7	261.3	281.4	4.8	4.9	4.9
Addendum						
Government transfer payments to persons	837.8	892.6	939.9	16.3	16.6	16.5
Total personal income less government transfers	4,316.5	4,482.5	4,761.8	83.7	83.4	83.5

Source: National Income and Product Accounts of the United States

Chairman ARCHER. Mr. Ramstad.

Mr. RAMSTAD. Thank you, Mr. Chairman.

Secretary Rubin, good to have you here today at the hearing. I think former Democratic Senator Paul Tsongas enjoys widespread bipartisan support, certainly in this body, as he does across the country. I think he put it best in commenting on the budget when he talked about the annual deficits of nearly $200 billion yearly for the rest of the decade in the budget. He said, "It is obvious the Clinton administration gave up the ghost on a balanced budget." I continue the quote of Senator Tsongas, "That is a pretty devastating fact of life."

I think that is pretty devastating for people where I come from. I know it is very devastating for people where I come from, and I think it is very, very unfortunate that there isn't an attempt to balance the budget. I think if anything derived from the message of November 8, the election, was that people want us to get our fiscal house in order.

For 26 years—and certainly there is enough blame to go around, historically—but for 26 years, since 1969, we have not had a balanced budget from the Federal Government. I think it is a national outrage. Then you come up and say we will get to a balanced budget all in good time. You are quoted today in the Washington Post as saying you do not want to have an arbitrary time by which the budget has to be in balance.

Well, Mr. Secretary, with all respect, it seems to me the American people want and deserve a balanced budget, and it seems to me a greater effort should be made.

Having said that, by your own Office of Management and Budget figures, the debt will increase from $5 to $6 trillion, which is an increase of 20 percent, by the end of 1996. If I heard your testimony correctly today, you said the debt will go down as a percentage of GDP.

Well, do you actually think that GDP will go up by more than 20 percent, therefore?

Secretary RUBIN. No, but as long as you have the deficits—let me go back to the first thing you said, though, because I think it is very important, with respect to Mr. Tsongas.

With all due respect to Mr. Tsongas, I don't think there is any question—we agree with you. The American people want their fiscal house in order, and I don't think that there is any question but that this President in the first 2 years of his administration has manifested an enormous commitment to fiscal order. In fact, I could make the argument that it was the enormous commitment to fiscal order and the things that we did to reverse what really had been a fiscal morass that may have cost a fair bit politically.

Having said that, we are now on the right road, and this budget is designed toward keeping us on the right road and getting this budget down in the manner that I described.

Mr. RAMSTAD. What year will we see a balanced budget pursuant to this plan?

Secretary RUBIN. I think it would be a very serious error of economic policy to have an arbitrary date for a balanced budget for the reason that I said. I don't think that you can feel any more strongly than I do about fiscal order. But I think that the issue

that we are debating—and it is a good debate—should you have an arbitrary date, with all of the economic rigidities that that creates, including loss of the automatic stabilizers, the risk that I first became very troubled about when somebody first talked to me about a balanced budget amendment, which is trying to squeeze into a preset arbitrary period all the reduction that you would need to take place to reach the balanced budget, when you did not know what the economic circumstances were going to be like.

So I think that the hazards, the macroeconomic hazards, the economic hazards, the risk of creating slow growth or even recession by working toward an arbitrary date make that a very unsound economic policy. I think what is a sound objective is the one that I think you and I would agree on, which is fiscal order and continuing to move toward a balanced budget.

Mr. RAMSTAD. Well, Mr. Secretary, with all respect—and I do have a lot of respect for your expertise and your experience, your background and your education, you would certainly qualify as an expert witness were we in a legal proceeding. Therefore, I could ask you the question: Would you speculate, would you guess that it would happen in our lifetime? I think we are about the same age.

Secretary RUBIN. I think I feel somewhat older—not as a consequence of this proceeding, just my last 2 years—I think my speculation would be as follows, that we have a President who is enormously committed to fiscal order and that we will continue to move on this track as aggressively as makes economic sense, and particularly so if we can work together toward the common objective of health care reform.

Mr. RAMSTAD. Again, Mr. Secretary, with all respect, I think your response underscores the need for the balanced budget amendment. We have heard this line for 26 years in this country, and again historically there is enough blame to go around on both sides of the aisle, and we understand that. However, that was then and now is now. We have got to balance the budget, and I just hope the amendment passes.

Thank you.

Chairman ARCHER. Mr. Secretary, we are going to take a break now and go to vote, and hopefully that will give you some time to stretch your legs and loosen up your back and relax a little bit. We will be returning after the vote, as soon as we can get back.

Let me simply say before we do leave, though, that I have a real problem with your analogy of a family whose income is going up and, therefore, it is OK to borrow more each year. You increase your debt because your income is going up, and as long as your income is going up more than the increase in your debt, everything is OK.

The problem is that in the real world things do not go up forever, and when a correction occurs, you are left with this tremendous mountain of debt. Debt which you said it is OK to keep increasing as long as you do not increase it as much as your increase in earnings. Then you are left high and dry with the inability to be able to service that debt when times are lean. I am concerned that we as a country are a combination of families where things will not go up automatically all the time, and that we had better start think-

ing about taking our increase in earning capacity and reducing our debt, rather than continuing to see it go up.

If you want to respond in 30 seconds, I will go and vote.

Secretary RUBIN. My 30-second response, Mr. Chairman, is that we would share your objectives. I think the difference may be in how we get there and how we balance those objectives against other objectives. But we would share your objectives.

Chairman ARCHER. The committee will stand in recess.

[Recess.]

Mr. ZIMMER [presiding]. Could you please be seated. I have been instructed by the chairman to get started without him, in the interest of time.

Secretary Rubin, you have said a number of times today that the principal reason why the deficit numbers start tailing up again in the outyears is because of the problem of health care, and that if we enact health care reform, that will be the way to bring the deficit down toward zero.

Are you aware of the fact that the CBO, Congressional Budget Office, in the last Congress calculated that if the Clinton health care plan were enacted, it would in fact increase the deficit rather than reduce it?

Secretary RUBIN. We submitted a comprehensive health care plan, and what you said is correct. When they scored it or evaluated what it would cost, they said it would increase the deficit. It was not our judgment, but our response to that was that we would reconfigure it so that we would accomplish deficit reduction, and we in fact did do that so that we would have a plan that would accomplish deficit reduction.

Having said that, the brief I was making was not for the plan that we put forth last year, although I think that plan was structurally very sensible. But that is neither here nor there. It was not a brief for that plan. It was a brief for working with Congress to accomplish health care reform.

Mr. ZIMMER. Do you have any idea on how we can reform health care in a way that actually reduces, rather than increases, the deficit, and how that would differ from the plan that was originally scored by CBO?

Secretary RUBIN. We have had a process going for quite some time in the administration focusing on the question of health care reform. We have a lot of thoughts that we think are worth pursuing with Congress. It was our view, and I think rightly, that the way to do this is really to work cooperatively with Congress, not get out ahead of Congress. I think the appropriate thing to do is to engage in this structure with the members of this committee and others who are involved with health care and work these out together, rather than my coming out and putting forth proposals once again, or ideas which could once again interfere with that process.

Mr. ZIMMER. Mr. Secretary, I would suggest that you not rely so heavily on health care reform as the reason why the budget cannot be balanced, if the one specific plan that was put forward by the President would have increased the deficit, and if the administration is not prepared to submit another one.

Secretary RUBIN. Mr. Zimmer, I think that the plan that we put forth, I think it would have resulted in deficit reduction, particu-

larly in the outyears when health care entitlements start to increase. In its first iteration when we first put it forth, you are absolutely correct in your observation. The Congressional Budget Office disagreed with us on some numbers. What we did then was to reconfigure the plan so that we would accomplish even by their standards deficit reduction in the outyears. But that was all for naught, because it did not get adopted in Congress.

Mr. ZIMMER. I would like to follow up on a question that Mr. Ramstad put to you about whether in fact the national debt is going to decrease as a percentage of GDP as a result of your program. As he summarized it, the debt is going to go up by 20 percent in 5 years. In order for it to be a lower percentage of the GDP, the GDP would have to go up at least more than 20 percent. How do you account for that?

Secretary RUBIN. I should have responded. I apologize. We got caught up in another subject, and I apologize for not responding.

The debt, as you say, would increase by something in the neighborhood of 20 percent. GDP in that period, if GDP grows at the rate we projected, which is a real increase of 2.5 percent—and that, as you know, is after adjustment for inflation—that comes out to about, if you have an inflation rate of 3 percent, which is roughly what we are projecting, that would give you 5.5 percent per annum, so that is 27.5 percent over a 5-year period.

I apologize for not responding when he asked the question.

Mr. ZIMMER. Thank you.

One final issue. We have debated in this room and elsewhere what the eighties really meant and what lessons can be learned from it. It seems to me we are now starting a similar debate about the nineties. You have said that it was the interest rate reductions that took place during the Clinton administration that accounted for the economic recovery. What was the interest rate on the long bond when President Clinton was sworn into office?

Secretary RUBIN. The interest rate on the long bond, that is 30-year government, was roughly 7.7 percent, which is roughly where it is today.

Mr. ZIMMER. What was it 1 year before that?

Secretary RUBIN. I can describe what happened. I do not remember the precise rate, but I will tell you what I at least think happened, and I spent 26 years running very, very large trading operations, so it is something I know a touch about.

I think what you saw happen was interest rates come down, long-term rates come down, rather, during the years of the prior administration, because we were wallowing in what was effectively a virtually no-growth or very low-growth economy. I think what happened is they came down to about as low as they would have gone, and we still had a very large deficit premium in long-term rates.

Then the Clinton administration began working on a deficit reduction program and that started to get into the public domain, not through our release really so much, as to some extent through leaks and some extent through I guess some discussions as to what we were doing. The markets believed for the first time in a long time there was going to be discipline with respect to the deficit, and then rates came down to something under 6 percent in 1993,

and they then came back up. When they came back up, it was not because they had a deficit premium. It was because we were growing, and so the 7-percent rate you have today is a very, very different interest rate than you had in the end of the last administration.

Mr. ZIMMER. But was not the economy growing fairly rapidly at the end of 1992?

Secretary RUBIN. Well, what actually happened is you had a fairly good first quarter, you had two quite poor quarters, and then the fourth quarter was strong. But it is very interesting, if you look at the fourth quarter and break it down, what you find is that the first month was not particularly good, and the second 2 months were very good.

The other interesting thing is that the consumer confidence index jumped remarkably in the last 2 months, and I believe that what happened is that there was this general sense of morass and slow growth and lack of fiscal discipline and all the rest that was burdening the economy, and that with the election of the President, there was a sense of change and that in turn, as evidenced by the consumer confidence index, improved the general mood and that in turn fed into the economy.

Mr. ZIMMER. So the bottom line is that when interest rates go down, even when they go down in somebody else's administration, it is because of Bill Clinton. But when they go up, it is not?

Secretary RUBIN. No, I think the bottom line is that you need to look not only at what interest rates are doing, but why they are doing it, and that is what people in markets spend their lives doing is trying to figure out not only just very simply what the rate is doing, but why did it do it. In this case, I think what you had was the restoration of a sense of fiscal discipline and that caused rates to go down, and now they have come back up with growth.

Mr. ZIMMER. Well, if you had a budget that you proposed to us with a plan for getting to a balanced budget by the year 2002, do you believe that would reduce interest rates as a result?

Secretary RUBIN. Well, I think that would depend on a lot of circumstances. But I think if we did what you just hypothesized, I do not think that you would get—this is my view—I do not think that the macroeconomic impact of trying to compress all of that deficit reduction into a preset arbitrary period is worth the risk that it exposes the economy to. Obviously, to the extent that you have the deficit going down and you have a negative macroeconomic impact, that can get offset by lower interest rates.

My judgment, for whatever it is worth, is that the lower interest rates would not generate enough activity to offset the negative impact of arbitrarily getting down to a balanced budget by 2002 under many circumstances that you hypothesize. So I do not think it is worth taking the risk of being arbitrary. I think we should do it year by year.

Mr. ZIMMER. Regardless of whether it is worth taking the risk, you do think that it probably would reduce interest rates?

Secretary RUBIN. Oh, if we had a recession, it would reduce interest rates. But the object is to get interest rates down by virtue of fiscal discipline, not by virtue of slowing down the economy or, even worse, having a recession.

Mr. ZIMMER. Thank you very much.

Mr. Kleczka.

Mr. KLECZKA. No questions.

Mr. PAYNE. Thank you very much, Mr. Chairman.

I noticed as you were making the presentation and looking at these charts that the deficit has been reduced 3 years in a row, which is the first time since Harry Truman was President that we are able to say that. I also noticed that, as a share of GDP, the chart that is being shown now, that the budget has been cut in half since 1992, again the budget deficit as a percent of GNP.

My recollection, as I was thinking about my time on the Budget Committee in the 102d Congress when Mr. Darman came and talked to us about OMB and projections at that time, the last projection I remember seeing for the years 1997 and 1998 were that we would have a budget deficit that would be close to $400 billion. Would you comment on that as the starting point from which you and the administration began this process?

Secretary RUBIN. Mr. Payne, your recollections are correct. We were in Washington in December 1992 during the transition, and I guess in early January, and beginning to prepare the President-elect's economic program, and we had a sense of what we would try to accomplish, how we would balance one thing against another. Then the last numbers of the prior administration came out and I remember calling the President-elect—he was in Little Rock at the time—and saying the projections are far worse than anybody expected and it looks to us as if they amount to a $400 billion deficit in 1998.

His reaction was our first priority has to be to get our fiscal house in order. If we are now facing those kinds of deficit prospects, we have to have a plan that is correspondingly effective on deficit reduction. The result is the program that we began in 1993 will continue in this budget—and we will take that same year you just mentioned, Mr. Payne, 1998—and instead of having a $400 billion deficit, the one that was projected based on the last numbers of the prior administration, we have a projected deficit of roughly $193 billion or less than half of the previously projected number.

Mr. PAYNE. I think we can look at a lot of progress, and I was one of those who participated in the 1993 deficit reduction package. I think certainly that could be pointed to as one of the things that has happened that in fact allowed us to be able to say today for the third year in a row, we reduced the budget deficit.

I am also one of those who has sponsored the balanced budget amendment and feel that we need to work toward balancing the budget by a date certain, in the year 2002. As we have held hearings on the Contract With America, I have been concerned about some of the projections that we have seen relative to some of the cost of the elements of the contract. I believe the Joint Tax Committee has just come out with some estimates that say the cost will be roughly $200 billion over 5 years and $700 billion over 10 years. Do your own numbers confirm that?

Secretary RUBIN. Mr. Payne, as part of our responsibility to deal with issues of tax policy, we evaluated the Contract With America when the tax proposal was first put forward, and our judgment on the 10-year numbers was something like—I think it was a little

over $700 billion. I have forgotten the exact number, $720 billion or some such number, and we were criticized for having arrived at such a number.

We now have observed that the Joint Tax Committee has come up with approximately the same number, a shade over $700 billion. Yes, our numbers which originally were criticized by some turn out to be almost the same as the Joint Tax Committee. Both are estimating that the Contract With America tax provisions will cost a little over $700 billion over a 10-year period.

Mr. PAYNE. In the budget we are looking at today, over a 5-year period, middle-income tax cuts savings provisions amount to roughly $63 billion. If we had the provisions of the Contract With America in lieu of these provisions, that number would not be $63 billion, but, rather, $200 billion and, consequently, we would need to find another $137 billion in additional cuts in order to be at the same place that your budget is as it relates to the deficits in the outyears. Is that a correct assumption?

Secretary RUBIN. Yes, the answer to the question, Mr. Payne, is that accords with our numbers. Of course, it raises the question, since we all seem to agree that the President certainly said this, and I think there is general agreement, that all tax cuts have to be fully paid for and without using unusual budgetary practices, how this is going to get paid for. How ours is going to get paid for is very clear. It is in the budget. We have specific budget cuts.

Mr. PAYNE. So the task we will be faced with on this committee is looking at many of these provisions, many of which are very desirable, but in the light of knowing that we will have to find an additional $137 billion in cuts over and above the President's budget in order to stay at precisely the same place?

Secretary RUBIN. Well, that is to stay in the same place. But if you also want to accomplish deficit reduction, as we thought was imperative and as we did, of course, then you have to find considerably more than the amount that you have just mentioned.

Mr. PAYNE. Thank you very much, Mr. Secretary.

Mr. ZIMMER. Mr. Johnson.

Mr. JOHNSON. Thank you, Mr. Chairman.

Mr. Secretary, you kind of used the words "deficit" and "debt" interchangeably.

Secretary RUBIN. I do not believe I did. They are obviously very different concepts.

Mr. JOHNSON. We talk about the debt going up in precise dollar numbers. How much is it going to go up in your budget?

Secretary RUBIN. Under our budget, as I think I discussed before with—I have forgotten which member it was now——

Mr. JOHNSON. I do not think you ever answered him.

Secretary RUBIN. What I said was that under our budget it will begin, not to go too far, but we will begin for the first time in a long, long time to get the debt down as a percentage of the total economy.

Mr. JOHNSON. As a percentage, but what is the exact number? It has gone up over $1 trillion, to be truthful, has it not?

Secretary RUBIN. It will go up in absolute terms, but if I may say so, Mr. Johnson, if you as an individual or if you were a business entity looking at your debt, I think what you would look at is how

well is it covered, in other words, how large is it relative to your ability to service it. The answer to that question in the context of a nation is what is your debt relative to your GDP.

Mr. JOHNSON. I think you would find in business that people are going into bankruptcy, chapter 11, trying to figure out how to get out of the position that we have got ourselves. We are not doing that. We are not even addressing the problem.

Secretary RUBIN. I know a fair bit about business. My instinct would be to think that if we were a business, we would be enormously critical of what we did in the eighties and what we would be trying to do now is just continue to get our debt down as a percentage of our total income.

Mr. JOHNSON. You also spoke about health care being a problem. I do not think the numbers are there to indicate that health care by itself, to quote a Perot phrase, "will fix itself." So what else do you propose to bring the debt and deficit down?

Secretary RUBIN. Well, if you were to adopt the program that we put forward, then, as the budget book shows, you get the deficit down by the year 2005 to 1.6 percent of GDP. The only items in the budget that are of major consequence that are growing faster than the rate of inflation are the health care expenditures, so I do think that is the area that we should be focusing on. If we can accomplish something there, you can really get yourself in the position that many of you all believe in and that we believe in, which is to get an even more rapid rate of decrease in the deficit as a percentage of the total economy.

Mr. JOHNSON. It surprises me that you all did not discuss that at all.

Also, you talk about, well I think you called it wallowing in fiscal discipline—causing the interest rates to do what you described. Does that mean you do not have fiscal discipline now?

Secretary RUBIN. No. What I said was that in my view rates came down in the early nineties because of a broad-based feeling that we were not only wallowing in a period of very slow growth, which we were, but that that was likely to continue for a long time.

I think what happened in very early 1993 is that the financial markets began to see a seriousness about fiscal discipline they had not seen in a long time, and that then took the deficit premium largely, not totally, I do not think, but largely out of long-term rates, so then rates started to go down again, but for a different reason. Now rates have come back up, but they have come back up reflecting growth, which is what you want. What you want is a system where the deficit premium is largely out of long-term rates. Rates go up when you are growing fast, they go down when you are growing more slowly, and then you have a system that works.

Mr. JOHNSON. Do you see it slowing down right now?

Secretary RUBIN. It is our projection and judgment that the economy will grow at something like 2.4 or 2.5 percent over each of the next 2 years, and that, as you know, is——

Mr. JOHNSON. For the long term, and you expect interest rates to continue up?

Secretary RUBIN. Well, let me say what our projection is on interest rates. Our projection on long-term interest rates is that interest rates this year in 1995 will average 7.9 percent. Given the rates

are below that now, I suspect in a fiscal sense that may turn out to be a conservative assumption, and then we assume rates will come down to about 7 or 7.1 percent on the long side.

Mr. JOHNSON. Thank you very much, sir.

Thank you, Mr. Chairman.

Mr. ENGLISH [presiding]. Thank you.

Mr. Secretary, I have a couple of brief questions. First, with regard to the extension of the R&E tax credit, which I believe in your testimony you indicated the administration would be receptive to, with the qualifier that it be revenue neutral. I applaud your willingness to go on record in support of the extension. My question for you is can you offer us any detail in how you might be prepared to pay for it?

Secretary RUBIN. Our view on the R&E tax credit, which, as you know, the President has been in favor of all through his administration——

Mr. ENGLISH. I understand.

Secretary RUBIN. —is that it is a tax credit that has bipartisan support, and what we need to do is sit down with the members of this committee and the Senate Finance Committee, but I guess primarily this committee in the first instance, and determine how to pay for it, much as we did with GATT last year. As you may remember, there was broad-based bipartisan support for GATT. The question was how to pay for it, and we sat down with the relevant committees and worked out a way to pay for it.

Mr. ENGLISH. We have discovered in the course of our hearings on tax policy that there is some consensus among the experts that because of our tax structure in this country as it applies to business, particularly as it is imposed on our manufacturing sector, you can make a very powerful argument that our workers are put at a competitive disadvantage with respect to many of the other workers in countries across the globe who are laboring in different tax climates. Do you share that view, Mr. Secretary?

Secretary RUBIN. I think rather than answer it in that most general sense, tell me a little more specifically what you have in mind.

Mr. ENGLISH. I was actually looking for generality. A couple of people that we have had testify have suggested that, taken as a whole, given the tax structure as it is imposed on—let us take manufacturing, to be specific—that our workers in those industries are at a competitive disadvantage because of the tax structure.

Secretary RUBIN. My instinct would be to think not. A study was released recently—and I think it was McKinsey, but do not hold me to that, but I think it was, which is a very highly respected consulting firm—that reported that, for the first time in a long time, our industry was the most competitive in the entire world, so that——

Mr. ENGLISH. That would be based on quite a few factors.

Secretary RUBIN. Yes, it would be based on many factors, I absolutely agree with that.

Mr. ENGLISH. My own view, and I suspect my experience is considerably less than yours, is that American workers are at some kind of a competitive disadvantage. I noted in your testimony, and I want to applaud you on this, that you take considerable credit for the administration for the fact that business investment has increased and that there is an increased investment specifically in

machines and buildings. I think those sorts of investments protect the jobs of American workers in a dynamic and increasingly competitive international marketplace.

The question I am moving toward is would the administration, provided it would be deficit neutral, be supportive of some additional tax incentive for investment in capital equipment, whether it be neutral cost recovery—and we have heard testimony from the administration expressing some concerns on the design of that tax credit—or some other similar tax break? Again, assuming it does not balloon the deficit, could the administration be supportive of that kind of tax benefit?

Secretary RUBIN. A neutral cost recovery proposal, which we have looked at and analyzed, in our view, and my view personally, has an enormous cost and it seems to me exceedingly unlikely to produce benefits commensurate with the costs. Beyond that, it is hard for me to comment on something in quite that hypothetical a stage, but we would be happy to discuss any proposal that comes from members of this committee, if those are proposals that are designed to be helpful to the economy.

Mr. ENGLISH. Do you feel it should be a priority of the committee to consider an affordable tax break to encourage capital investment, specifically in manufacturing and, shall we say, specifically in smaller manufacturers?

Secretary RUBIN. I think the best thing that this committee can do in terms of investing in manufacturing is to continue on a path of fiscal discipline, because, as that chart shows, investment in equipment and machinery—it was not buildings, by the way, it was equipment and machinery—is at an all-time high.

So I think we need to keep on the deficit track that we have put ourselves on or at least that this budget would put us on. We did in fact in the 1993 budget put forth expensing for small business, and it is something the President very much favors. I suspect that if there was a desire to increase that, and if we do it in revenue neutral fashion, that is something we would very much be interested in discussing.

Mr. ENGLISH. You would specifically say that you would be receptive to our looking at the section 179 expensing for small business?

Secretary RUBIN. Tell me what 179 is, and I will give you an answer. That is the expensing for small business?

Mr. ENGLISH. Yes.

Secretary RUBIN. That is right, I remember that. I had forgotten the number. I know the concept.

I think if you were to look at it and come to us with a proposal that was revenue neutral, then that is something we would be interested in discussing. The President originally wanted to have $25,000, and it turned out we have $17,500 or some such number, because that was the resolution we made with Congress.

Mr. ENGLISH. Thank you for your openmindedness. We appreciate your testimony today.

I would now like to recognize Mr. Cardin who will inquire.

Mr. CARDIN. Thank you, Mr. Chairman.

Secretary Rubin, thank you for your testimony. It has been a long morning for you between the Senate and the House, and we

thank you very much for your patience and for your service to our country.

It is also refreshing to see that the predictions that were made in 1992–93 when you were working up the economic plan, following up on Mr. Payne's questioning, have really been consistent to what you present now 2 years later, and that the economic plan that you brought forward with the Clinton administration has in fact reduced the growth of our deficits, as was predicted.

I also remember very vividly listening to President Clinton's predictions that if we did not do health care reform, that much of the progress on deficit reduction would be lost, that Medicare and Medicaid and the entitlement programs were the fastest growing part of the budget, and we had to get health care reform under control if we were going to deal with the deficit and get it back to a balanced level.

I really do applaud you, because, yes, we could have irrational Medicare cuts in here, but, as I understand it, the administration is taking the position that it is not rational just to cut Medicare and shift the cost to private payors or to wreck the program that provides seniors with their health care, that that would not be a rational economic program to bring forward. So you have deferred, I assume, Medicare to when we get to health care reform, and I think that is obviously the right way to proceed.

If I might, let me get to what you have done on spending, on discretionary spending. How much growth do you allow during this period in discretionary spending?

Secretary RUBIN. Mr. Cardin, in this budget we project discretionary spending in each of 5 years after 1995 that is at a lower level than it was in 1994. So what you actually have is you have I think $555 billion in 1995, is my recollection of the number, and every year thereafter you have a lower number with respect to discretionary spending.

If I recollect correctly, in the last year of that 5-year period it is $549 billion. Not only is it lower, though, in nominal terms, but if you think of it in an inflation adjusted sense—after all, $100 today is worth a lot more than $100 5 years from now, because of inflation—so in an inflation adjusted sense, it is less by a lot more than it is in the pure nominal sense that I have just described.

Mr. CARDIN. So what you have brought forward is even larger cuts than what we call a hard freeze, no growth, no inflationary adjustment. That is the most aggressive attack on spending I think any administration has brought forward.

Secretary RUBIN. Mr. Cardin, I think we need to look, and we will look, to see what it looks like. My guess would be that it has been a long, long, long time since anybody has put forward a budget with realistic projections that project discretionary spending being lower in the 5 years of the budget than it was in the year preceding that.

I will tell you, to get there has taken a lot of tough, tough cuts, because we not only, as I said a moment ago, are having discretionary expenditures below the current year, but we lose because of the effects of inflation each year, and so that makes the cutting process even tougher.

Mr. CARDIN. I appreciate that, because it is very difficult to have a freeze. We have not been able to do that in too many years, actually hold the line on discretionary spending in this country, and I applaud you for bringing forward a budget that actually goes below a hard freeze, and on inflated dollars it is much more dramatic progress on reducing spending in this country. That has not been the case. We have not seen prior administrations bring anything like that forward.

It is interesting to point out that we have a lot of rhetoric from members of this committee about reducing the deficit, and yet I do not know of any proposals that have been made from the other side of the aisle at all on spending cuts to get us anywhere close to what your budget does in deficit reduction. We have a lot of specifics on tax cuts, but we do not have anything specific on spending cuts that will give us the type of deficit performance that you have brought forward.

I hope we can reduce the deficit more aggressively, but let us come forward with specific recommendations on spending cuts, rather than these generalities that it would be nice to reduce the deficit.

Thank you.

Mr. ENGLISH. Thank you.

Mr. McDermott will inquire.

Mr. MCDERMOTT. Thank you, Mr. Chairman.

I want to thank you for coming and for your testimony. As you notice now, all the Republicans have left, especially the ones who were badgering you about not being here early, so I guess they could not wait to hear the answers.

I just want to ask one parochial question. Bonneville Power Administration is not on the sale list of this budget, as I understand it. Is that correct?

Secretary RUBIN. That is correct, Mr. McDermott.

Mr. MCDERMOTT. You are talking about a public corporation, but not privatizing the Bonneville Power Administration.

Secretary RUBIN. We do not plan to sell the Bonneville Power Authority.

Mr. MCDERMOTT. I want to ask one other thing. Everybody talks about this balanced budget, and I know you know more than I do about money. You know way more than I do about money, but I have a feeling that what is being attempted here by these people who say they are going to balance the budget by the year 2002 is simply not good public policy. Certainly it is politically possible, but it is not good public policy.

The Joint Tax Committee yesterday, I think, came out with numbers of about $750 billion that would be needed to pay for the tax cuts. Do those figures square pretty much with what the Treasury has put out?

Secretary RUBIN. Yes, Mr. McDermott. We originally estimated that the Contract With America would result in something over 700 billion dollars' worth of costs or increase in deficit which would have to be made up through whatever programs determined it is to be made up with. We were somewhat criticized at the time for that number, but the Joint Tax Committee has now come up with a number of something in excess of $700 billion that these Contract

With America tax cuts will cost, so roughly speaking corresponds to our own numbers.

Mr. MCDERMOTT. The members who are pushing this are blithely going along, as Mr. Cardin suggests, talking about what we will be able to do, that we will be able to do it.

My mother watches C–SPAN and she is 85 years old, and she does not really understand all of how the Federal budget is put together. It would be helpful I think for all of us to understand what really has to go into reaching 750 billion dollars' worth of cuts.

Secretary RUBIN. Let me go at it just a little bit differently, if I may, Mr. McDermott. I think the problem that we have with the balanced budget amendment and having an arbitrary date by which you must balance the budget, as opposed to really tough-minded fiscal discipline where you each year make a decision based on what seems to be in the best interest of the economy that year, puts you in a straightjacket, and then you have to do what the balanced budget amendment requires, regardless of economic circumstances. In our opinion, that is a dangerous position to be in.

Now, if you take the arbitrary date of 2002, we have estimated that if you take the tax cuts you have just mentioned, plus that which is requisite to meeting balance, it is going to cost you about $1.6 billion. I do not know quite how you get to that.

Mr. MCDERMOTT. To $1.6 trillion?

Secretary RUBIN. Yes, $1.6 trillion. The $1.6 billion we could figure out—$1.6 trillion. I do not know how you get there other than to either decimate the discretionary side of the budget, that is to say education and training and Head Start and the programs that we think are critically important to the future of this country, or decimate defense or impose very substantial reductions on Medicare and Social Security. Those are your choices. There are no other choices, because that is the budget.

Mr. MCDERMOTT. My mother lived through the depression. Let us say a depression occurred internationally in the next 5 years. What would that do to the straightjacket that you have then put the country into?

Secretary RUBIN. Well, my view—and I suspect this may correspond to your mother's, if she remembers the Keynesian economists of that last depression—my view is that what would happen is that we would be in a position where you have a depression that vastly increases the deficit and that deficit under ordinary circumstances would then be stimulative, and so it would bring you back out of the depression.

In fact, Mr. McDermott, with those automatic stabilizers—that is what they are called, in effect, you ought never really get into a depression, because as the economy slows down and the deficit starts to widen as a consequence, that deficit is stimulative and so that brings you back out of your slow growth or out of your recession.

Mr. MCDERMOTT. That is what Franklin Delano Roosevelt was doing with the Public Works Administration and all the construction and all that sort of thing.

Secretary RUBIN. Precisely, that is exactly what happened during the——

Mr. MCDERMOTT. So it actually increased the deficit during a recession?

Secretary RUBIN. Right, which is what you want to have happen, because the increased deficit will generate more economic activity and get you back out of the recession. The problem with the arbitrary date of 2002 is that if you go into a recession and you have that arbitrary date, you can't have those deficits, so, instead, you have to cut the deficit and that worsens the recession, that increases the deficit again, and then you have to cut that. What you really do is put yourself on a track toward either a horrendous recession or possibly something that could be called a depression.

Mr. MCDERMOTT. Can you reassure us that there will be no events that will require from a fiscal policy the increase of the debt in the next 5 years?

Secretary RUBIN. I do not think, Mr. McDermott, anybody in the world could give you that assurance, and I think that is the problem with getting ourselves into arbitrary dates. It is why we so strongly advocate fiscal discipline accomplished through very careful, thoughtful, tough-minded decisions each year as to what we can accomplish in the context of the circumstances of that year.

I really do believe that an arbitrary date and a balanced budget amendment are dangerous public policies. I might add, as just an additional comment, that if one does feel that one wants to have a balanced budget amendment considered, then it seems to me what you should say to people is, if you are going to have a balanced budget amendment and balance by an arbitrary date, these are the cuts you are going to have to make, and then somebody could see whether the cuts that have to be made to get there by 2002 are worth getting to in an arbitrarily balanced budget by 2002. That is the way the debate should be framed, in our judgment.

Mr. MCDERMOTT. Even with that, it would be risky, because you do not know what the factors will be between now and the year 2002.

Secretary RUBIN. Mr. McDermott, I think it is bad economic policy, period. But if you can get past that issue, which I would not get past, because I think it is bad policy, then it seems to me to say to people, to get there, we are going to have to do this to Social Security or that to Medicare or whatever the things are, defense or education or whatever, and then they can judge whether that tradeoff is worthwhile.

Mr. MCDERMOTT. Thank you very much.

Mr. ENGLISH. Thank you very much, Dr. McDermott.

Thank you, Mr. Secretary, for your lengthy testimony today, as always, most eloquent. We appreciate your presence here.

Secretary RUBIN. Thank you, Mr. English.

Mr. ENGLISH. This committee stands adjourned until 10 a.m. tomorrow morning.

[Whereupon, at 1:27 p.m., the hearing was adjourned, to reconvene on Wednesday, February 8, 1995, at 10 a.m.]

PRESIDENT'S FISCAL YEAR 1996 BUDGET

WEDNESDAY, FEBRUARY 8, 1995

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, D.C.

The committee met, pursuant to call, at 10 a.m., in room 1100, Longworth House Office Building, Hon. Bill Archer (chairman of the committee) presiding.

Chairman ARCHER. If our guests will take seats, please, we will commence. The Secretary is on a tight schedule, and we would like to proceed expeditiously.

Today we welcome the Honorable Donna Shalala, Secretary of HHS, Health and Human Services. Welcome back to the committee. You were here earlier this year. Without a doubt, this year is going to be a challenge for you, your department, and for us here on the Ways and Means Committee.

At the end of it all, I hope we will have turned that challenge into unquestionable success, for us and the government, the people that we serve. In the near future, the committee will begin markup of the welfare proposals that are part of our Contract With America, and this is going to be a sweeping change in the way our country provides assistance to low-income populations.

It will change not only the policy but the operation of your agency over at HHS. All of us want to make sure that it is good social policy and a system that your department can administer.

I can assure you that we are going to be working with you to reach that outcome. The Speaker has asked me and my colleague, Mr. Thomas, to look into transforming Medicare, taking a creative approach not solely to reduce costs but to design a program for the 21st century, not the sixties. We are going to need your help and that of your excellent technical staff in that endeavor.

Thank you again for joining us today. I am pleased to recognize Pete Stark for the opening statement of the minority.

Mr. STARK. Thank you, Mr. Chairman.

I am pleased to welcome Secretary Shalala for a discussion of the President's budget for fiscal year 1996. The President has chosen to keep reductions, happily, in Medicare to a minimum. The result is keeping Medicare savings to $140 million in 1996, and $9.8 billion over the next 5 years, a record that we in a bipartisan sense in the past have been able to achieve without disrupting the system through the cooperation of the then-minority, and the Republican and Democrat administrations over that period of time.

The President's approach is the correct approach. For 30 years, we have been working successfully to uphold the true contract with Americans, and that is Medicare. We have not and will not agree to breaking that contract in order to finance a Republican tax cut for the wealthiest people in this country.

The President has endorsed this approach in his budget, and we intend to follow his lead in protecting Medicare from mindless budget cutting. That is not to say we shouldn't work to reduce the growth rate in Medicare.

This committee proposed last year in its health reform bill several cuts, and we maintained the solvency of Medicare. It is required that we do so. But mindless slashing of Medicare will only disrupt the health services on which America's seniors depend and will have a ripple effect into the entire health delivery system of this country.

It is the vulnerable parts of the health system, inner city and rural hospitals, teaching hospitals, centers of excellence, children's hospitals, all stand on the brink of destruction if we were to follow the Republican budget proposal and not the President's cautious and conservative proposal.

It makes sense to reform the health care financing system comprehensively, shoring up financing where it is needed and reducing financing where we can. That is the sensible way. It is more sensible than the Republican social policy, which is to give everything you can to the rich and find a way to pay for it by impacting the poor.

I know the Secretary joins me in resisting that policy, and we will work with you, Madam Secretary, to protect the most vulnerable people in this country, as your department has done for so many years. Welcome to the committee.

Thank you, Mr. Chairman.

[The prepared statements follow:]

Statement of the Honorable Pete Stark

February 8, 1995

Mr. Chairman, I am pleased to join in welcoming the Secretary of Health and Human Services for a discussion of the President's budget for fiscal year 1995.

I am very pleased that the President has chosen to keep reductions in Medicare to a minimum. The result is to keep Medicare savings to $140 million in FY 1996 and to $9.8 billion over the next five fiscal years.

The President's approach is the right one. For 30 years we have been working successfully to uphold the true contract with America -- Medicare. We have not and will not agree to breaking that contract in order to finance today's Republican tax cuts for the wealthiest. The President has endorsed this approach in his budget, and I intend to follow his lead in protecting Medicare from mindless budget cutting.

That is not to say that we should not work to reduce the growth rate in Medicare, as this Committee proposed last year in its reported health reform bill. Maintaining the solvency of Medicare requires that we do so. However, mindless slashing of Medicare will only disrupt the health services on which America's seniors depend. It is the vulnerable parts of the health system, such as inner city and rural hospitals, which bear the brunt of that approach.

It makes far more sense to reform the health care financing system comprehensively, shoring up financing where needed, and reducing financing where we can. That is the sensible way to reach the goals we share. I want to work with you Madame Secretary to do just that.

Thank you, Mr. Chairman.

STATEMENT OF REPRESENTATIVE JIM RAMSTAD
WAYS AND MEANS COMMITTEE
HEARING ON CONTRACT WITH AMERICA
February 8, 1995

Mr. Chairman, I appreciate the opportunity to speak with Secretary Shalala about the health care provisions in President Clinton's 1996 Budget.

As I mentioned to Secretary Rubin yesterday, I am disappointed in the President's newly-released budget.

President Clinton missed an excellent opportunity to work with Congress on significant deficit reduction. As the President explained last year, we will never reduce the massive budget deficit without stemming the astronomical rise in federal expenditures on health care.

I believe we must fundamentally restructure the system currently in place to finance these public health programs. The private sector has gone through dramatic changes in recent years, resulting in significant control of the rise in health care costs. It is essential to bring similar changes to public health programs.

Mr. Chairman, thanks again for calling this hearing. I look forward to hearing Secretary Shalala's testimony and to exploring in greater depth this important issue.

Chairman ARCHER. Madam Secretary, we would be pleased to receive your oral testimony. If you have a lengthier written testimony, all of it without objection will be inserted in the record.

You may proceed.

STATEMENT OF HON. DONNA E. SHALALA, SECRETARY, U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES

Secretary SHALALA. Thank you very much, Mr. Chairman, and members of the committee. Thank you for giving me the opportunity to appear before you to discuss the President's 1996 budget.

We believe this budget is another bold step toward fulfilling the President's commitment to put people first, and to address the long-term challenges facing this country. The Health and Human Services budget request is $716 billion, a 7.5-percent increase over the 1995 budget.

The increases in the entitlement budget represent 98 percent of our overall budget growth. Our budget for discretionary programs is $37 billion, an increase of $1.5 billion or 4 percent over last year.

This budget reflects the core values of the Clinton administration. We believe government must focus on the everyday needs of American people. We believe government should empower people to take greater responsibilities over their own lives. We believe that local communities know what their problems are and that they should be the driving force in fixing them.

We believe that certain jobs now done by the Federal Government should be turned back to the States. But we also believe that some issues require leadership at the Federal level.

We believe that there is an important role for the Federal Government in protecting the elderly, the disabled, and children, in conducting basic scientific research and ensuring that all of our children receive immunizations and a head start in life.

We are fundamentally changing the way the government works to serve the American people better. In our 1996 budget, we look seriously at our discretionary programs to find opportunities to cut spending, to seriously consolidate services, and to do more with less.

In fact, we reduce categorical programs in this budget by 22 percent departmental wide. We consolidate 108 PHS activities into 16 performance partnerships to give States greater control, greater flexibility, and greater accountability.

We reduce funding for 69 programs, taking them below the levels approved by Congress in the 1995 budget. We froze an additional 57 program activities at their 1995 levels.

These savings are real. But they don't represent the full scope of our achievement in reducing the deficit. The most dramatic success story in this budget is our ongoing effort to reduce the rate of growth in health-related entitlement programs.

We are now finding that for the period 1994–98, spending on entitlements is likely to be a whole lot less than it was projected to be when the President took office in 1993. To be precise, $212 billion less. I mean billion with a "B."

For the first time since 1988, the anticipated growth in Medicare and Medicaid dropped below double digits, from 12.7 percent a year

to 9.5 percent—the chart here shows that drop—reducing our expected deficit and the debt burden we leave to future generations.

I would like to take 1 minute to talk about several factors contributing to reduction in the projected growth of Medicare and Medicaid. In 1993, this administration worked successfully with the Congress to enact the largest deficit reduction bill in history.

This tough spending program was designed to reduce projected deficits by $500 billion over 5 years. Because the economy has responded so strongly, experts now predict our deficit will drop by more than $600 billion.

The President's economic program has curbed both the general and health care inflation. That has built a framework for our improved picture on entitlement spending, and we have been working hard to make sure that that picture doesn't change.

We appreciate and noted the bipartisan support Congress gave to the 1991 legislation on taxes and donations, which limits inappropriate Medicaid financing schemes used by the States. Today we are working in partnership with the States to narrow those loopholes. That saves us money.

We are aggressively managing our Medicare and Medicaid programs, replacing five underperforming Medicare contractors over the past 2 years, and we are waging an all-out attack on waste, fraud, and abuse.

In 1994 our Inspector General helped recover and save $5.4 billion in Medicare and Medicaid. Across the Department, we have recovered and saved more than $8 billion.

That is the largest amount ever in the history of the Department in 1 year. In addition, last year coordinated efforts among our Inspector General and several other Federal and State agencies yielded the largest single health care fraud settlement in history, totaling a record of $379 million. These are major accomplishments. But the American people deserve more.

We will intensify our assault on waste, fraud, and abuse. To accomplish this we are considering as part of Reinventing Government II a new innovative program with stable and reliable funding. We will focus our efforts on parts of the country where the problem is the greatest, on those activities that achieve the most effective results.

We are also changing the way Medicare and Medicaid work to improve quality, to promote efficiency, to lower costs, and give the American people more health care choices.

More and more States are taking advantage of new opportunities to offer managed care programs under Medicaid. More and more health plans and individuals are choosing the managed care option under Medicare.

Last year, Medicaid had a 63-percent increase in the number of Americans enrolled in managed care plans, from 4.8 million people in 1993 to 7.8 million in 1994. In addition, the number of older Americans choosing managed care through the Medicare program grew by 16 percent, from about 2.7 million people in 1993 to more than 3.1 million in 1994.

We expect it to grow by another 20 to 25 percent next year.

Managed care's emphasis on prevention and primary care is cost effective, and particularly for Medicaid customers, much less expensive than reliance on emergency health services.

We note that American people appreciate being able to choose managed care options, and we are committed to preserving and enhancing those choices. Our commitment to expanding health care options extends beyond the Medicare and Medicaid programs, and that is why the President has asked both Democrats and Republicans in Congress to work with him to expand insurance coverage for the American people, and to contain health costs for families, businesses, and governments.

There are many other exciting things to say about health care, but for now, I would like to turn to another equally important service, Social Security. We have got a great story to tell here, too. Our Social Security Administration has completely overhauled the way it does business, providing better and faster service.

By the end of 1996, people will no longer have to wait 100 days or more for disability claims to be processed. We will have cut the time by one-third. At any time, no matter how old you are, you can write to find out how much you have contributed to Social Security, and obtain an estimate of your potential monthly benefits when you retire.

We will tell you promptly, in words that make sense. I know, because I did it myself.

The SSI program has received a lot of attention lately, and we are working to reshape this program to better serve both taxpayers and those it was intended to help: disabled children and their families. Among other things, we have appointed a Childhood Disability Commission headed by former representative Jim Slattery.

Just a few weeks ago, I had the privilege of appearing before this committee to discuss another issue, welfare reform. Since that time, we have all been encouraged by the bipartisan commitment to overhaul our broken welfare system, as evidenced by the President's recent working session on welfare reform and the ongoing work of this committee.

As the committee prepares to mark up its legislation, this administration looks forward to working with you to move Americans from welfare to work.

Mr. Chairman, I believe that we are standing at an important crossroads in American history. The American people are frustrated with government, and they want real change. They have challenged us to join hands to make government work better, to make it cost less, and to reflect the core values of our country. Over the last 2 years, that is just what we have done.

Throughout our department we have enhanced customer service and achieved real results. For example, immunization rates for preschool children are now at their highest in American history. We have granted more health care and welfare waivers than any other administration. Head Start is improving its quality and serving more children than ever before.

At the National Institutes of Health, we have made critical breakthroughs in basic medical and science research, in areas ranging from AIDS to breast cancer, from sickle cell anemia to the Human Genome project. We look forward to working with you to achieve even more.

I greatly appreciate the opportunity to testify before you this morning and I would be happy to answer any questions.

[The prepared statement follows:]

STATEMENT OF DONNA E. SHALALA, SECRETARY
U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES

Good morning. Mr. Chairman and members of the Committee. Thank you for giving me the opportunity to appear before you today to discuss President Clinton's 1996 Budget.

This budget is another bold step towards fulfilling the President's commitment to put people first and address the long term challenges facing this country.

The HHS budget request is 716 billion dollars, a 7.5 percent increase over the 1995 budget.

Increases in the entitlement budget represent 98 percent of our overall budget growth.

Our budget for discretionary programs is 37 billion dollars, an increase of 1.5 billion dollars or 4 percent, over last year.

This budget reflects the core values of the Clinton Administration:

We believe that government must focus on the everyday needs of the American people.

We believe that government should empower people to take greater responsibility for their own lives.

We believe that local communities know what their problems are -- and they should be the driving force in fixing them.

We believe that certain jobs now done by the federal government should be turned back to the states ...

... but we also believe that some issues require leadership at the federal level.

We believe that there is an important role for the federal government in protecting the elderly and disabled, conducting basic scientific research, and ensuring that our children receive immunizations and a Head Start in life.

We are fundamentally changing the way that government works to serve the American people better.

In our 1996 budget, we looked seriously at our discretionary programs to find opportunities to cut spending, consolidate services, and do more with less.

In fact, we reduced categorical programs by 22 percent department-wide.

We consolidated 108 PHS activities into 16 Performance Partnerships to give States greater control, flexibility, and accountability.

We reduced funding for 69 programs, taking them below the levels approved by Congress in the 1995 budget.

We froze an additional 57 program activities at their 1995 levels.

These savings are real -- but they don't represent the full scope of our achievements in reducing the deficit.

The most dramatic success story in this budget is our on-going effort to reduce the rate of growth in health-related entitlement programs.

We are now finding that, for the period from 1994 to 1998, spending on entitlements is likely to be a whole lot less than it was projected to be when President Clinton took office in 1993.

212 billion dollars less, to be precise.

Yes, that's "billion" with a "b."

For the first time since 1988, the anticipated growth in Medicare and Medicaid dropped below double digits -- from 12.7 percent a year to 9.5 percent, for the period from 1994 to 1998.

Since the 1993 projections, anticipated growth in Medicare has dropped from an average of 11.9 percent per year to an average of 9.9 percent per year from FY 1994 to FY 1998.

That reduces projected expenditures by 79 billion dollars over five years.

Expected growth in Medicaid has fallen from 13.9 percent per year to 8.7 percent from FY 1994 to FY 1998. That results in projected spending that is 133 billion dollars lower over the same five-year period.

And this difference goes straight to the bottom line, reducing our expected deficit and the debt burden we leave to future generations.

I'd like to take a minute to talk about several factors contributing to the reduction in the projected growth of Medicare and Medicaid.

In 1993, this Administration worked successfully with the Congress to enact the largest deficit reduction bill in history.

This tough spending program was designed to reduce projected deficits by 500 billion dollars over five years.

And, because the economy has responded so strongly, experts now predict that our deficit will drop by more than 600 billion dollars.

The President's economic program has curbed both general and health care inflation.

That's built the frame for our improved picture on entitlement spending.

And we've been working hard to make sure that picture doesn't change.

We appreciate the bipartisan support Congress gave to the 1991 legislation on taxes and donations, which limits inappropriate financing schemes used by states.

Today, we're working in partnership with the states to narrow those loopholes -- and that saves us money.

Our aggressive management of the Medicare and Medicaid programs is also keeping spending in check and improving program efficiency.

Over the past two years, we've replaced five underperforming Medicare contractors.

And our oversight of the other Medicare contractors has resulted in more efficient provider payments.

We're also waging an all-out attack on waste, fraud and abuse.

In 1994, our Inspector General achieved more than 1,500 successful prosecutions and administrative sanctions in Medicare and Medicaid -- which, combined with legislative and regulatory

changes -- helped secure 5.4 billion dollars in savings for the American people.

And, across the Department, we recovered and saved more than 8 billion dollars -- that's the largest amount ever by HHS in one year!

In addition, last year, coordinated efforts among our Inspector General and several other federal and state agencies yielded the largest single health care fraud settlement in history.

A firm with more than 60 psychiatric hospitals agreed to pay back the Federal government a record 379 million dollars.

These are major accomplishments -- but the American people still deserve more.

We will intensify our assault on waste, fraud and abuse. To accomplish this, we are considering as part of Reinventing Government II, a new innovative program with stable and reliable funding.

We are also going to focus our efforts in parts of the country where the problem is greatest -- and on those activities that achieve the most effective results.

But that's not the only part of the Medicare and Medicaid programs that we are reinventing.

We have approved more health care waivers than any other Administration, providing states the flexibility to address their own health care issues with their own solutions.

We're also changing the way Medicare and Medicaid work, to improve quality, promote efficiency, lower costs, and give the American people more health care choices.

More and more states are taking advantage of new opportunities to offer managed care programs under Medicaid.

And, more and more health plans and individuals are choosing the managed care option under Medicare.

Last year, Medicaid had a 63 percent increase in the number of Americans enrolled in managed care plans -- from 4.8 million people in 1993 to 7.8 million in 1994.

In addition, the number of older Americans choosing managed care through the Medicare program grew by 16 percent -- from about 2.7 million people in 1993 to more than 3.1 million in 1994.

And we expect it to grow another 20 to 25 percent next year.

Managed care's emphasis on prevention and primary care is cost-effective, and, particularly for Medicaid customers, much less expensive than a reliance on emergency health services.

We know the American people appreciate being able to choose managed care options -- and we are committed to preserving and enhancing those choices.

Of course, our commitment to expanding health care options extends beyond the Medicare and Medicaid programs.

That's why the President has asked both Democrats and Republicans in Congress to work with him to expand insurance coverage for the American people, and to contain health costs for families, businesses and governments.

There are many other exciting things to say about health care. But for now, I'd like to turn to another, equally important service: Social Security.

And we've got a great story to tell here, too.

The Social Security Administration is completely overhauling the way it does business -- providing better and faster service.

By the end of 1996, you will no longer have to wait 100 days or more for your disability claim to be processed -- we will have cut that time by a third.

At any time, no matter how old you are, you can write to find out how much you have contributed to Social Security and obtain an estimate of your potential monthly benefits.

We'll tell you, promptly, in words that make sense.

I know -- because I did it myself.

The SSI program has received a lot of attention lately -- with allegations about parents using their children as pawns to rip off the system and cheat the taxpayers.

In May of 1994, our Inspector General completed a study of about 600 cases of children receiving SSI because of behavioral or learning problems.

The Inspector General found no evidence of widespread coaching by parents.

But, even one case is too many -- and that's why we are taking strong steps to stop these abuses once and for all.

Among other things, we've appointed a Childhood Disability Commission, headed by former Representative Jim Slattery.

I have asked them to complete their report as quickly as possible and recommend ways that we can reshape the program to better serve both taxpayers and those it was intended to help: disabled children and their families.

In addition, the Administration is conducting its own review of all our disability policies to assure strong, efficient protection of people with disabilities.

* * *

Just a few weeks ago, I had the privilege of appearing before this committee to discuss welfare reform.

Since that time, I have been encouraged by the bipartisan commitment to overhaul our broken welfare system -- as evidenced by the President's recent working session on welfare reform and the on-going work of this Committee.

As the committee prepares to mark up its legislation, this Administration looks forward to working with you to move Americans from welfare to work.

Mr. Chairman, I believe we are standing at an important crossroads in American history.

The American people are frustrated with government -- and they want real change.

They've challenged us to join hands to make government work better, cost less, and reflect the core values of our country.

And, over the last two years, that's just what we've done.

We've made accountability the watchword of this department by consolidating programs, slashing administrative costs, and cracking down on waste, fraud, and abuse.

We've granted more health care and welfare waivers than any other Administration -- thereby giving states and local communities the flexibility to solve their own problems.

We've enhanced customer service in countless ways:

For example, we have improved our home and community-based long term care programs ...

... and we have brought Medicare and Medicaid into the 21st century with cost-saving, state-of-the-art technology that will empower people to make more informed choices about their health care.

Throughout our department, we've demanded quality and achieved real results:

Immunization rates are at their highest in history.

Head Start is improving its quality and serving more children than ever before.

And, at the NIH, we have made critical breakthroughs in basic medical and scientific research in areas ranging from AIDS to Breast Cancer and from Sickle Cell Anemia to the Human Genome Project.

We're proud of these accomplishments -- and, we look forward to working with all of you to achieve even more.

I greatly appreciate the opportunity to testify before you this morning. I'd be happy to answer any questions. Thank you.

Chairman ARCHER. Thank you, Madam Secretary. I am going to yield my time for questioning to Mr. Crane.

Mr. CRANE. Thank you, Madam Secretary.

How does the projected rate of growth for Medicare and Medicaid compare with the cost of coverage in the private sector?

Secretary SHALALA. It is ahead of the private sector, and there is no question about that. The only point that I was making here was that it is starting to come down, and that is because of legislation that was passed, the impact of bringing down the deficit, the slowdown in inflation, the private sector beginning to slow down, particularly the large corporations who are negotiating tough deals with hospitals. So there are lots of things going on.

But we still are very much above private sector growth and health care costs. We deal with different populations, Congressman Crane.

Mr. CRANE. Is it the different populations you are dealing with that create that disparity in costs in the private sector versus Medicare and Medicaid?

Secretary SHALALA. The difference between the growth in the government programs and growth in the private sector is the result of a combination of factors. From 1984 to 1993, for instance, the Medicare growth per enrollee was less than the private sector. Starting in 1994, we are ahead of the private sector. But the slowing down of growth rates that I reported today means that we are getting on top of some of the things that were happening, including the creative use of provider taxes and other kinds of things by the States which the Congress closed down.

It would be too early to say that we are going to get down to where the private sector is because of the difference in population. Remember, the health care programs in the government deal with long-term care for a highly vulnerable population. We are the major providers of health care to the disabled, to the severely disabled. We have the elderly population.

So one should expect some changes, but we also can demand real discipline in the management in the programs, in our anticipation of how the programs work. I think the efforts that have been made are reflected in the baseline starting to come down.

Mr. CRANE. I know there is an effort being made in the private sector to streamline, figure out how to economize. I was wondering if there are any other changes in Medicare to attempt to replicate some of that streamlining and cost cutting in the private sector that are being contemplated.

Secretary SHALALA. Yes, sir. Our consolidation of our computer systems, the better management of the private insurance companies that are managing the Medicare program, doing real analysis on what is happening to home care costs, there are lots of things going on within the Medicare program.

The movement of people in both Medicare and Medicaid to managed care, while in Medicaid it may produce some savings, in Medicare it has not yet produced the kinds of savings we would like to see. We have a lot more to learn about managing that program. So there is a lot of work to be done.

But the kinds of things the private sector is doing are helping public sector programs at the same time. It is, however, not helping

the smaller markets, the small business people who don't have the kind of clout that the large corporation does coming in to negotiate. So the context still has to be comprehensive health care reform.

We can do only so much to reduce costs through managing these programs. Comprehensive health care reform, reducing the number of people who are walking into emergency rooms, that are not getting preventive care, dealing with long-term care issues—there are a lot of things in cost containment that have to be part of a comprehensive effort, and that is why the President still believes that in a bipartisan way, we ought to sit down and work on comprehensive health care reform.

Mr. CRANE. Does HCFA provide unlimited latitude to States in dealing with the Medicaid question, to in effect put those folks into managed care or health maintenance organizations?

Secretary SHALALA. We have worked closely with a number of States who wish to move their beneficiaries into managed care. I think if you spoke to the Governors across the country, they would say there has been a new atmosphere in terms of our relationship.

I recently talked to a Governor who wanted to move many of his beneficiaries into managed care, and he said that the questions he got back from HCFA which made him reshape his strategy but stick with his goal were extremely helpful. His staff hadn't thought of them, and he liked the going back and forth of working through the waivers. So I think we have a healthy relationship with the Governors, and they know that we very much want to work with them on these issues.

Mr. CRANE. One final question. Medicare part B is a very expensive welfare program. Initially at its outset my understanding is 50 percent was paid by the individuals, and that that is down to about 31 percent today.

In your estimation, should that be raised back to the 50-percent figure?

Secretary SHALALA. We have favored the deal that was cut with the beneficiaries at around 25 percent, which we think is fair. But again, any review of the payment mix ought to be part of a comprehensive effort to review health care programs, because what we are all trying to do is to hold down the cost of health care in the public sector without shifting it onto the private sector, to be fair to beneficiaries.

The mix of what beneficiaries pay is very much a fairness issue. Our only plea is that we do all of this within the context of overall health care reform so we don't have the health care costs popping up in the private sector because we have shifted them to the private sector.

Mr. CRANE. Thank you, Madam Secretary.

Secretary SHALALA. You are welcome.

Chairman ARCHER. Mr. Stark.

Mr. STARK. Thank you, Mr. Chairman.

Madam Secretary, I must say I was more than pleasantly surprised by the size of the Medicare cuts that the President put forth in his budget. I don't want to help my Republican colleagues out of their dilemma of how they can possibly pay for this silly contract. But I had anticipated somewhat larger cuts, not the $200 billion they are talking about, but yours seem rather modest.

In light of this idea that Medicare is going to go broke one of these days, why are your cuts at the level they are, and can you give us a reassurance that 10 years from now we will still be around discussing Medicare?

Secretary SHALALA. I think there are two questions there, Congressman Stark. One is our concern about the financing of the Medicare program. I am a trustee of the system along with Secretary Reich and now Secretary Rubin. In terms of any thoughts we have on the financing of the system, the trustees will meet again in April and have some new actuarial estimates and then we will come back and talk with all of you about that information.

On the issue of the President simply extending existing restraints on the Medicare program as opposed to adding new ones, he has always said that he is willing to consider changes in the government's health care programs, in particular the Medicare program, but only in the context of health care reform.

Both in his letter to the Congress, as well as in his State of the Union speech, as well as in the language in this budget where health care reform is discussed, he has made it very clear he opposes cutting Medicare to finance tax cuts. He opposes cutting Medicare just to reduce the deficit, outside of the context of health care reform.

So we are anxious to start the discussion with this Congress on taking some steps toward health care reform, and would be happy to discuss these programs within that context.

Mr. STARK. The Republicans are suggesting, I guess in the words of Speaker Gingrich, that we eliminate the Health Care Financing Administration. I notice that Mr. Vladeck is not here today. I assume that doesn't indicate it has already been done.

Can you explain to me and my colleagues and for the record why the Health Care Financing Administration is a necessary operation in the Department of Health and Human Services, and why Mr. Gingrich should perhaps rethink his rash suggestion?

Secretary SHALALA. Thank you, Congressman.

The Health Care Financing Administration and the management of the government's health care programs are best seen in the context of a public-private partnership. In fact, unlike Social Security, which is totally managed by public sector employees, the Medicare and Medicaid programs are managed—and the Medicare program particularly—is managed by the private sector. What HCFA does is manage the contractors, the private sector insurance companies, and does oversight over the private and nonprofit facilities that deliver health care in this country.

HCFA actually is quite efficient. It manages the government's program with an overhead of less than 2 percent. I don't know of an insurance company that would be willing to take on these programs for 2 percent or less in terms of its management.

There aren't a lot of employees there. What they are doing is managing this public-private partnership. The government sets the rules for the programs. But the management is very much private sector management, large contractors.

So it is not—we have moved away from government just running the program directly as we have in the Social Security program to this public-private partnership in which 99 percent of the employ-

ees that are involved in the government's health care program are private sector doctors, physicians, insurance companies who are managers of the system.

Mr. STARK. Don't we return about 97 or 98 cents of every $1 we collect to the system for health care benefits for the seniors under Medicare?

Secretary SHALALA. Yes, and that is the point I am making, that the money goes out to the delivery system, to the private sector, to health care, as opposed to having a huge bureaucracy in Washington. It actually is a very thin layer, managing what are essentially private sector contracts. That was the decision early on in terms of the evolution of the program.

I also think that we get a lot of bang for the buck from HCFA. They really see themselves as partners with the States in the Medicaid program working through, for instance, this new and I think quite exciting movement to manage care, working with the States, using the experience around the country, working within individual States to help them set up the capacity to move beneficiaries into managed care, and making certain there is choice for elderly citizens, managed care, other kinds of options for them.

Chairman ARCHER. The time of the gentleman has expired.

Mr. Thomas.

Mr. THOMAS. Thank you very much, Mr. Chairman.

Yesterday, Secretary of the Treasury, Mr. Rubin, in his presentation indicated that if we were ever going to get a handle on the deficit, that the entitlements were the area that we were going to have to begin to control. He referred specifically to Medicare as one of the larger ones, and obviously Social Security is as well.

Last year the President offered a very ambitious, flawed but bold, plan to deal with this very question. As I recall, he had $124 billion in cuts in Medicare over 5 years.

You have shown us a chart in which the January 1993 projected baseline has been cut by that yellow amount to the Clinton 1996 baseline. It says, Medicare and Medicaid growth slows under the Clinton administration.

Would you agree that the single biggest impact was the $56 billion in Medicare cuts that were included in the budget reconciliation in 1993?

Secretary SHALALA. No, actually, as I indicated, this is a $200 billion reduction in the baseline over time. There were lots of explanations for——

Mr. THOMAS. Would you agree that one of them was $56 billion in Medicare cuts in the 1993 budget?

Secretary SHALALA. Certainly. We did those as a buildup to health reform.

Mr. THOMAS. Then you offered $124 billion in Medicare cuts after the $56 billion in Medicare cuts. Then in this budget, the last budget that President Clinton knows he has complete control over, what are the Medicare cuts? What was the amount that Mr. Stark raised?

Secretary SHALALA. The baseline would be reduced about $13 billion.

Mr. THOMAS. About $13 billion, 9.9 is the actual budget figure. When Secretary Rubin says it is critical to address this area, the

Clinton budget response, the last budget he has complete control over, there is a $9.9 billion response.

I guess in today's Post it says it best, and I hate bringing in a third-party neutral objective position. I know how folks don't like to do that. Jim Glassman in today's business section, headline on deficit cutting, Clinton Simply Gives Up the Ship. Balancing is up to the GOP.

I don't think it can be underscored more than by looking at what the Clinton administration promised it was going to do during the election, cut the deficit in half, by the bold $56 billion move which is reflected in this chart, following up with the bold $124 billion move in the health care reform, and then taking a look at the $9.9 billion response. You have given up the ship in the direction of balancing the budget.

I guess my question, Madam Secretary, is what was left on the budget cutting room floor behind closed doors that would have assisted us working as a partnership to solve this problem that you folks clearly understand to be a problem?

Secretary SHALALA. A spirit of bipartisanship, a desire to steer that ship in a bipartisan manner within the context of health care reform. The decision that was made was not to back off from this country's need to do health care reform and comprehensive health care reform as a way to continue to pull down that baseline and that growth.

So our commitment was not to back off of health care reform, but to do it in a bipartisan manner and to be ready within the hour to sit down with you and your colleagues to look at drafting a bill for comprehensive health care reform that will in fact not cause a cost shift to the private sector, in particular to small businesses in this country.

Mr. THOMAS. In that regard, is the administration going to support us in the effort to make permanent Medicare Select which is currently the only real ability to get managed care effectively into the Medicare structure?

Secretary SHALALA. The administration has always been committed to the issue of choice, and would be happy to work with this committee to expand choice for Medicare recipients. We have some concerns growing out of the Medicare Select demonstrations that have been going on, and we would like to discuss those with you within the context of a discussion about choice and about expanding choice.

Mr. THOMAS. Once again, the headline. On deficit cutting, "Clinton Simply Gives Up the Ship. Balancing is Up to the GOP." We are willing to do the heavy lifting if you are willing to help us.

Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Bunning.

Mr. BUNNING. Thank you, Mr. Chairman.

I would like to shift gears here just a little bit, Madam Secretary, because of my interest in the Social Security Administration. Social Security benefits and SSA operating administrative budgets are independently funded from the trust funds, which you know will have reserves of about $420 billion this year. SSA administrative budget requests for 1996 are just a little over $6 billion, less than 2 percent of what SSA pays out in benefits.

Would you agree that the reserves appear to be more than adequate to absorb a $6 billion administrative budget?

Secretary SHALALA. You are asking me a policy question that I am not sure I am prepared to answer here. I think I'd better provide the answer to that question for the record, Mr. Bunning.

[The following was subsequently received:]

As you know, Congress has authorized a mix of funding for SSA's principle administrative account—the LAE, limitation on administrative expenses, account. The LAE account provides resources for SSA to administer the Social Security (OASDI) programs, certain health insurance functions, and the SSI program for the aged, blind, and disabled. Funds for annual reporting of earnings and certain activities related to pension reform also are included, as well as automated data processing and telecommunications expenses.

Currently, administrative expenses are financed from several different sources. In fiscal year 1994, for example, nearly 48 percent of the LAE account was financed by the Medicare trust funds and SSI program, while about 52 percent was financed by the OASDI trust funds. Congress has authorized this mix of funding because the Social Security trust funds and SSI service delivery mechanisms are so integrated—and we continue to support that approach.

Mr. BUNNING. The answer to that is obviously a yes. I mean, less than 2 percent or around 2 percent. Particularly since—by the end of fiscal year 1996, the Social Security trust funds will be about $540 billion in surplus.

For the record, since SSA is still part of HHS until March of this year, removing the SSA administrative budget from the domestic discretionary caps, would you be in favor of doing that?

Secretary SHALALA. I think that we thus far have not agreed to do that, and therefore we left the administrative budget for SSA under the discretionary caps. But you are raising an issue that we have discussed before within the administration. I would rather provide you with the official answer on that question.

[The following was subsequently received:]

We believe that keeping SSA's administrative expenses in the discretionary spending category provides a healthy tension that results in incentives for efficiency and encourages SSA to continue to provide service in the most productive, cost-effective manner.

Mr. BUNNING. Under the current rules, the SSA administrative budget is subject to the domestic discretionary caps, as we told you, even though SSA is independently funded by payroll taxes. Is that true or false?

Secretary SHALALA. It is funded by payroll taxes.

Mr. BUNNING. Does this mean even though it is independently funded, SSA has to fight against initiatives dreamed up by the administration for the resources it needs just to process its retirement and disability claims?

Secretary SHALALA. Well, if your general point is, are we prepared to move the administrative costs of the SSA budget under the entitlement side of the budget, I think our point is that we have not been willing to do that up until now. The administrative budget has always been on the discretionary side, Mr. Bunning.

Mr. BUNNING. Secretary Shalala, you realize there are over 1 million people backlogged in SSDI right now.

Secretary SHALALA. I do. Let me also point out that we have made an extraordinary effort to catch up on those and——

Mr. BUNNING. But we haven't. That simply is untrue. The fact of the matter is they keep growing. We keep spending more money to process it and the amount of disability claims keeps growing.

Secretary SHALALA. We have—our projections show that we will cut—with our reengineering proposals, that we will cut by one-third the amount of time it takes to get into the disability program.

Mr. BUNNING. I am not going to fight with you on that because I have no senior reengineering program. The Commissioner has not brought it forth for us to examine it yet. So how in the world can you say that you are going to cut by one-third when there is no positive proof that that is the case?

Secretary SHALALA. Those are our plans, Congressman Bunning.

Mr. BUNNING. I know. We spent $200 million extra to reduce the backlog 2 years ago. It was spent on bonuses for members of the Social Security Administration; 67 percent of the Social Security employees received bonuses. It didn't reduce the backlog.

So what I am saying is that we ought to at least take the administrative cost and put it on budget. Is the independent agency going to be able to do that? That is the question I am asking you.

Secretary SHALALA. The independent agency will not have the independent authority to move its budget from the discretionary side to the entitlement side without a congressional decision and a recommendation from the President.

Mr. BUNNING. It will not have the ability?

Secretary SHALALA. As far as I know, it does not have the authority under the Independent Agency Act.

Mr. BUNNING. It is my opinion that it will.

Secretary SHALALA. We will be happy to discuss that with you.

Mr. BUNNING. All right. Thank you.

Chairman ARCHER. Mr. Matsui.

Mr. MATSUI. Thank you, Mr. Chairman.

Secretary Shalala, thank you for your testimony today, we appreciate it very much. The one question that I have is, some have been talking about making massive cuts in the Medicare program without health care reform. The President's proposal last year in which he suggested cuts in Medicare was based upon health care reform, bringing everybody into the system and creating the system in which perhaps cuts could have been made because, obviously, there would have been a balancing.

But in terms of making cuts without health care reform, keeping the status quo, essentially, the fear that I think you and others have had is the issue of the cost shift. Would you get into that and talk about the cost shift and what would happen if in fact we made cuts that are being proposed in the Medicare system without health care reform.

Secretary SHALALA. Well, we testified last year at some length, Congressman, about our concern in doing health care reform in a way that simply drove down the cost of the government programs and then shifted those costs onto the private sector. We have even more concern this year about part of the private sector being able to pull down their own costs through tough negotiations with hospitals, with HMOs, and with other providers, which means that if we independently cut the Medicare program, for example, the group that we will be shifting costs onto will be even narrower. It

will be small businesses, those that don't have the clout to get the kind of discounts that larger companies get.

So it becomes an even more serious problem when we narrow down the group to whom the costs will be cost shifted. We may well increase—as you well know, over 1 million people lost their health insurance last year. Most of them were working people, 85 percent. They don't even have access to adequate health insurance. So we are accentuating the problem by putting off comprehensive health care reform.

Mr. MATSUI. So you are saying that if in fact these cuts should occur, the shift, the cost shift will occur basically on small businesses, because they don't have the wherewithal to negotiate with insurance carriers, and undoubtedly those that would be affected by this would be employees of the small businesses.

Secretary SHALALA. Smaller businesses and individuals, those left who aren't part of these larger groups that are negotiating for discounts. There is no question that health care costs in the private sector are starting to slow down. But it is in large part because of the kind of clout big businesses have and because hospitals themselves under pressure are starting to slow down some of their growth.

There are efficiencies that are going on in the system, but we will not be able to take advantage of those or be able to do the kind of comprehensive health care reform we need to do if we start picking out segments.

Mr. MATSUI. Thank you.

I have no further questions, Mr. Chairman.

Chairman ARCHER. Mr. Camp.

Mr. CAMP. Thank you, Mr. Chairman.

Madam Secretary, in your testimony you mentioned with regard to the SSI program that the Inspector General found no evidence of coaching by parents. In testimony before this committee, we found that that is only part of the problem; that there are lack of audits, there is no accounting for how the money, the funds are spent, that they are even spent on behalf of the child for medication.

I guess I would like you to speak to that concern for a moment, if you would.

Secretary SHALALA. Well, the program was set up to provide flexibility to the family because each family, as you probably heard from testimony, has different needs, and a child with a different range of disabilities. So rather than bureaucrats determining specifically what the expenditures ought to be, the check is given to the guardian, to the family member to determine what is the best way to support the child.

That was the decision that was made. I think that—it had bipartisan support at the time—that we do not know a lot about specifically how the money is being spent except through our audits in these reviews that are going on.

But the intent I think was to support the family and the judgment of family members in terms of what was good for that child as opposed to government bureaucrats having a set of fixed rules about what the money could be spent on and then auditing that.

Mr. CAMP. The point I want to make is that even with the fact that there may or may not have been evidence of coaching by parents found by the Inspector General, there are a great number of concerns being raised if the children have a medical condition and the government has decided to give funds to the family for the medical condition of the child.

I think we have an interest in seeing that those funds are spent on behalf of the child's medical condition. I have another——

Secretary SHALALA. Mr. Camp, might I answer? We have zero tolerance. The fact that the Inspector General didn't find widespread coaching does not mean we have any tolerance for one child being coached and one person getting inappropriate funds.

Mr. CAMP. Good. Thank you. I am glad to hear that.

In your comments about the Supplemental Security Income program, you also didn't mention any reform involving drug addicts and alcoholics who are considered disabled and get monthly cash payments as well as other coverage, Medicaid. Should Federal taxpayers be paying money for chronic drug addicts?

Secretary SHALALA. We support the legislation that was passed last year by Congress which puts a time limit and insists on treatment for those that are drug abusers or have alcoholic problems—that the program be used as a transitional program for them while they are in treatment. The Social Security program—the Social Security agency is in the process of setting up that new system.

Mr. CAMP. Has the number of addicts receiving SSI benefits increased in the last few years?

Secretary SHALALA. Yes.

Mr. CAMP. Has that not been a rather dramatic increase?

Secretary SHALALA. The biggest increase has been children on the SSI program, as you know, because you have spent time worrying about the program. There has been an increase. Without the kind of tightness in terms of the fit with treatment programs and oversight that we really need to do, which the new legislation will strengthen our ability to do, the increases will continue.

Mr. CAMP. Thank you very much.

Secretary SHALALA. You are welcome, Congressman.

Mr. CAMP. I yield back the balance of my time.

Chairman ARCHER. Mr. Ramstad.

Mr. RAMSTAD. Thank you, Mr. Chairman, Madam Secretary.

I think you are fully aware of the importance of the medical device industry, not only to our health care delivery system but to our macroeconomy as well—$4 billion plus trade surpluses generated from the medical device industry, high quality jobs, and obviously a major contributing factor to the high quality of health care in the United States.

I am concerned about the user fee that is being imposed in the budget on these companies, without a commensurate guarantee that there will be any improvement in the medical device review process, which right now is literally driving hundreds and I daresay thousands—there has been at least one study that quantifies at least several thousand—jobs offshore.

Let me ask you this. Is the money that is allocated to the FDA, Food and Drug Administration, through the user fees imposed on

medical device manufacturers a replacement of appropriate funds or an additional $24 million burden on the medical device industry?

Secretary SHALALA. It is additional money. If I might answer the issue of whether using user fees has produced results, in drug approvals, the user fee helped us to clean up 90 percent of the backlog, for example. In almost every case we have worked through with the appropriate industries what we intended to do with the user fees. In the drug user fee in particular, we had the support of the companies.

The medical device issue 1½ years ago when I first arrived was one of the first issues that was put on my plate by both the FDA Commissioner as well as by the community itself. All of us have to find a balance between making sure that we do appropriate reviews and making sure that they are done in a timely manner so that they don't have a negative economic impact on the companies that are involved.

That was also true on drugs being approved and other FDA approvals. To the extent these are resource issues, we have tried to address them and to streamline the process for approvals. We have new leadership—we have done a number of things—new leadership, new strategies, new resources to put in place to try to find that balance between safety for the American people and obviously the economic balance we are trying to achieve.

Mr. RAMSTAD. Madam Secretary, before my time expires, I have to ask a followup question. You said that 90 percent of the backlogs—you are talking about the 510(k) removal process or the PMAs have been cleared up at the FDA?

Secretary SHALALA. Of the backlog in drug approvals—let me check my notes. Not medical devices. I am talking about drugs, not medical devices.

Mr. RAMSTAD. I am talking about medical devices. My question is totally geared toward medical devices. I am talking about heart valves. I am talking about pumps and other——

Secretary SHALALA. No, I didn't say that about medical devices. My answer to the question was to say what the relationship has been in our experience. Our longest experience is on the drug side with the drug user fees.

Mr. RAMSTAD. I am talking about user fees imposed on medical device manufacturers. Is the money allocated to the FDA through user fees? Is this a replacement of appropriate funds or an additional $24 million on the medical device manufacturers?

Secretary SHALALA. It is additional, and it is to be used for streamlining the approval process for medical devices so we can reduce the amount of time that it takes for the approval process.

Mr. RAMSTAD. What is the quid pro quo? I mean, how do we know that the extra revenues will go to expedite the process?

Secretary SHALALA. My view is that we ought to be able to demonstrate that. This is a public budget, and you ought to haul us in and have us explain exactly what we are doing with the money and how we are streamlining the process. We have testified on that on the drug side. If we go to the business community and say, we need a user fee, and with that user fee we are going to streamline the process and cut down the approval times and do everything we can

simultaneously to maintain quality, we ought to be able to demonstrate that.

Mr. RAMSTAD. Would you agree that the performance standards should be built into statute?

Secretary SHALALA. In general, I think that we can discuss performance standards. We have been supportive of the use of performance standards and outcome measures. Whether you want to put them into the statute or you want us to lay them out for you, I think I would rather discuss it with you.

Mr. RAMSTAD. I see my time is up.

Secretary SHALALA. I mean, they ought to be reasonable. We have got to think through what kind of performance standards are reasonable given the level of what the investment is.

Mr. RAMSTAD. But certainly what is happening is now an outrage. The average time for 510(k) approval is 240 days compared to 90 days, what it is supposed to be. Just in the last month, I have talked to a medical device company that is building a plant in the Netherlands, one in France, one in Italy. Those are good jobs we are losing and it is all because of delays in the approval of medical devices. There has got to be some restoration of reasonableness to the process. We have got to expedite this process.

Secretary SHALALA. Congressman, that is what we have tried to do from the point at which we first got into office in relationship to the FDA as well as the SSI program. I mean, across the government in terms of my responsibilities, I have very little tolerance for long delays that are inappropriate, that are just a matter of us getting the resources and the leadership and the management systems in place.

You will get no argument from me about it, particularly when we go directly to an industry and make a pledge, that if you give us the resources, we are going to tie them directly to a new system and make them additive.

Mr. RAMSTAD. Thank you, Mr. Chairman.

Chairman ARCHER. The gentleman's time has expired.

Madam Secretary, I had told you when you came earlier this morning that I thought perhaps since your piece of the budget was a very small part, that we might complete this hearing within 1 hour. It is clear now that the members have a great interest in this small part of the budget. I need to ask you whether your schedule will permit you to stay until each member has a chance to inquire if they so wish.

Secretary SHALALA. I think that I ought to stay, Mr. Chairman. Being respectful to this committee and to your interest in the range of responsibilities that I am responsible for, I will stay.

Chairman ARCHER. Thank you.

Mrs. Kennelly will inquire.

Mr. Coyne.

Mr. COYNE. Thank you, Mr. Chairman.

Madam Secretary, I noticed in the President's budget that Medicare part B premiums are set at 25 percent of the program's cost. Is this going to have an adverse effect on low-income seniors?

Secretary SHALALA. No, actually the percentage comes down a little. That is about what most people believe are fair, the beneficiaries as well as the Congress.

So our sense is that that is a fair number.

Mr. COYNE. The question is, though, is it going to increase the cost to low-income seniors?

Secretary SHALALA. I think the answer is, it is probably $3 less per participant than the previous year. So it will not increase their costs.

Mr. COYNE. Thank you. I represent over 20 hospitals. How will the President's budget impact these institutions, particularly the teaching hospitals?

Secretary SHALALA. The graduate medical education is left intact in this budget. Obviously, as the health care system is squeezing down with the reorganization of the private health care system and the movement of participants to HMOs, there is some impact on the academic teaching institutions.

This budget also has what I believe is a very generous increase in the National Institutes of Health, concerning the fact that we have straight-lined almost every other program in our budget. A 4-percent increase in NIH obviously impacts in a favorable way on the great teaching and research institutions in your district.

But I have been very candid with the academic health institutions in this country that they themselves are going to have to go through some changes to adjust to this much more competitive world, both for the private sector as well as from the public sector, and most of the institutions are going through those changes.

Mr. COYNE. Thank you very much.

Chairman ARCHER. Mr. Zimmer.

Mr. ZIMMER. Thank you, Mr. Chairman.

Madam Secretary, do I understand the administration's position correctly when I say that major cuts in Medicare will not be acceptable to you for funding tax cuts or for reducing the deficit? Major cuts in Medicare, and by cuts, of course, we mean reductions in the growth of Medicare, are acceptable to this administration only in the context of the kind of sweeping health care reform that a Democratic Congress refused to approve last year.

Secretary SHALALA. Let me sort out the two issues. Cuts in Medicare are not acceptable to us to support tax cuts. We did do some and we have always believed that comprehensive health care reform is what is needed to hold down the deficit and in fact reduce the deficit.

So within the context of more comprehensive health care reform—and the President has asked that we be able to sit down and to start taking the first steps toward comprehensive health care reform—that is the context in which we wish to discuss any changes in the Medicare program.

Mr. ZIMMER. What do you mean by comprehensive health care reform?

Secretary SHALALA. The President has suggested in his State of the Union speech and in his transmission of the budget to Congress that we start by discussing those things that we have some consensus on. Some insurance reforms that we discussed, long-term care issues, expanding coverage to children, perhaps, first, as a way of starting to reduce the number of people who have no health insurance that use the most expensive parts of the health insurance system, and providing more fairness to those and more flexibility for

families who now use—may use a very expensive part of institutionalized care and may well want an alternative to keep their loved ones at home.

So there is a list of issues that we very much would like to discuss, and within the context of a discussion of moving toward everyone in this country having access to good and adequate health insurance, we are prepared to discuss the Medicare program.

Mr. ZIMMER. Do you have any specific numbers in terms of how much any of those incremental reforms are going to reduce expenditures in Medicare?

Secretary SHALALA. We presented a comprehensive plan last year in which we presented one option. Many Republicans as well as Democrats had other approaches which impacted on the Medicare program. What the President is committed to is a bipartisan approach. Have we changed our strategy? Yes. Are we backing away from health care reform? No. But we would like to sit down with you and look at options and look at their impact and what effect they may have on helping us slow down the growth in the Medicare and the Medicaid program.

Mr. ZIMMER. Is it not true that the Congressional Budget Office last year estimated that the administration's health care plan would increase the deficit rather than decrease it?

Secretary SHALALA. I think there were some findings that it would have some initial effects. But the point that we are making now is, let us sit down, not take just the President's model that he presented last year, but let's sit down at the table and talk about your ideas and our ideas and see where we can go. What we have argued is that it is hard to pull this down without having an impact on the private sector.

What we don't want to do is to start bludgeoning down the Medicare and Medicaid populations, putting at risk very vulnerable populations, and then shift the cost onto small businesses and middle-sized businesses, and individuals. What we would like to do is to sit down and look and see what we can do that would slow down the growth in the government programs, help to get some cost containment in the private sector, expand coverage, and help families deal with their long-term cost. But rather than our coming in with a rigid proposal, we have lots of computer runs and technical assistance that we can offer. Let's sit down and see what we can do, and that will help all of us to slow down the growth of health care in this country.

Mr. ZIMMER. Do you believe it is possible to balance the budget without applying some savings from Medicare to deficit reduction?

Secretary SHALALA. We do not believe that it is possible to reduce the deficit significantly in this country and to keep it down without doing something about the growth of health care in this country, and that requires a comprehensive strategy, taking steps this year and steps next year and steps the year after that.

Mr. ZIMMER. I know my time is up. Could you answer my question? Do you believe it is possible to eliminate the budget deficit without applying savings from Medicare to deficit reduction?

Secretary SHALALA. We do not believe that it is possible to reduce the deficit significantly and to keep it down in this country without comprehensive health care reform, working with—in a bipartisan

way—with this Congress. The deficit will continue to grow—the government's own costs will continue to grow—unless we take a comprehensive approach. That is what we are prepared to do. We don't come to this with rigid ideas. We are prepared to sit and listen to what ideas you all may have.

Mr. ZIMMER. Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Levin.

Mr. LEVIN. Thank you.

The private sector costs were less for the first time in Medicare, right, in previous years? Just review quickly, so we all understand it, as I understand it, Medicare costs in previous years went up less than the private sector?

Secretary SHALALA. They did.

Mr. LEVIN. This is a reversal, right?

Secretary SHALALA. Yes.

Mr. LEVIN. Some have suggested that we might save some money in Medicare and still further, Medicaid, by essentially requiring all beneficiaries to be in a managed care program, requiring it. Your position on that is——

Secretary SHALALA. We have been committed to choice for Medicare recipients. We believe that that choice ought to include HMOs, and we do not believe that people should be shoved into HMOs as a way of reducing the budget.

We also believe as the managed care industry does, that there has been a history in this government on at least two other occasions of trying to shift people perhaps too quickly and not thoughtfully into managed care as a way of reducing the budget. Neither of those efforts was very successful.

This is—the population for Medicare, the population for Medicaid—a vulnerable population, including disabled people. Some parts of it are very high cost. Whether managed care is a solution for everyone, whether people ought to have choices—we are very committed to choices. It ought to be—the whole business of laying out choices and giving people opportunities—ought to be done very thoughtfully and very carefully.

We are working with the industry. If you brought up here the people that represent the industry, they would say, this administration is working with the industry to think through how we array those choices and how we provide very good health care for people.

Mr. LEVIN. Let me pick up Mr. Zimmer's question, because I think it is important that everybody understand the administration's position. It is true, last year there were proposed cuts in Medicare, substantial cuts, as part of a larger comprehensive health care reform.

Some of us bore some considerable heat for supporting these cuts as part of an overall approach.

Give us an example of why it is relevant to look at the whole picture as we look at the major cuts to providers.

Secretary SHALALA. If we cut one part of the health care system, our experience is that we cost shift on the other part of the health care system. That was the standard operating conclusion of people who study the health care business in this country.

But it is compounded now by a slowing down of health care costs for some part of the private sector. The large corporations have

been able to negotiate discounts in the system to protect themselves and their workers, leaving the rest of the market, smaller businesses and individuals, who would get caught if we started to squeeze down unilaterally, independent of a more comprehensive approach.

In addition to that, there are 1 million people that lost health insurance last year. For them, anything that started to squeeze down costs without simultaneously providing them access to the health care market would cause them to continue using the most expensive part of the health care market, many of them, the emergency rooms. So we have changes going on in the system that are not helped by simply pulling down on a small part of the health care system.

Mr. LEVIN. Thank you.

Chairman ARCHER. Madam Secretary, I did not contemplate inquiring, but I really would like to jump in on this issue. The bill that the administration supported and that came out of this committee last year for health care reform, if I remember correctly, included a cut of Medicare and Medicaid in the amount of $490 billion over 10 years. I believe that is an accurate number. It was supported by the administration and came out virtually on a straight party line vote out of this committee.

I am not sure I understand how you can take that much money out of Medicare and Medicaid, even if it is part of an overall health reform program, without shifting costs onto the other parts of health care. If there are ways to efficiently administer Medicare and Medicaid so that that does not become a shift cost, even as a part of overall health reform, then it seems to me that we ought to be working very diligently right now to implement those irrespective of whether we do health reform or not. Because, unless those cuts in the proposal that came out of this committee were the result of efficiencies in the delivery of health care through the Medicare and the Medicaid system, they still will shift cost over to the other elements of health care.

I would appreciate your comments on that.

Secretary SHALALA. You will remember that the President's bill had a number of elements to it, including holding down the costs in the private sector and having universal coverage so that there were not individuals without insurance coverage. So there were a couple of different things that went on in the President's bill, that is, everyone eventually got insurance. The private sector was able to hold down its costs because there were recommendations to control growth on that side. The public sector at the same time was bringing down its costs.

So it was the comprehensive nature of comprehensive coverage for everyone and holding down both private and public sector costs that slowed down the growth. Everybody has been talking about slowing down the growth in the public sector programs.

Chairman ARCHER. I understand that, but if you are going to take that massive amount out of Medicare and Medicaid, other than through efficiencies in the delivery of the care, it must be shifted on to the rest of the health care population. It makes no difference whether you do it by itself or whether you do it in conjunction with overall health reform.

I am not really sure that you responded to that inquiry. But I do hope that if there are efficiencies that can be brought to bear to reduce the costs of both the increases in costs in Medicare and Medicaid, that we would receive that in the way of proposals. Otherwise, whether we do it in the context of overall health care reform or we do it independently, it is going to cost shift to somebody else.

Secretary SHALALA. Mr. Chairman, I understand your point. I think the point that I was making is that one of the most efficient things we can do is to move people who have no health insurance out of emergency rooms into prevention programs. One of the other things we can do is expand the prevention programs and get some discipline—individual discipline in terms of how they use the health care system. So that is comprehensive—these programs now pick up with extra payments some of those additional costs.

There is no question that we are trying to introduce efficiencies into the system at the same time.

Chairman ARCHER. I can understand how that would apply to Medicaid, but not to Medicare. I don't think that there is a big problem with senior citizens using emergency rooms, nor is there a big problem relative to preventive health care in the Medicare population.

We are going to have to break and vote, and then we will come back immediately, and I appreciate your willingness to stay on with us.

Thank you very much.

[Recess.]

Mr. JOHNSON of Texas [presiding]. I will recognize myself. If you don't mind, I will ask you a couple of questions, Madam Secretary.

Your budget request is $716 billion. That is 7.5 percent, I am told, over the 1995 budget. The discretionary program's budget is about $37 billion, an increase of $1.5 billion, 4 percent over last year. Yet you keep talking about cuts and consolidations, yet you keep asking for more.

Can you tell me why you are asking for an increase?

Secretary SHALALA. Some of the President's key investments are part of the discretionary program, Congressman Johnson. That includes an increase in the Head Start program of $400 million, targeted specifically to improving the quality of the Head Start program, and a new initiative for zero to three that will allow communities across the country to fit in an earlier childhood program with their Head Start program, and to move the Head Start program to a full-time, full-year program so it will be supportive of low-income working families.

The National Institutes of Health also receives a $400-plus million increase, specifically for basic science research in cancer and AIDS, and in the Human Genome project. So a big chunk of that increase is Head Start, and the research program, plus an increase in this Nation's commitment to addressing drug addiction.

I had a question before on SSI. We need drug slots so that addicts receiving SSI get into treatment programs. So there are just a handful of targeted programs receiving increases. The rest either come down or we flatten out. But in addition to that, as I indicated,

we consolidate the 104 public health service programs into a smaller number.

The community health centers in your community, which now apply for eight separate grants, will have one application, and it will be simple and straightforward, so that we cut out levels of bureaucracy. We reduce our personnel by the end of this century by 12 percent in the Department of Health and Human Services.

There are lots of things going on, but there are in fact new investments.

Mr. JOHNSON of Texas. I am told those consolidations don't result in any savings.

Secretary SHALALA. Some of them do and some of them don't. They result in savings, not in the money that goes directly to your community health center, they result in savings on the administrative side, in administrative costs. So we are eliminating positions, layers of positions, including some of our administrative costs in the regional areas.

So we are trying to protect the money that goes to citizens and reduce the amount of bureaucracy that gets that money there.

Mr. JOHNSON of Texas. Well, it seems to me, you talk about reductions in Medicare, for example, and I think Mr. Archer asked the question earlier, there were large reductions in that program forecast, though, and yet you are saying that costs are down to somewhere around 9.9 percent, and yet you are asking for I believe it is an 11.7-percent increase in the Medicare funding; is that true?

Secretary SHALALA. Well, what you are seeing is these costs go down over time, and we are projecting what we think the Medicare cost increase will be based on new populations coming in.

All of that, including the lower estimates, are reflected there in our actuarial statements.

Mr. JOHNSON of Texas. You are saying the costs are lower but you are asking for more money, so you don't expect costs to stay low; is that true?

Secretary SHALALA. The point I have made, Congressman Johnson, is what we are all trying to do is manage down the increases in these programs that we expect as new populations are added. Congress, in its wisdom, expanded the Medicaid program to very young children of low-income working parents, for example. So there will be new populations added to these programs. Also, as the country grays, we will have more elderly coming into the program.

What we are demonstrating, though, very much with the help of Congress on the Medicaid side, with management changes on the Medicare side, and with what is happening in the economy, as a result of taking big bites out of the deficit as well as other changes that are going to be happening in the economy, we are able now for the first time to show that the growth is slowing down. It is not slowing down enough.

That is why comprehensive health care reform very much has to be on the table this year and part of the discussion.

Mr. JOHNSON of Texas. I agree with you and I hope we can do it together. But you still have an increase in that program with a decrease in cost.

Let me ask you one other question. You have got $2.7 million in the budget for health care reform data analysis. I think that is the

staff for the President's health care reform bill. As I recall, we are still fighting over some of the secret committee and secret deals that they made.

Why do you need this money?

Secretary SHALALA. There is nothing in our budget that doesn't support existing health care programs and the Department's own capacity to analyze data so that we can tell both the private sector as well as the managers in the public sector what is going on in the system, and our staff is very much focused on outcomes measures, setting up performance standards in the new kind of quality assurance systems.

Mr. JOHNSON of Texas. What does HCFA do?

Secretary SHALALA. We have policy staffs that are doing the theoretical work in quality assurance under the Public Health Service, that are analyzing low-income populations. HCFA has a database and in fact in this budget, as well as in the reinvention of government proposal, RIGO II, that we will present, we are rationalizing our database to make sure that we are collecting data that are useful in managing the programs and in exploring the impact of health care decisions in this country.

We would be happy to lay out that budget in some detail for you.

Mr. JOHNSON of Texas. Thank you. I appreciate that.

Mr. Christensen will inquire.

Mr. CHRISTENSEN. Thank you, Mr. Chairman.

Ms. Shalala, we appreciate your testimony today. Over the last several years, when Republican presidents submitted a budget to the Hill, it was always dead on arrival. It never got any kind of consideration. This year, President Clinton submitted a budget and we are looking forward to working with him, although it probably didn't go as far as we would liked to have seen.

I heard Congressman Steve Horn say yesterday that it is a different kind of DOA, devoid of accountability. You are asking us to do a lot of the heavy lifting in these areas. I think the budget is noticeably absent of entitlement reform.

Where I come from, in Omaha, Nebr., a cut means spending less than you spent the year before. In the 4 weeks that I have been here, I see that in Clinton-speak, a cut means a decrease in the increase. I think if there was ever a time that the American people are wanting to see this budget and this deficit and this debt come under control, it is now.

President Clinton's budget adds about $1 trillion to the debt. You said earlier you would be ready within 1 hour to sit down with us in a bipartisan fashion.

I am hoping that you have some specifics. You have mentioned a couple. Yesterday we heard from Senator Kerrey and another panelist about some specifics. Congressman Johnson talked earlier about some closed-door meetings and some things that maybe went on that didn't make it into the budget.

Do you have any suggestions, any specific ideas that we can look to that you might be able to work with us on in terms of transforming Medicare?

Secretary SHALALA. We have indicated both in my testimony as well as in the President's own budget report that we are prepared to sit down on a bipartisan basis and discuss specifics. But not sim-

ply to bludgeon down the Medicare and Medicaid programs, the most vulnerable populations we have in our society, but to look overall at health care costs in this country and at health care growth and not to shift additional costs on to State and local governments and on to individuals.

What we have said all along is that we believe that these growing health care programs cannot be brought under control until we have an overall strategy for health care costs in this country. That is the only point that I have been trying to make.

Do we have specifics? Yes. We laid them out in detail last year. They were rejected. Do we have alternatives to those? We would like to talk about those, too. Are we ready to sit down? We have experts sitting behind me that are ready to meet within the hour to discuss comprehensive health care reform.

Mr. CHRISTENSEN. Senator Kerrey mentioned yesterday about adjusting the CPI. How does the administration feel about that?

Secretary SHALALA. I think Mrs. Rivlin has expressed some reservations about that. It is more appropriate for her to talk about whether we should use something like an adjustment as opposed to what the President would prefer to do, and that is to get some genuine discipline into health care cost containment in this country, and that involves a comprehensive approach.

We believe that by cutting spending, which we are doing, by reducing the number of Federal employees, as we are doing, by getting the kind of deficit reductions that we got in our first year budget and which we continue to get in this budget, that way the government ought both to reduce the deficit now as well as get long-term deficit reduction through comprehensive health care reform.

Mr. CHRISTENSEN. Well, Madam Secretary, I think we are both headed in the same direction. One of us wants to get there a little quicker than the other. We hope we can work together on this.

Secretary SHALALA. Thank you, Congressman.

Mr. JOHNSON of Texas. The time of the gentleman has expired.

Mr. Cardin will inquire.

Mr. CARDIN. Thank you, Mr. Chairman.

I would like to follow up on Mr. Archer's point about the package that was submitted last year, which contained significant savings in Medicare and Medicaid, as Mr. Archer pointed out. But if memory serves me correctly, the lion's share of those savings were used to finance comprehensive health care reform, in order to expand the number of people who would have a rational way to pay for their health care services, to give us the ability to have everyone covered by health insurance, and to institute discipline in health care costs in both the private and public sector.

Wasn't that the whole strategy of the plan and why you could get savings if you can have parity and reduction in health care costs across the board rather than picking on the elderly and the Medicare system?

Secretary SHALALA. Exactly, Congressman Cardin. We do not believe that simply bludgeoning the Medicare and Medicaid programs will produce anything other than our populations, the elderly, the disabled, young, having less health care and being far more vulnerable. Nor will it take care of the problem of millions of Americans

who don't now have health insurance. One million last year, most of whom were working, having lost access to health insurance. It really does require a comprehensive approach.

Mr. CARDIN. In response to Mr. Christensen, we were ready to act last year and move last year, and we have lost a year, and I regret that. We are not going to be able to enact a 1995 comprehensive health care reform bill that will deal with universal coverage and the effect of cost containment. That is not going to happen, unfortunately, in 1995. So I applaud you for coming forward with some steps that I think can help us to move toward the goal of universal coverage, and to bring down health care costs which will ensure savings to Medicare and Medicaid.

Let me just mention a couple of those areas. If I heard you correctly, you granted a lot of State waivers. So you are going to permit at least States to move forward. If we are not able to at the national level, States can come forward with some constructive approaches to reduce cost and expand access. The administration is prepared to work with the States?

Secretary SHALALA. We are.

Mr. CARDIN. Good. Let me give you the figure. I always like to brag about the Maryland system. The statistics indicate that for this year the cost for Maryland hospital care rose slower than the national growth rate, saving our State and the Federal taxpayers additional moneys. The States are prepared to move forward, and I hope that we will continue to work in that direction.

Choice, I think, is an excellent suggestion, to give the elderly additional options, to allow the elderly to choose what type of health care plan they would like to be in, and save us some money and still protect the program for the elderly. I think that is another concrete way that we can move forward to save some money, and I am glad to see the administration is prepared to move in that direction.

I want to follow up on Mr. Coyne's thoughts on graduate medical education. One of the issues that we were working on in a bipartisan basis last year was to try to share some of the cost of our academic medical centers. I agree with you, our academic centers have to be more efficient than they have in the past. All medical facilities are going to have to be more efficient than they were in the past.

But it is not fair to ask an academic medical center to recoup all of its cost through a competitive rate structure when it has to compete with hospitals that don't have the same type of cost.

Medicare—government has been prepared to help our academic centers; the private sector has not. I would hope that one of the ways we may want to look at correcting that would be to provide a system where all payers or users of the health care system contribute fairly to the extra cost associated with academic health centers.

I see by your nod that you would be prepared to work with us to try to develop that type of a proposal?

Secretary SHALALA. Absolutely, Congressman. As you have pointed out, the academic health centers do have extra costs. They treat a population that is very high cost. They are in the process of training the next generation of health professionals. That costs more. I

think that there are multiple functions that have to be recognized as part of an overall comprehensive health care reform effort.

Mr. CARDIN. I thank you for being here and I thank the willingness of the administration to look at all these issues, to work with this Congress to move forward as far as we can in 1995 on health care reform. We are not going to accomplish everything we want to, but it would be a shame if we don't take advantage of this opportunity to work in a bipartisan basis to achieve some health care reform.

Mr. JOHNSON of Texas. I thank the gentleman.

The chair recognizes Mr. Collins to inquire.

Mr. COLLINS. Thank you, Mr. Chairman.

Thank you, Madam Secretary. In the district I represent, hospitals constantly tell me that they are having to shift costs primarily because of reductions in reimbursements to providers. Reimbursements were reduced in the 1993 tax reform. Would that not have resulted in additional cost shifting by providers to those who are insured by private sector insurance?

Secretary SHALALA. I think the point I was trying to make, Congressman Collins, is the way to avoid cost shifting is to avoid just making cuts in one part of the system as opposed to making certain that we have coverage for everyone, because what happens to a health care provider, to a hospital, for example, is if we keep squeezing them down on the public programs, then they have to squeeze down on their coverage, for example, of services they offer to people that are uninsured. Or they have to shift, if we inappropriately squeeze down on this side, they have to shift their costs to the insurance plans of those who do pay.

So what we are not anxious to do is to simply squeeze down on the public pieces without having a comprehensive plan and taking some steps toward coverage, toward insurance reform, and doing some things with the Governors to give them more flexibility to handle their costs on Medicaid. If everybody—if we move toward everyone getting coverage, then the health care providers who are very committed to high quality care in this country can better manage the resources.

Mr. COLLINS. I understand because you have said this about 10 times already to different——

Secretary SHALALA. I think 23.

Mr. COLLINS. For 23 times. I didn't take my shoes off, so I can only count to 10. But the point, too, is that any time you have a reduction in reimbursements, not only do you have a tendency to shift costs, but you also have a tendency to reduce services that could be or may be provided to seniors who are insured under the Medicare insurance program. Also, President Clinton's comprehensive health care plan contained a provision that would have determined what was necessary and appropriate when it came to providing health care services.

So in a sense, reduction and reimbursements can lead to means testing of services to seniors who are covered under the insurance program. Is that not true?

Secretary SHALALA. Well, it could lead to a number of things that I would not like to pinpoint what Congress may do if we are trying to reduce costs under the Medicare program.

I also think that, to be fair, there also are efficiencies that can be built into the system. While health care providers want to tell us about their need to reduce service if we cut down their resource, they have also made an effort to get more efficient in terms of the delivery of services.

So it is always a combination of things. What we have to do is be very careful we are not shifting the costs and eliminating participation from the health care system in the United States by doing something that is reckless.

Mr. COLLINS. But you do agree, then, that one of those tendencies could be to means test services or determine what is appropriate.

Secretary SHALALA. It certainly has always been on the list of what people have told us they will do if we recklessly start reducing the programs. But it certainly is not something I would recommend.

Mr. COLLINS. One other question, before my time runs out. A lot has been said about those who are covered under Medicare insurance who are in higher incomes, $90,000, $100,000, and up. What would be the administration's position, or does the administration have a position on increasing the premium cost to those who are of higher income versus reduction of reimbursements?

Secretary SHALALA. In the past we have made some recommendations, but only in the context of health care reform. Again, we have in this budget committed ourselves to having those part B premiums at about 25 percent of the cost. We think that is about right.

Again, any changes in the Medicare program we are suggesting would be discussed within the context of health care reform. So I can't answer specific questions about what would we do if, except in the context of health care reform. That is 24.

Mr. COLLINS. I didn't use an if. I just said does the administration have a position on increasing the premium cost to the higher income versus reduction in reimbursements.

Secretary SHALALA. Our position is a negative one, and again, let me repeat that all of these issues have to be done within the context of a broader discussion about health care reform. What we want is a fairer system, not adding to the financial burdens of our most disabled and most senior citizens.

You don't want to do that any more than I do. So I just can't answer a specific question about a piece except in the context of health care reform. So the answer would be no, if it was independent of—but we would be happy to discuss a number of things in the context of health care reform.

Mr. JOHNSON of Texas. The time of the gentleman has expired.

Mr. Ford will inquire.

Mr. FORD. Thank you very much, Mr. Chairman.

Madam Secretary, the administration deserves high praise in proposing increases in Head Start, early childhood programs that you talked about earlier, breast cancer research, along with AIDS research. The administration does not leave those programs which place the largest burden on HHS untouched.

Some of my Republican colleagues have suggested block granting many of these proposals as the answer to many of the problems.

Let's talk about the Medicaid program. We talked about a 9-percent increase. The Republicans are saying with flexibility give the Medicaid program in a block grant to the States and cap it at about 5 percent.

What is the administration's position on the Medicaid block grant program?

Secretary SHALALA. We have been happy to discuss with individual States flexibility in the use of their Medicaid program. We have some serious reservations about moving programs that have very vulnerable populations to a situation where we would cost shift to the States a much higher burden, which is essentially what some of the discussion of block grants is suggesting.

The populations in Medicaid are children and mothers and heavily—the costs are heavily related to the disability population and to the frail elderly population. So what we ought to do is to take a position that these vulnerable populations are ones which this country has a longtime commitment to protect. We ought not to be deep in discussions about limiting resources so that the States get higher burdens themselves in any way for helping these populations.

Mr. FORD. Are you witnessing the impact of some of the waivers you have given to the States?

Secretary SHALALA. We have tried to be very careful and all of those waivers have had to be budget neutral. As you know, your own State of Tennessee, what it has tried to do is take the existing expenditures on Medicaid and add some things and tried to cover more people, some low-income working people, putting people into a managed care situation.

Mr. FORD. Overall, it has been a pretty good program, but I am wondering whether they are running into financial problems.

Secretary SHALALA. I think we want to watch it very carefully. The new Governor has had some concerns about this. I have talked to him myself. We are at the beginning of that program. While they have overcome some huge obstacles, we want to work with the State to make sure that none of the populations, who the citizens of this country care deeply about, are adversely affected by these decisions.

Mr. FORD. Madam Secretary, let me change the subject a little bit. Can you tell me what the status of the disability backlog is today? Some of my colleagues on the other side of the aisle brought the issue up earlier. I would like to follow through on some of the questions here.

Secretary SHALALA. We have committed ourselves to reducing the disability backlog. The Social Security program in the eighties went through radical reductions in the number of employees, from about 80,000 to 60,000.

Mr. FORD. So that was about a 20-percent cut in the staff?

Secretary SHALALA. That was about a 20-percent cut.

Mr. FORD. That was under the Reagan administration.

Secretary SHALALA. Exactly. Simultaneously, the rules of who was eligible for the programs changed the numbers in terms of who was coming on to the programs. We produced a huge backlog. We have put together what is called reengineering——

Mr. FORD. The backlog started back a decade ago in the eighties or more, and we have not been able to catch up on that backlog.

Secretary SHALALA. We have not been able to catch up, and one of the things that this administration pledged itself to is to develop a strategy for bringing down the backlog, and for processing claims considerably faster. To do that, we had to rethink with our employees the entire disability process, trying to find out where the glitches were in the system.

W now have a strategy that we believe will cut down on the number of days it takes for the initial disability decisions and help us reduce the number of pending claims. It has been a painful process.

Mr. FORD. Are you seeing a significant growth in claims since about 1988?

Secretary SHALALA. We have, and that is a result of children coming into the SSI program and to some extent some of the alcohol and drug addicts coming into the program, but particularly children coming into the program. It has overloaded the Social Security program, which of course was operating with significantly fewer employees.

But we have thought it through, we have some new resources, we have got the strategy, and it will start coming down. But it is very tough to do when you are dealing with very vulnerable people.

Mr. FORD. Some of my colleagues on the other side of the aisle are suggesting we cut all children off SSI in order to get to the root of the problem rather than just trying to go after those who defraud and abuse the system.

Do you have any suggestions what we should do in this area?

Secretary SHALALA. First of all, cutting all the children off would be a national tragedy. There are children in this program that are disabled and who have a very low income who need help. What we have done, though, is recognize that there may be some problems with the program, and there are two activities that are going on.

First, Congress in its wisdom made some changes in SSI in relationship to drug and alcohol addicts. It is now going to be a more temporary program that puts people into treatment programs.

Second, the Congress in the Social Security independent agency bill asked me by January to appoint a commission to take a look at the children's issue in disability. I appointed former Congressman Jim Slattery of Kansas to head that commission. They have already had their first meeting. The first thing I told them at the meeting was that they were out of time, that Congress needed their advice as soon as possible, and I pleaded with them not to take the whole year. But I think that Mr. Slattery will be up to talk to many of you.

Finally, the administration itself has its own internal review of all of our disability programs headed by the OMB Director, the domestic policy director, and me, reviewing all of the disability programs in the administration.

Mr. JOHNSON of Texas. I thank the gentleman. His time has expired.

I would like to note we love children too, and we are not about to take any programs away from them indiscriminately. I don't know of the proposal that you are talking about, Mr. Ford.

Mr. FORD. Mr. Chairman, I am only making reference to the welfare reform package that the Republicans keep talking about with all of the—many of the problems that we witnessed with some of the abuse and fraud with SSI. But I think many of your colleagues on the Republican side are in fact suggesting that in order to address the problem, that we do away with the supplemental security income of all children who are now receiving it.

Those who abuse it should be cut from the program, but it is a very responsive program to the needs of disabled children in this country, and we on the Democratic side of the aisle want to make sure that we keep it intact.

Mr. JOHNSON of Texas. I hope you do.

The chair recognizes Mr. Hancock to inquire.

Mr. HANCOCK. Well, I would like to respond also to the gentleman from Tennessee. I don't know of any recommendation on our side of the aisle to completely eliminate helping children or getting rid of the SSI to protect children. If it has been mentioned, I haven't heard it, and I think I have heard just about the most conservative reductions in government proposals that are submitted to any congressional office.

I would like to just make a comment rather than ask a question, or maybe the Secretary can explain it. The largest percentage increase in the President's proposed budget is the judiciary. I realize that that is a very small part of the overall budget. It is not going to balance the budget.

But I would just like to make the comment that a lot of us in the private sector are pretty consistently or pretty regularly concerned about the growth and the money that we are spending primarily for the purpose of protecting government rather than spending the money to protect the citizens.

I think that is what some of the crime bill is all about. I mean, we want to spend more money, we want to solve the crime problem. But it would appear that some of the money that we are spending in the judiciary isn't to solve the problems of the citizens, it is to protect government from their own citizens. I would just like to make that observation.

You may or may not want to make a comment on it, but if we are going to take a look at the growth of government, let's take a look at where the most rapid growth is, and the most rapid growth in this budget is in the judiciary.

Secretary SHALALA. I probably should take a pass on this. I am responsible for 44 percent of the budget, but not the judiciary.

But let me say that the President recognizes the very serious growth in health care costs in this country, and we are obviously anxious to bring down those costs. In this case what we are trying to do is protect very vulnerable populations.

The growth in the judiciary, in crime costs, to the extent that it is related to our ability to get our values straight, is part of the discussion that we are having here—a broader discussion about how we treat our vulnerable citizens and what kind of opportunities we offer in this country, so that we reduce the number of people that end up using—particularly the criminal parts of—the judiciary system.

So you obviously are entitled to your views, and I respect your right to exercise them, but whatever our feelings about the judiciary, our commitments, and our values about children and about the elderly and the disabled ought to be kept firmly in mind as we work through a very large part of the government's commitment.

Mr. JOHNSON of Texas. Thank you, Secretary Shalala.

Mr. Rangel will inquire.

Mr. RANGEL. Thank you.

Welcome, Madam Secretary. You and the President have done a wonderful job in working toward reduction of the deficit in a way that doesn't pain people. I think it would have been a more tremendous job if we didn't have this middle-class tax cut. But that is another issue.

My concern has always been provisions for the treatment of drug addicts. While it appears, though, the war against drugs has been declared over and that we don't see any Member of any Cabinet position stressing the importance of dealing with this problem, and it costs us hundreds of billions of dollars in terms of crime and health expenses and productivity, and I assume that in your budget the treatment provisions have been expanded.

Secretary SHALALA. They have, sir.

Mr. RANGEL. What bothers me is that there never seems to be a connection between treatment, so-called rehabilitation, and job training, and jobs. I have told Secretary Reich that every program that I have seen, not every, but most, that is funded, it is funded by the States, because we give them more flexibility, they are closer to the problem, we can't have the Federal Government interfering with these things, and the States not only make assignments politically, but the same drug addicts are going in and out of the programs.

There is no training. There is no education. So you come out with self-esteem and you are drug free and you are unemployable. Nothing seems to change over 20 years. Could you respond?

Secretary SHALALA. I share your view that the programs have to be connected in a way that we don't concentrate just on getting someone drug or alcohol free without the connection to job training and other kinds of programs. Let me give you—well, one of the examples you know very well. In Harlem we are working very hard on an empowerment zone that will try to make these connections.

In the crime bill, the prevention part of the crime bill, the importance of it is the way in which we work with the young person right through into that employment. In Oregon we are embarked upon an experiment with the State to connect Federal programs with State and local commitments so that there is a seamless approach to youth, to children, so that the job connections are done.

In the welfare reform bill we have done the same thing, so that education is in there as well as the connection to the job and staying in the job.

Mr. RANGEL. That brings me to my next question. First of all, in the welfare reform bill we are working off of the Contract With America. So I don't know what is going to be in there. In the crime bill, the majority is trying to remove those preventive measures that were placed in it.

Is there a White House or Cabinet team that would give a theme to all of the inner cities or all of the areas that are connected, that takes us from the rehabilitation center to placing someone back in the job market?

Secretary SHALALA. There is a team at the Cabinet level as well as at the sub-Cabinet level. I have assigned our regional directors, one of whom is with me here today, Lynn Yeakel, who is from Philadelphia and represents that region, to work almost full time with those empowerment zones to make sure we bring not only the resources that are committed to the empowerment zones, but it is really the connection with the rest of the resources—the State programs with Federal programs—there really is a seamless connection.

Mr. RANGEL. We have a group, we don't know what to call ourselves because it is not here what the new rules will allow us to do, Members of Congress, Republicans and Democrats, that are concerned about this issue, that sit on the various committees that have jurisdiction, and we would hope that your team member that works with the Cabinet, we could ask Lee Brown whether he could put together a team too, so that no matter what legislative committee has jurisdiction, we will be able to work more closely with you.

Secretary SHALALA. Exactly. We are looking at our administrative requirements, too, to make sure we don't produce things under our control that would impede the connections between the programs.

Mr. RANGEL. Thank you, Madam Secretary.

Mr. JOHNSON of Texas. I thank the gentleman.

The chair recognizes Mr. McDermott to inquire.

Mr. MCDERMOTT. Thank you, Mr. Chairman.

During the 1994 elections, the Republicans bragged all over the country and took great pleasure in announcing that they killed health care reform. It seems today from listening to their questions that they really are upset at you for not coming up here with a budget that cut the daylights out of Medicare and Medicaid, as though it was now your responsibility to come up with the proposal on health care.

I think there are some of us on this committee who applaud you for not putting up big cuts in Medicare and Medicaid for deficit reduction, but rather holding it back to be used as a part of a comprehensive reform. I think that it is incumbent on the other side at this point to come forward.

The President rightly put this on the agenda and said if we don't have health care reform, we will not get deficit reduction. Now, my mother and her sisters, one in Detroit, one in Dallas, one in Seattle, they watch this and they can't understand sometimes what the connection is between health care reform and deficit reduction.

I would like you to take the rest of my time explaining what the connection really is so that people understand what this whole debate is really all about.

Secretary SHALALA. What the debate is really about is that some people have health insurance in this country and others don't. Unless everybody has health insurance, adequate, high-quality health insurance, then some of us will pay more than others. Any time we try to fix the system by cutting down the costs on the government

program, we will shift some of the cost to those who have health insurance. They will pay more money. The people who have no health insurance won't have a chance to get any health insurance.

So it really is a question of how we are going to keep our budget with some kind of discipline and reduce the deficit. We cannot reduce the deficit in this country until everybody has good health insurance and access to health insurance.

We can't do it by bludgeoning the programs for the elderly and for children and for the disabled, because that will only shift the costs on to State and local governments, on to hospitals, and they will pass on those costs to private people who pay for health insurance.

So I think the answer to your mother is, we are all in this together, and each of us must make a contribution. The government—and the government programs have to make sure that they are well managed and that they don't spend more than is necessary. The private sector has to do everything it can to cover its workers.

All of us must work together to make sure that those who get up in the morning and go to work—after all, they are left out of the system—have coverage, or the system will be expensive because the people without coverage will put off their health care or they will walk into an emergency room for their health care.

So the answer really is that we cannot reduce the deficit, we can't get anywhere near getting a budget that is anywhere near balanced, unless we get everyone covered, and we all work on the efficiencies ourselves and together.

Mr. McDERMOTT. Let me carry that a little further, because I listened very carefully to the Republicans, looking for some hope that there might be some thought over there about doing something about health care. The Speaker has talked about getting rid of Medicare and giving my mother a medicheck kind of voucher saying, no longer are we going to do it through the Medicare system, you are going to take that check and buy from an insurance company.

Now, is my mother going to be better off with that sort of situation where she goes and buys a private insurance program than what she presently has under Medicare today? Would you recommend that to her?

Secretary SHALALA. No, I wouldn't recommend it to her. For a number of reasons. She is part of a segment of our population that is at higher risk in terms of health care. One of the reasons that the government got into this in the first place was because the private health insurance system in 1965 only actually covered half the elderly population.

Now only 1 percent doesn't have coverage. The private insurance market, while it has begun to move to offer HMOs, for example, to the elderly, want people that are as healthy as possible because of their costs.

Mr. McDERMOTT. So they are risk selecting?

Secretary SHALALA. They are risk selecting and they admit that they are risk selecting. One of the reasons they are doing that is because they can't absorb the cost of the higher risk populations without increasing their premiums.

So——

Mr. McDERMOTT. So you are really saying that any senior who has any problem would be worse off with a voucher system where they had to go into the private system than they are under the present system.

Secretary SHALALA. One of the reasons the President said let's take some steps, we need insurance reform, is that most seniors will have a preexisting condition. Being senior is a preexisting condition. So simply giving people vouchers and expecting the market to respond to a high risk population—it is not just seniors on Medicare, as you well know, or on Medicaid. It is disabled people. There is not a private sector market that will absorb all of the most disabled people in our society.

The private sector very much wants to work with the government. They administer the Medicare program. I think they do a pretty good job. Together we are going to make even more reforms. But they also want their risk protected from high risk populations, and the government's role is very much to do that.

That doesn't mean we should be paying more for healthy people than the private sector. But it does mean that we have to share the risk and share the responsibility and find a public-private partnership.

What we learned the last time around, it seems to me, Congressman McDermott, is that we have a mature private health care system in this country, that whatever reform needs to take place can't take place just on the government's piece. It has to be a partnership between the private and the public sectors, thoughtfully closing this huge gap of people that have no access to health insurance, thoughtfully getting more efficiency into the system, and that we shouldn't be bludgeoning down the public sector's health care programs for vulnerable people as a way of trying to deal with health care costs or reducing the President.

Mr. McDERMOTT. I hope you will tell the President to hang in there and force the other side to put up or shut up.

Mr. JOHNSON of Texas. The time of the gentleman has expired.

In defense of the Speaker's comments on medicheck, let me indicate he was looking for choice and that is one of the options available. I think the Secretary would agree that—in fact, you made the statement earlier that you wanted the elderly to have a choice, and in health care the same thing applies.

So thank you for your comments in that regard.

Mr. Payne will inquire.

Mr. PAYNE. Thank you very much, Mr. Chairman.

Thank you, Madam Secretary. Since this is a budget hearing, I had questions about numbers. These are numbers that I think are really good news in terms of the presentation you have made. Specifically those that are on the chart that is still here, talking about the Medicare and Medicaid growth slowing. I think you said in your presentation that we can look at some $212 billion in deficit reduction that has occurred as a result of the slowing of the growth of Medicare and Medicaid.

Specifically, in your testimony you mention that Medicaid has been reduced from 13.9 percent growth to an 8.7 or 5.2 percent, which is a very substantial amount of growth. Medicare, from 11.9

to 9.9 percent, or has been lowered by some 2 percent over the course of the last 2 years as we project forward.

You then went on to say that Medicaid last year had experienced a 63-percent increase in the number of Americans enrolled in managed care, and that there had been a lesser, I think a 16-percent increase in individuals on Medicare into managed care.

I guess my question then has to do with these facts and these figures. Are you suggesting that there is a direct correlation between those people who are going into managed care programs and the ability to limit the growth of cost of the Medicare and Medicaid programs?

Second, what other significant factors would you attribute this lessening of the rate of growth to? Because it could be helpful to us as we look forward policywise.

Secretary SHALALA. Let me make two points about the Medicaid program. First, the dramatic effects of the 1991 provider tax restrictions, removing the creative financing that States have been doing to try to leverage more Medicaid money. That was a bipartisan bill. I have acknowledged that, and all of us together ought to take credit for pulling down some of the growth in the Medicaid program.

Second, the use of waivers by States, moving some of the populations into managed care. In the process of those negotiations, those waivers have a contract, often 5 years, that is budget neutral, which means that we are getting some discipline from the States as part of our negotiations with them, which is holding down some of the costs over a period of time, the term of these waivers.

While we are saving money, the States are saving some money, which is what they were up to, by moving some people to managed care, and we are saving it because those waivers had to be budget neutral. I think that the court is still out on the issue of how much managed care for vulnerable populations saves us money.

Certainly with children, where you have managed care that has a big investment in prevention, immunization, prenatal care, perinatal care—all of us can see in our heads that we are going to save money if we make those early investments.

For very disabled people, whether managed care will work for them or a very specialized kind of group, for the elderly where we have choices, we know there is some risk selection. There are wonderful stories which I think indicate high intelligence on the part of managed care, their recruiting efforts at health resorts, where large numbers of elderly are to find healthy elderly to put into managed care.

There is some risk selection going on. You can't blame them for doing that. The issue is, are people in Medicare satisfied. It is a new generational experience. My generation is much more used to managed care than some previous generations. So I think in Medicaid, there are actually two things, two significant things going on. One is the law that was passed, and the other is these contracts, these managed care contracts and the way they have played out. They said I have learned my lesson well.

Mr. PAYNE. I see my time is almost up. I had some other questions. What I will do is submit those in writing.

Secretary SHALALA. I would be happy to handle them or come see you, whatever.

Mr. PAYNE. Thank you very much.

[The information follows:]

QUESTIONS FROM MR. PAYNE

1. What has been primarily responsible for this reduction in growth?

- In 1993, this Administration worked successfully with the Congress to enact the largest deficit reduction bill in history;

- Successful implementation of regulations following the bipartisan passage of the 1991 provider taxes and donations act has had a significant effect toward limiting Medicaid DSH payments and states' use of creative financing mechanisms which increase Federal payments;

- Aggressive program management, such as replacing five under-performing Medicare contractors and redoubling our efforts to combat fraud and abuse in the Medicare and Medicaid programs;

- A slow-down in both general and health care inflation reduces the rate of spending growth.

2. To what extent has the increased use of managed care in the Medicare and Medicaid programs contributed to this reduction? What percentage of the Medicaid population is currently enrolled in managed care? of the Medicare population?

- It is not clear to what extent managed care has contributed to the reduction in Medicare and Medicaid spending.

- In the Medicare program currently, differences in enrollee health status between managed care and the general Medicare program have hindered out efforts to achieve savings. We have attempted to make adjustments to our payment rates to account for these differences between the populations.

- To help ensure that future growth in Medicare managed care produces savings, we are exploring methods such as competitive bidding for risk contracts, as well as improving our health status adjusters.

- In the Medicaid program, studies have generally found that managed care only produces a one-time savings of about 5 percent to 15 percent over baseline costs without slowing the rate of growth.

- Twenty-three percent of the Medicaid population, or about 7.8 million people, is enrolled in managed care. About 9 percent of the Medicare population is enrolled in managed care, which is 3.1 million beneficiaries.

3. What should be the target growth rate for federal health care spending: CPI, CPI plus growth in population, the rate of private medical inflation, etc.?

- In the President's Health Security Act, the target rate of growth for overall health spending was CPI four years after the bill was enacted. However, I believe that rate of growth is achievable only if we reform the entire health care system.

4. What is the anticipated rate of growth for long-term care in the Medicaid program? acute care? care for the disabled?

- Medicaid long-term care services are projected to grow at an average annual rate of less than 8 percent from 1996 through 2000. Within that overall growth rate, institutional long-term care is expected to grow at an average annual rate of 7 percent while community based long-term care is projected to grow at almost 11 percent.

- Acute care services are projected to grow at an 11 percent average annual rate between 1996 and 2000.

- The cost of Medicaid services for the disabled are expected to increase at an average annual rate of almost 10 percent from 1996 through 2000.

5. What are the fastest growing costs/programs in Medicare and Medicaid?

- In the Medicare program, based on projected expenditure growth for the FY 1996-2000 period, Part B expenditures are projected to outface Part A expenditures. Within Part B, the fastest growing areas are: outpatient hospitals, independent labs, and group practices.

- In the Medicaid program, acute care services are the fastest growing component. The costs of acute care services are projected to increase an at average annual rate of 11 percent from 1996 through 2000. While prescription drugs represent the bulk (over 40 percent) of acute care services costs, clinic and health center costs (25 percent of acute care costs) are the primary drivers of the rate of increase. These costs are projected to grow at an average annual rate of over 14 percent.

6. What should be done to bring down the rate of growth in the future in order to save additional federal funds?

- I believe we must be more aggressive in combating waste, fraud, and abuse.

- We must explore ways to manage the program more efficiently, and give beneficiaries more options than they

presently have to receive their health care.

- Reform to the overall health care system would also have a significant impact on reducing costs.

- I want to work with the Congress in a bipartisan manner to find ways to control the growth in the Medicare and Medicaid programs.

Mr. JOHNSON of Texas. Thank you very much, Mr. Payne.

The chair recognizes Mr. Lewis to inquire.

Mr. LEWIS. Thank you, Mr. Chairman. Thank you, Madam Secretary.

Madam Secretary, I think it is possible for us to remember that we did a lot of heavy lifting, the Democrats for President Clinton, and led the way on deficit reduction during the past 2 years. It was not an easy vote, but we did it. I hear from some of my colleagues this morning that the sinners have become the preachers. I think it is about time for the Republicans to do some of the lifting. I think we all would appreciate it.

Madam Secretary, I don't want you to respond to that, that was just a little editorial.

Madam Secretary, the administration has been at the forefront on welfare reform. Last year you introduced a welfare reform bill proposal. This year you have pledged to build upon your budget proposal by working with Congress to reform welfare. I commend you for your hard work and for your leadership in this area.

You have been keeping your eyes on the prize. I agree that welfare reform should focus on moving those on welfare into the work force. We must provide the necessary training, education, child care, and health care. Unfortunately, many of my colleagues on the other side, many of the Republican efforts at welfare reform appear to focus less on work and more on morality.

It creates paternalism, not opportunity. I fear that as you work with Congress, you will be—I hope this is only a fear, Madam Secretary—but that you will be influenced by this attempt to legislate morality. Will you comment on whether your efforts to reform welfare will emphasize work or Federal micromanagement of people's lives.

Secretary SHALALA. It will indeed, and frankly we believe that the President's proposal reflects the values in our larger society. It moves people from welfare to work. It has time limits. It holds both parents responsible, including the establishment of paternity and child support enforcement. We have been working with the committee. We still have some disagreements.

We would like to put more emphasis on the family, for example, than on the bureaucracy. We have disagreements about what happens to a young child born to an unwed mother, and disagree sharply on whether those children should be denied cash assistance for their entire lives.

In addition to that, we believe that young people who make the decision to have the child ought to stay at home, and that their parent ought to get some assistance if they stay at home, as opposed to putting the money in the bureaucracy and letting the bureaucracy make a decision. In many ways, my response is the same as with the SSI. I think we have to hold parents responsible. I think that is moral and reflects values.

We did put forward a welfare reform plan. We have been discussing our ideas with the committee. I am sure there is more debate ahead, not only in the subcommittee in the next few days, but also in the larger committee as well as in the House and then in the Senate. But we intend to hold to our standards, and that is that we ought to have welfare reform.

Simply shifting the responsibility from one bureaucracy to another is not welfare reform. Reducing the amount of money the States get for welfare reform is not welfare reform. It is simply cost shifting. Not putting education and training into place and real job opportunities is not welfare reform, it is simply reducing the rolls by throwing people off of welfare.

So we bring both values as well as strong views that we think are reflected in many of the experiments that have gone on and the work that has been done by Governors and by county officials over the years, and by those of us who have spent our lives working with populations that are very vulnerable.

Mr. LEWIS. Thank you very much, Madam Secretary. I look forward to working with you.

Secretary SHALALA. Thank you.

Mr. LEWIS. Thank you, Mr. Chairman.

Mr. JOHNSON of Texas. Thank you, Mr. Lewis.

Madam Secretary, I want to thank you for being so gracious to accept inquiry from all sides up and down the spectrum and for extending your time with us this morning. Thank you so much. We hope to see you again.

The committee stands adjourned.

[Whereupon, at 12:25 p.m., the hearing was adjourned and reconvened on Thursday, February 9, 1995, at 10 a.m.]

PRESIDENT'S FISCAL YEAR 1996 BUDGET

THURSDAY, FEBRUARY 9, 1995

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, D.C.

The committee met, pursuant to call, at 10 a.m., in room 1100, Longworth House Office Building, Hon. Bill Archer (chairman of the committee) presiding.

Chairman ARCHER. The committee will come to order.

Mr. FORD. Mr. Chairman.

Chairman ARCHER. Mr. Ford.

Mr. FORD. Mr. Chairman, could I be recognized just for 1 minute, please? I would like to make an inquiry to the chairman, really.

Chairman ARCHER. Does the gentleman wish to make an opening statement today?

Mr. FORD. No, I would like to make an inquiry to the chairman on a different subject matter, Mr. Chairman.

I read this morning, Mr. Chairman, with great interest in the Washington Post, which described the welfare reform mark that Chairman Shaw is apparently announcing today before the Chamber of Commerce; and I would like to know, when will members of this committee receive copies of the mark on welfare reform, when will the Democratic members receive the Republican welfare reform package?

Our staff, Mr. Chairman, was told that a markup document would be delivered yesterday. Then they were told that it would be available today. Obviously, something is available that the Washington Post has printed and quoted Chairman Shaw on welfare reform. Why was the information given to the Washington Post; and the ranking minority member of the committee and Democratic members and other members of this committee, we have not received the welfare reform package?

You have repeated over and over, Mr. Chairman, that you wanted to be fair with the Democratic members of this committee, and I would urge the chairman of this committee to be fair with us, not let us read in the Washington Post what is going to be unveiled in the welfare reform package that we have waited on. I have asked Chairman Shaw over and over, when will we receive a copy of this document. It is insulting to us on this side of the aisle to read it in the Washington Post and not have a copy of it delivered to us when the chairman of this full committee has promised us and assured us that he wanted to be fair in these areas as we try to move to mark up many of these bills within the first 100 days, in keeping with what you have promised the American people.

Chairman ARCHER. The gentleman's comments are not in order relative to the business before the committee today. The gentleman should take his comments to the chairman of the Subcommittee on Human Resources.

This chairman will be fair, including listening to repeated derogatory remarks against the chairman himself, which occurred redundantly yesterday and were out of order under the rules of the House and the rules of this committee. This chairman has been more tolerant than any chairman that I can remember in many, many years in this committee. The markup document has been given earlier to the minority than was ever given to us during the time that you controlled this committee, and for any further comment on that, I would suggest that you go to the chairman of the subcommittee.

Mr. FORD. Mr. Chairman, I want you to know——

Chairman ARCHER. In fairness to our witness today and the announced proceedings of this committee, we will commence with the hearing.

Mr. FORD. Mr. Chairman, I wanted to say that I have great respect for you.

Chairman ARCHER. The gentleman is not recognized.

Mr. FORD. May I be recognized?

Chairman ARCHER. We will proceed with the agenda that was scheduled for the committee today.

Our witness today is Dr. Alice Rivlin, who is the Director of the OMB. We will continue to proceed with our hearings on the President's budget, which we believe should be given serious consideration by the Congress—and not declared dead on arrival as our predecessors did, because we believe that there are many elements of it about which we can work together.

We do believe that our Nation is at a fiscal crossroads, and I know that Dr. Rivlin over the years has been very much of a deficit hawk. Yet we see in the President's budget continued deficits as far as the eye can see of $200—perhaps $300 billion a year. The public is demanding a smaller and smaller deficit, however, and not continued deficits that go out into the future.

Congress has its responsibility in this regard, and we would like to work together with the administration in doing all that we can to downsize government and reduce spending in the years ahead with a commitment to get to a balanced budget. As has been the custom of the committee through this hearing process so far, I will yield to Mr. Coyne for the opening statement of the minority.

Mr. COYNE. Thank you, Mr. Chairman.

Dr. Rivlin, I want to thank you for appearing before the committee here today. Your expertise on budget issues is highly respected in this country, and we always profit from your testimony before the committee. I also want to commend you for all your efforts in producing the administration's fiscal year 1996 budget proposal. We all realize how much work it takes to put together a comprehensive plan like this, and your competent, dedicated service is greatly appreciated.

I also want to commend the administration for its past budget recommendations to the Congress. Over the last 2 years, the administration has brought a degree of fiscal responsibility to the

budget that was sorely needed by this country. I am sure that you, more than most people, appreciate the fact that the 1993 deficit reduction package represented a lot of tough decisions and sacrifice. The payoff, however, has been well worth it. OBRA 1993 reduced Federal deficits between 1994 and 1998 by more than $500 billion from what they otherwise would have been.

Tuesday in your testimony before the House Budget Committee you mentioned that the latest estimates indicate that the deficit reduction package we passed in 1993 will cut over $600 billion from Federal spending by 1998. That accomplishment should not be taken lightly. As a result of this responsible stewardship, economic growth in 1994 and 1995 has been very strong and unemployment has dropped to its lowest level since 1990.

I think that we must recognize the Clinton administration's past efforts at deficit reduction when we consider your new budget submission this year. OBRA 1993 wasn't the administration's only contribution to deficit reduction, either. We must also remember that the Clinton administration took the lead on deficit reduction last year when it proposed its health care reform plan to the Nation. The Clinton administration recognized that in order to achieve a sustainable budget in the long run, runaway health care costs have to be restrained. Since Congress chose to reject the administration's proposal, it is incumbent upon this body to propose a different solution to the problem.

The same is true of welfare reform, I might add. I suspect, however, that the American people, as well as some Members of Congress, don't yet have a clear understanding of the pain and sacrifice that lie ahead if we expect to achieve and maintain a balanced budget after the year 2000. With that concern in mind, I think that this committee should be very cautious about any decisions it makes to enact sweeping tax cuts this year. We should make certain that any tax cuts we do enact meet the most demanding criteria. Paying for tax cuts will require cutting or eliminating a great many existing programs, and let's not kid ourselves that all of the necessary cuts will come from eliminating waste, fraud, and abuse. That just won't happen. We will have to cut programs that really do make people's lives better. We had better be sure that the benefits of these tax cuts outweigh the benefits from the programs we are cutting.

By the same token, we had better make sure that these tax cuts are designed to address our Nation's most pressing problems. Is making life better for families that do have a roof over their heads a more pressing need than reducing the number of homeless families in the Nation? Is investment in new equipment more important than investment in our children's education?

It seems to me that our mission is to find the proper delicate balance between competing worthy goals. There is no easy answer. In short, any tax cuts we must enact should meet the test of providing substantial, tangible benefits to this Nation, and they should do so without placing additional burdens on the most vulnerable members of our society.

Dr. Rivlin, you have been an ardent advocate of fiscal responsibility. I hope that I have placed your presentation today in its

proper context, and I thank you for appearing before us today. I look forward to hearing your testimony.

Ms. RIVLIN. Thank you.

Chairman ARCHER. Dr. Rivlin, welcome to the committee. I think you are aware of our rules. We will be pleased to hear your verbal testimony. Should you wish to submit something of greater length, without objection, it will be entered into the record. You may proceed.

[The prepared statement follows:]

STATEMENT OF HON. JIM RAMSTAD

Mr. Chairman, thank you for giving us the opportunity to question Director Rivlin this morning.

Like many of my colleagues, I am extremely disappointed in the President's recently released budget. At the same time, I think it is important to commend Dr. Rivlin for her efforts to inject a sense of urgency about the deficit in the administration's internal dicussions of this matter.

Last Saturday's article about the President's budget described Dr. Rivlin as the sole administration advocate for strong deficit reduction measures. While I don't share Dr. Rivlin's desire to cut Social Security or raise taxes on the already overtaxed American public, I am deeply concerned about the Federal deficit and the President's fiscal year 1996 budget.

Mr. Chairman, thanks again for calling this hearing. I look forward to hearing Dr. Rivlin's testimony and to exploring in greater depth this important issue.

STATEMENT OF HON. ALICE M. RIVLIN, DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

Ms. RIVLIN. Thank you, Mr. Chairman. I would like to submit a longer statement, and I will briefly summarize it so that we have plenty of time for questions.

I am pleased to be back before this committee and to have an opportunity to participate in the opening stages of the dialog about the 1996 budget. I look forward, as does the administration, to working with this committee—not only on the budget, which is the subject for today, but on other parts of our mutual agenda. We especially look forward to working with the committee on health care and welfare reform. While these parts of our mutual agenda are not in the budget we are talking about today, they are very important priorities of the administration on which we look forward to working with you.

The administration has worked hard on this budget, and as Mr. Coyne says, it is not easy to make a budget. We believe that it is a good budget and that it continues our work on the goals we have held for the last 2 years.

A major theme of this budget is raising living standards for average Americans, both now and in the future. This has been a major element of the Clinton administration's economic strategy. From the start, the Clinton administration has emphasized deficit reduction and, at the same time, investments in people, technology, and infrastructure so we can have a more productive, higher wage economy in the future. This budget continues the fight for higher wages and better lives for average Americans. It does it in several ways.

We are proposing a tax cut, not for upper income Americans, but for working families with children under 13, young families who are having a hard time making ends meet. We are proposing that education and training be made more available and more affordable to average Americans. We believe that increased education

and training is the key to better jobs in the future; that theme runs throughout the budget. You see it in our tax proposals, with the education and training deduction. You see it in our proposal for broadening the individual retirement account and making it possible for more people to participate, save, and use those funds, penalty free, for a broader range of nonretirement purposes (for example, education, extraordinary medical expenses, and the purchase of a first home). You see it in our proposal for a GI bill for American workers. We believe this proposal sends an important signal to American workers about the Federal Government's willingness to help them get the skills they need for better jobs.

In the GI bill we are proposing that we pull together a plethora of training programs already on the books, thereby creating a pot of money for skill scholarships for dislocated and low-income workers and giving States increased flexibility to provide services their workers need.

Although this budget cuts severely in other places, it invests in Head Start, WIC, the School-to-Work Program, Goals 2000, and science and technology programs. We believe these programs will raise productivity and wages in the future.

This budget also continues our commitment to fiscal responsibility. We cannot be faulted for not caring about that.

The deficit was out of control when we came into office. In fiscal year 1992, the deficit was the highest it has ever been. It was $290 billion and headed up. That was an unsustainable situation. The use of the Nation's saving on an escalating basis to finance the government, as opposed to productive investment, was the greatest threat to future living standards. This threat caused us to put forth a great deal of effort on deficit reduction in the first few days of our administration. We got a deficit reduction plan up here in 17 days. It was a plan for 505 billion dollars' worth of deficit reduction over 5 years, about half spending cuts and half revenue increases.

The Congress worked hard on our plan, modified some of it, and by a bare majority had the courage to vote for it in each House. It took effect and has been enormously successful. Since the plan was put into place, it has actually worked better than we thought. We now estimate that the effects of the deficit reduction plan on cutting the deficit will total about $616 billion cumulatively over the 5 years to which it applied.

This deficit reduction package has produced a rapidly growing economy. We are even in the pleasant situation of having to worry about whether it is growing too rapidly. That is much better than 2 years ago when we were worried about stagnation and whether there would be a recovery. We have created almost 6 million jobs. Things also look good on all the statistical fronts—little inflation, high growth, and a very successful economic picture.

This budget contains more deficit reduction measures. There is a total of $144 billion in budget savings, of which we propose to use $63 billion over 5 years to fund provisions of the Middle-Class Bill of Rights. Most of the cuts, $101 billion of the $144 billion, are in discretionary spending. Others are mandatory.

We are not proposing any tax increases in this budget. Although we have emphasized cutting discretionary spending, we do not believe in slashing government indiscriminately. We believe that we

must all work together to have a leaner, more effective government.

A government that works better is the second theme that animates this budget. This, too, has been a continuous emphasis of the Clinton administration from the beginning, with the Vice President's leading of the National Performance Review. This budget accelerates the Vice President's work by detailing plans for aggressive restructuring at the Departments of Transportation, Energy, Housing and Urban Development, along with the General Services Administration and the Office of Personnel Management.

We have 131 programs that we are proposing to terminate. Most importantly, we are proposing to consolidate 271 programs into 27 performance partnerships. Performance partnerships, we believe, are a new addition not only to the lexicon of talking about government, but to concepts of how the Federal Government, States, and localities should work together. It is not just a new name for block grant. We believe that the Federal Government, the States, and in some cases, localities must work together to decide what the grants are supposed to produce. Why are we doing this? How can it be measured? What results do we want? When we have agreed on the answers to these questions, the Federal Government should allow the State or locality to get results in the way that seems best adapted to their conditions. It is not just a grant for States and localities to use the money any way they want; results have to be there for all to see.

The Vice President likes to talk about trust and accountability. We trust the States and localities to use the money well, but we must all be accountable to Federal, State, and local taxpayers.

The final theme that runs through this budget is that of American leadership. We want a leaner, more effective government, not just in the domestic arena, but in the international arena as well.

The budget emphasizes the quality of life in the military, which Secretary Perry has been emphasizing, and the importance of force readiness. In December we announced an addition of $25 billion over 5 years to the defense budget, which we believe will give us a more ready and modern force. It brings on line modernization at the end of the decade—supports initiatives that Secretary Perry is taking to attract and retain the best young people for our armed services.

In conclusion, Mr. Chairman, I am very happy to be here and look forward to working with the committee, not only on the budget, but also on welfare and health care reform, which we believe to be key to future deficit reduction.

We did not put our health care reform proposals in this budget. There are no Medicare cuts in this budget because we do not believe Medicare cuts should be used for tax cuts; but we want to work with this committee and other committees of jurisdiction as we consider health care reform, including the reform of Medicare and Medicaid. I believe all of us have an opportunity, Mr. Chairman, to work together and fashion a budget and a program for this government that is fiscally responsible, preserves and strengthens the activities people need from their government, and eliminates or changes those activities that are not working well.

It is a hard job, and we want to work together with you.

[The prepared statement follows:]

TESTIMONY OF
ALICE M. RIVLIN
DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET
BEFORE THE
HOUSE COMMITTEE ON WAYS AND MEANS

FEBRUARY 9, 1995

Mr. Chairman, members of the Committee, thank you for inviting me to offer the Administration's views on the President's fiscal 1996 budget. For the third straight year, the President has proposed a detailed plan to create a smaller, more effective Government for average Americans -- that is, to help create his "New Covenant" between the Government and the American people.

Executive Summary

The President proposes to build upon his strong record of achievement. With the help of his economic plan, which Congress passed in 1993, the President helped to jump-start a weak recovery. The result was lower interest rates, little inflation, and the creation of more than 5.6 million new jobs.

With a plan that called for a record $505 billion in deficit reduction over five years, and has in fact produced over $600 billion in deficit reduction, the President has reduced the deficit from $290 billion in 1992 to $203 billion in 1994. We expect the deficit to be under $200 billion this year. By 1998, the deficit will fall to its lowest level as a percentage of GDP since 1979.

At the same time, the President has made great progress in reinventing Government through the National Performance Review. We have reduced the workforce by 102,000 positions while streamlining departments and agencies, cutting red tape, and providing better service.

Now, we plan to go further. The President has proposed $144 billion of budget savings -- $63 billion to finance the middle class tax cut that I will discuss in a moment and $81 billion to reduce the deficit further over the next five years. As part of those savings, he proposes to terminate 130 programs and consolidate 271 others into 27 new "performance partnerships."

Not everyone has shared in the economic recovery. As a result, the President proposes a Middle Class Bill of Rights, which will cut taxes for middle-income Americans and give unemployed or dislocated workers grants to purchase the job training they need.

He also is continuing to reduce the Federal bureaucracy and will, by the end of this decade, cut it to its smallest size since John Kennedy was President. As part of Phase II of the National Performance Review, he has proposed to restructure the Departments of Housing and Urban Development, Energy, and Transportation, the General Services Administration, and the Office of Personnel Management.

In the coming months, also as part of Phase II, the President will examine every other program and activity to determine which to terminate, which to restructure, and which to shift to the States, localities, or private sector.

Major Themes

This budget revolves around three major themes -- themes that have dominated the President's economic strategy for the past two years.

1. Raising the standard of living for average families, now and in the future: The President is proposing a Middle Class Bill of Rights. For the short term, it will provide needed tax relief to help millions of average families raise their living standards now. And for the long term, it will give those families the tools they need to raise their living standards in the future.

The Middle Class Bill of Rights:

* Provides a $500 per child tax credit for middle-income families with children under 13;

* Expands eligibility for Individual Retirement Accounts (IRAs) and allows families to make penalty-free withdrawals for a range of educational, housing, or medical needs;

* Offers a tax deduction for the costs of college, university, or vocational education; and

* Creates a G.I. Bill for America's Workers by consolidating 70 job training programs and using the money to offer "Skill grants" through which dislocated and low-income workers can choose and pay for the training they need to find new and better jobs.

The President proposes to build upon his investments in human and physical capital -- investments that will help to raise national productivity and, in turn, living standards for the future. Overall, he proposes to increase investment spending by $9.7 billion in fiscal 1996 over 1995.

The G.I. Bill for America's Workers is a new element of his continuing agenda for improving the education and skills of America's workers, enabling them to compete for high-wage jobs in the new economy. In the last two years, the Administration has enacted the Goals 2000 bill to encourage States and localities to reform their educational systems; revamped the student loan program to make post-secondary education affordable to more Americans, and pushed successfully for the School-to-Work program that enables young Americans to move more easily from high school to training or more education.

In this budget, the President proposes a 10 percent increase for the Special Supplemental Feeding Program for Women, Infants, and Children (WIC), to $3.8 billion; an 11 percent increase for Head Start, to $3.9 billion, and an 86 percent increase for Goals 2000, to $750 million.

As you know, the President has proposed a complete overhaul of the welfare system. Under reform, welfare recipients would get the training they need to go to work. By helping low-income families help themselves, reform would mean greater self-sufficiency for these families.

The President's bill embodied certain key principles: time limits on AFDC for parents who can work, and job placement assistance and training for those who need them; greater State flexibility to experiment with innovative programs that aim to increase self-sufficiency; strict parental responsibility requirements to ensure that both parents support their families; a national campaign to emphasize to teens that they should delay childbearing until they can adequately provide for their

children; and a commitment that welfare reform must not increase the federal deficit.

This year, the Administration will work on a bipartisan basis with the new Congress to enact fundamental welfare reform -- the kind that embodies the principles listed above.

The President's budget also emphasizes investments in science and technology to improve future productivity and U.S. competitiveness in the new economy. It proposes a 13 percent increase for the Defense Department's core Technology Reinvestment Project (TRP), to $500 million; a 4 percent increase for biomedical research at the National Institutes of Health, to $11.8 billion; a 20 percent increase for the Commerce Department's National Institute of Standards and Technology, to a total of $1 billion; and a 4 percent increase for the National Science Foundation, to $3.4 billion. The President seeks to strengthen the Administration's coordinated efforts to promote science and technology through the National Science and Technology Council and to improve the payment system for federally-sponsored research at colleges and universities.

The budget also continues the Administration's strong commitment to deficit reduction. When we arrived, the deficit was a clear threat to future living standards. It was projected to rise from $290 billion in 1992 to more than $300 billion immediately, and then to near $400 billion a few years down the road. The deficit was absorbing a huge share of national saving that could otherwise be spent on the kinds of investments that increase productivity.

Working with Congress in 1993, we enacted a five-year budget plan designed to reduce the deficit by a cumulative $505 billion from 1994 to 1998. Because the economy has performed better than expectations, we now expect to generate $616 billion in deficit reduction over that time. The deficit measured $203 billion in 1994 -- a huge drop from the $290 billion of two years earlier. Except for an anomaly in 1997, we expect it to remain below $200 billion for the rest of this decade.

More importantly, we have reduced the deficit from 4.9 per cent of Gross Domestic Product (GDP) when we arrived to a projected 2.7 percent this year. Clearly, we have brought the deficit under control.

But we are not satisfied. In this budget, we propose to reduce the deficit between 1996 and 2000 by another $81 billion. More importantly, our budget would bring the deficit down to 2.1 percent of GDP by the end of this decade -- its lowest level since 1979.

We are proposing $144 billion in new budget savings -- $63 billion to pay for our middle class tax cut and $81 billion for more deficit reduction.

How did we generate the $144 billion in savings?

Most of them, $101 billion, come in discretionary spending cuts. Of the $101 billion, $21 billion comes from Phase II of the Administration's effort to reinvent Government through the National Performance Review. This includes the restructurings of the Departments of Housing and Urban Development, Transportation, and Energy, the General Services Administration, and the Office of Personnel Management. The rest of the savings are outlined in the program-by-program detail in the budget for the years 1996-2000.

Also as part of Phase II, the Administration has begun an intensive effort to examine the other Federal departments and agencies to determine which functions and activities to continue,

which to terminate, and which to shift to the States, localities, or the private sector. We anticipate that, through this effort, we will revise our five-year, program-by-program plan and offer proposals to restructure agencies in the same way that we have for those cited above.

The budget contains $29 billion of mandatory savings. Most of it comes from extending the Medicare and Veterans reforms of the 1990 and 1993 budget reconciliation acts, accelerating our successful direct student loan program, expanding the principle of user payment for the electromagnetic spectrum, and other smaller savings.

The budget also includes tax compliance savings of about $9 billion, including about $0.4 billion from reinventing Government.

Finally, the budget includes a small amount of savings that does not score for budgetary purposes, including net spending reduction from the Administration's non-emergency supplemental appropriation proposal for fiscal 1995, interest savings associated with the direct student loan program, and debt service savings from all of the other proposals. Partially offsetting these savings are bookkeeping costs due to personnel cuts; reducing the size of the Federal workforce means that the Federal Government and its employees make smaller contributions to the pension funds.

In sum, these proposals fully offset the tax cuts and leave enough additional savings to keep the deficit under control beyond the five-year budget window. While the economy is growing, the deficit is not.

2. Projecting American Leadership: Our funding proposals for international affairs, $21.2 billion, and national defense, $258.3 billion, support American leadership around the world. These two elements are synergistic: we design and prepare our forces and programs to support our national interests and foreign policy goals. Together, they create the foundation for our leadership. I will turn first to international affairs, then to national defense.

However critical to promoting our vital national interests, funds for international affairs programs and institutions constitute only 1 percent of our total budget, requiring that we carefully focus on their most effective use in supporting our most important goals and objectives.

Our budget promotes and defends our vital interests in regions that have long been central to our national security: Europe, the Middle East, and Asia. Our budget includes $788 million to support economic and democracy programs in the new independent states (NIS) of the former Soviet Union. In Central Europe, our budget supports the missions of supporting democracy, free markets, and peace by providing $480 million in funding to help healthy, market democracies emerge. The budget also maintains our long-standing support for the peace process in the Middle East, requesting more than $5.2 billion to assist countries participating in that process.

A strong and growing world economy that incorporates an increasing number of nations is essential to our own economic growth. Our budget provides increased support to strengthen our trade position in the global market and especially in Central Europe, Russia, and Ukraine through such agencies as the Export-Import Bank.

Our leadership is important to prevent and provide a humanitarian response to crises and conflicts that have so

visibly divided many nations in recent years. Our budget supports this leadership effort by providing $1.7 billion for refugee, humanitarian feeding, and disaster assistance programs.

The Nation has built, and this Administration continues to support, a powerful military capability. Our defense budget, which is significantly higher than that of any other nation, supports one of the world's largest military forces, with a superior level of quality and talent. It continues our commitment to maintaining high levels of training and readiness of that force and to equipping it with a technology second to none.

In discretionary spending, the budget requests $258.3 billion in budget authority and $262.2 billion in outlays for the National Defense Function. The outlays represent 16 percent of all spending in the budget.

The Administration continues to place its highest priority on the readiness of U.S. defense forces -- ensuring their ability to mobilize, deploy, and operate effectively in the face of varied challenges of the post-Cold War era. The Defense Funding Initiative, providing $25 billion in higher spending from 1996 to 2001, supports our commitment to high levels of readiness, as does the requested defense supplemental appropriation for 1995. For 1996, the budget proposes funding of $91.9 billion for Operations and Maintenance, the principal readiness-related account.

This budget also contains several initiatives to improve the quality of military life: a 2.4 percent military pay raise and an increase in military community and family support, including more child care facilities, family counselors, and improved recreational facilities.

Superior technology is the hallmark of the U.S. armed forces. In particular, we expect investments in information technologies and sensors to give our forces major advantages in gathering, processing, and acting upon information from the battlefield. The budget proposes $7.8 billion for science and technology programs.

The budget also enables us to maintain stewardship over our nuclear capability. The budget proposes $11.2 billion in total Energy Department spending on defense activities. It includes $6.6 billion of cleanup and disposal of wastes from prior nuclear weapons activities, $0.7 billion for developing nuclear reactors for Naval vessels, and $0.7 billion for nonproliferation, arms control, and other activities.

Intelligence remains a critical ingredient of our national security posture. To support it, we propose to keep the Intelligence budget at the 1995 level. To plan for the future, the President and Congress established a commission of distinguished Americans that will spend the next year reviewing the roles and capabilities of the Intelligence Community. Their conclusions will help to guide future decisions on goals and resources.

Wise investments with dual-use technologies support national defense. They allow defense systems to draw on leading-edge commercial developments in such areas as computers and communications, and they allow investments in defense programs to accelerate commercial progress in such areas as advanced materials and space systems. The Administration's dual-use investment strategy focuses heavily on electronics and sensors. The Technology Reinvestment Program is a key component of this strategy. It awards Federal funds competitively, on a cost shared basis, to enable industry-led projects to create new dual-use technologies. Since the start of the TRP program in 1993,

over 15,000 companies have submitted over 3,000 proposals to participate; the program has made over 250 awards. The budget requests $500 million for the TRP program.

The Defense Department's main challenge with its facilities is to tailor them to the downsized force structure. DOD is working to ensure that base closure and realignment decisions will generate a more efficient use of the remaining defense infrastructure. The budget provides $3.9 billion in 1996 to implement closure and realignment decisions. At the same time, DOD is committed to assisting the economic redevelopment of communities affected by base closures. In this effort, the budget increases funding for DOD's Office of Economic Adjustment (OEA) to $59 million, $20 million over 1995, to help Base Realignment and Closure Commission communities plan for economic redevelopment.

3. Making Government Work: The President is building on his initial success in making Government work and moving out in dramatic, new directions.

Through the National Performance Review (NPR), which the President created two years ago, the Administration has improved service to Government's "customers," cut red tape, empowered Federal employees, and eliminated programs that no longer serve a useful purpose. We have sought to ensure that Federal programs achieve real results -- e.g., cleaner air -- rather than merely spend taxpayer dollars.

We streamlined Federal agencies, cutting management layers and excessive controls. Already, we have reduced the workforce by 102,000 full-time equivalent (FTE) positions. Continuing the President's effort, the budget proposes 1.976 million FTE. By the end of 1996, the President will have cut FTE by 173,300, reducing the Federal Government to its smallest size in 30 years. He also will be nearly two-thirds of the way toward the required reduction of 272,900 by 1999, as outlined in last year's Federal Workforce Restructuring Act.

In its first phase, the NPR, under the direction of Vice President Gore, mostly examined the "how" of Government -- the human resource management, procurement rules, and other processes by which the Government operates. In general, it did not focus on the more basic question of "what" the Federal Government should, and should not, do.

With this budget, the President has begun to tackle this very fundamental question. He is proposing a major restructuring of three Cabinet departments -- Housing and Urban Development, Transportation, and Energy -- and two major agencies -- the General Services Administration and the Office of Personnel Management. We expect these restructurings to save $23 billion over the next five years.

We also are proposing to consolidate 271 programs into 27 "performance partnerships." In exchange for giving States, localities, and other providers more flexibility in how they spend Federal funds, we are seeking more accountability for that spending by focusing on actual performance. Rather than merely calculate the inputs of a program -- i.e., funding levels -- we are focusing on outputs -- what the programs actually accomplish.

The consolidated programs include 70 to create the G.I. Bill for America's Workers, mostly from the Departments of Education and Labor; 108 from the Public Health Service; 60 from the Department of Housing and Urban Development; 30 from the Department of Transportation; and three from the Department of Health and Human Services.

More importantly, these restructurings and consolidations are the first step in a Government-wide examination of departments and agencies, which the President has asked the Vice President to lead. This effort is designed to sort out responsibilities among the Federal, State, and local levels of government, and between Government and such private sector providers as businesses, non-profits, and community groups. Working with the NPR, OMB, the President's Management Council, and the White House policy councils, Federal agencies will examine every program, determine which to continue, which to eliminate, and which to shift to the States, localities, or private sector.

Program Detail

Restoring the American Community: American communities embody our sense of place, belonging, and togetherness -- the very security on which we depend. But our communities face the pressures of great challenges that threaten the ties that bind us together. Violence and drug related crime are tearing at our social fabric.

This budget would invest in our communities, by increasing funding for programs that help to strengthen our communities -- Americorps, empowerment zones, and the urban and rural economic development initiatives. It would continue to commitment undertaken in last year's crime bill, providing the funding necessary to continue making progress towards the goal of putting 100,000 police on the streets and providing increased funding for other crime control efforts.

Americorps: The 1996 budget proposes to increase funding for the President's national service initiative to $1.1 billion. This is a $290 million increase from the prior year, and would permit the expansion of the program to 47,000 participants. This would keep the program on the President's goal of reaching 100,000 participants over three years.

Empowerment Zones and Enterprise Communities: On December 23, the Administration designated nine Empowerment Zones and 95 Enterprise Communities, plus two additional urban enterprise zones. The Administration designated Atlanta, Baltimore, Chicago, Detroit, New York City, and Philadelphia/Camden as urban EZs, enabling each to receive $100 million in flexible block grants. We designated Kentucky Highlands, Mississippi's Mid-Delta Region, and Texas' Rio Grande Valley as rural EZs. Los Angeles and Cleveland were designated as supplemental urban EZs. The budget contains the funding necessary to continue these commitments.

Urban and Rural Economic Development: We propose $4.8 billion in 1996 to fund a new Community Opportunity Funds program to help local and State governments address the most critical needs of distressed communities. We also propose funding the Rural Development Initiative at a level of $5.8 billion to continue to support grants, loans and loan guarantees -- an increase of $716 million over the prior year.

Controlling Violent Crime and Drug Abuse: Our proposed $21.5 billion in discretionary spending in 1996 represents an increase of $3.4 billion from 1995 to fight violent crime. The largest share of the increase would go to help State and local law enforcement agencies.

Community policing: The President is committed to putting 100,000 cops on the streets, and this budget contains $1.9 billion in funding -- an increase of 45 percent from 1995. This additional funding will make significant progress toward meeting the goal, bringing the total number of new officers funded to over 40,000 by the end of 1996.

Crime Control: Overall, the level of funding for the Administration's major violent crime control initiatives increases from $2.4 billion in 1995 to $4.3 billion in this budget -- an increase of $1.9 billion.

Drug Control: Drug control spending will increase by $1.3 billion, from $13.3 billion in 1995 to $14.6 billion. The budget targets additional funding to treatment, prevention and education, and criminal justice.

Reforming the Nation's Immigration System: This budget reflects the Administration's continued commitment to controlling our Nation's borders and sharing the national burden of costs associated with illegal immigration.

Border Security Initiative: The budget includes $656 million in new funding to support the border security initiative. These funding increases will strengthen border control and management activities of the Immigration and Naturalization Service and the Customs Service, and strengthen enforcement through the INS and the Department of Labor to apprehend and deport illegal immigrants. The budget proposes to finance this initiative, in part, through a modest border services user fee.

Helping with the Costs of Illegal Immigration: The budget also contains an additional $370 million to assist States with particularly heavy burdens associated with illegal immigration. This increase is divided among three programs: State Criminal Alien Assistance Program; Medicaid discretionary grants to States; and the Immigrant Education Program.

Ensuring a Clean Environment: The Administration has developed several new approaches to advance the President's commitment that a healthy economy and a healthy environment go hand in hand. The budget targets spending to ensure that we make the Government a partner working with local citizens, not an overseer.

Ecosystem Management: Funding levels reflect the high priority that the Administration places in maintaining ecologically diverse and health environments along with economically viable communities -- $390 million to continue the Northwest Forest Plan; $99 million for the South Florida Ecosystem Restoration Initiative; and $70 million in joint Federal-State mandatory spending related to the Restoration of Prince William Sound.

Climate Change Action Plan: The budget proposes $336 million, an increase of $104 million -- 45 percent -- to fulfill the President's commitment to reduce greenhouse gas emissions to 1990 levels. This funding is designed to promote a public-private partnership rather than relying on command and control mandates.

Superfund: In each of the past three years, the Superfund program has cleaned up more sites than in its entire first decade. The budget proposes $1.8 billion for Superfund, a $332 million increase over 1995.

Investing in Science and Technology: Investing in science and technology is the key to assuring our Nation's economic well-

being for generations to come. During the Cold War, most Federal spending on research and development (R&D) was defense-related. This research not only produced the most advanced military technology in the world, but the most technologically advanced economy in the world. Today we face a no less serious challenge that requires us to improve our competitiveness through a balanced mix of civilian and defense, public and private R&D.

NASA: The budget proposes $159 million to begin research to produce a reusable space vehicle. This continues our Nation's leadership in space exploration and, at the same time, expands the opportunities for a commercial space launch market.

ARPA/TRP: The Technology Reinvestment Project implements the Defense Department's dual use technology strategy -- a critical investment in transferring technology to commercial applications. The budget proposes $500 million for TRP in 1996, a 13 percent increase from 1995.

NIST: The Commerce Department's National Institute of Standards and Technology has two core programs -- the Advanced Technology Program (ATP) and Manufacturing Extension Partnerships (MEP). The budget proposes $491 million in 1996 for ATP, $60 million more than 1995, and $147 million for MEP, a $56 million increase from 1995.

NIH: Proposed funding for biomedical research is $11.8 billion, a $468 million increase from 1995. This 4 percent increase includes targeted increases, such as those for HIV/AIDS-related research, breast cancer research, minority health initiatives, prevention research, environmental cancer research, and gene therapy.

Continuing the Commitment to Health Security: The President remains committed to reforms that will guarantee insurance coverage to every American and contain costs for individuals, businesses, and Government.

The President believes Congress can and should address the unfairness in the insurance market; make coverage affordable for and available to children; help workers who lose their jobs keep their health insurance; level the playing field for the self-employed by giving them the kind of tax treatment other businesses enjoy; and help the families provide long-term care for a sick parent or a disabled child. We are committed to working with Congress to achieve these objectives and put America on the road to health security.

At the same time, we are proposing major increases for high-priority programs:

Ryan White Act -- HIV/AIDS Funding: The budget proposes $723 million for the Ryan White program, which provides HIV/AIDS treatment services. Since this Administration took office, funding for the Ryan White program has increased by 82 percent. Our proposal for 1996 will more than double Ryan White funding since 1993.

Immunizations: We propose $844 million for immunizations in 1996 to support the purchase of more vaccine to distribute through public health clinics and continued improvements in infrastructure to enable the Childhood Immunization program to meet its goal of immunizing 90 percent of the Nation's children by the year 2000.

Special Supplemental Feeding Program for Women, Infants, and Children: The budget proposes $3.8 billion for WIC, which will raise the annual average WIC participation levels to 7.4 million individuals, up from 5.9 million in 1993.

Long-Run Budget Outlook

This budget preserves and builds upon the deficit reductions that the Administration accomplished in its first two years. We expect the deficit to drop again in 1995, this time to $193 billion. After that, it will fluctuate in a narrow range -- rising to $197 billion in 1996 and to $213 billion in 1997 (due to several anomalies in the budget numbers), then falling to $194 in 2000.

More importantly, the deficit continues to decline in relation to GDP. It drops from 2.7 percent of GDP in 1996 to 2.1 percent in 2000. By this measure, the deficit reaches its lowest level since 1979.

Current law requires that the President submit budget estimates through 2000. By enacting the policy proposals in the budget, however, we can preserve the improvement in the deficit for at least the next 10 years. Looking beyond the year 2000, we anticipate rough stability in the dollar amount of the deficit through 2005. As a share of GDP, however, the deficit likely will continue its gradual decline, falling below two percent early in the next decade.

The major upward pressure on the deficit continues to come from health care. Although the reforms enacted in the President's economic program and administrative efforts to control costs have helped, the projected growth of Medicare and Medicaid spending remains very high. We project that Medicare will grow at an average annual rate of 9.1 percent over the next five years, and that Medicaid will grow at 9.3 percent.

This rapid growth comes in part from the corresponding rapid growth in the elderly population. Medicare benefits go primarily to the elderly, and almost 70 percent of Medicaid spending benefits the indigent elderly, blind, and disabled. Thus, the growth rates of these programs are not surprising. However, at those rates, Medicare and Medicaid spending will double every eight years, and will rise from 3.4 percent of GDP in the year just ended to 4.2 percent by 2000 and 4.9 percent by 2005. The growth in all Federal health programs, of which Medicare and Medicaid are by far the largest, accounts for almost 40 percent of the total increase in Federal outlays between now and the year 2000.

We expect the number of people participating in Medicare and Medicaid to increase, bringing insurance protection to some of our most vulnerable citizens. The Medicaid population will grow at a projected average annual rate of 3.8 percent between now and 2000.

But this expansion in covered populations explains a relatively small part of the increased Federal spending for Medicare and Medicaid -- and could be accommodated without undue pressure on the deficit. More important, from a fiscal standpoint, is that Medicare and Medicaid expenditures per beneficiary keep rising faster than inflation -- indeed, faster than inflation plus the general increase in real per capita GDP. These increases in health care costs cannot be solved in isolation from reform of the broader health care system.

What would the deficit be if health care costs did not rise disproportionately? If Medicare and Medicaid expenditures rose to accommodate increases in the beneficiary population, but the per capita expenditures were limited to the general rate of inflation and increase in per capita output, the deficit would fall to zero by 2005.

Conclusion

This budget builds on the President's success to date in strengthening the economy, investing in the future, projecting American leadership around the world, and making Government work better.

It will reduce the deficit, increase investments in important domestic and military programs, cut taxes for middle-income Americans, and begin a serious, cross-Government examination to sort out Federal, State, and local responsibilities.

We look forward to working with you, Mr. Chairman, and this committee on these proposals.

Chairman ARCHER. Thank you, Dr. Rivlin. Your closing line is definitely agreed to mutually. It is a hard job, and we need to work together on it, because if we don't work together, we won't get it done.

Ms. RIVLIN. Right.

Chairman ARCHER. I would only say that I would hope that we could work together on a glide path to a zero deficit, not to a $200 or $300 billion deficit. That is what divides us right now, and if we are willing to get together and make the tough choices that do the tough job, I believe we can do it.

I am curious about how we get there, though. As I understand your budget, we would have $1 trillion of additional debt over the next 5 years compared to what we have today; is that not true?

Ms. RIVLIN. The deficits would add to the debt by that much, but we believe two things: One, we have gotten the deficits under control. Two, outyear deficits are declining as a percentage of the GDP. This latter point is the way one ought to look at deficits and the national debt.

A deficit has significance in relation to the size of the economy. We have brought the deficit down from about 5 percent of GDP in 1992 to its current level of about 2.7 percent. This budget keeps us on a glide path to decline, cutting the deficit as a percentage of GDP in half by 1998 and down to 2.1 percent by the end of the decade. But we don't think that is enough. We must mutually come back to the fastest growing large item in the Federal budget, health care costs. Reducing the rate of growth of those costs is the key to additional outyear deficit reduction.

Chairman ARCHER. Well, I understand your response because we have heard it from Secretary Rubin and we have heard it from Laura Tyson. They say we really don't need to worry about getting to a zero deficit, and that all we have to do is be concerned about the debt and the deficits relative to the GDP. I just don't think the American people buy that.

We will be adding, according to what you just said, $1 trillion to the national debt in the next 5 years, irrespective of what the relationship is between the deficit and the GDP, according to your projections. If we have roughly an average 7 percent interest rate, that is, $70 billion a year of additional annual debt service, that must be maintained and paid for in every year thereafter; and that is what the American people don't understand when you talk about debt going down relative to the GDP.

In addition, Secretary Rubin said, and I wonder if you agree with this, that we should look at the analogy of a family that is able to increase its earnings every year. He feels there is nothing wrong with increasing debt because earnings are increasing; and therefore, relative to the total earnings of the family, the debt is not increasing, and therefore, that is what we are doing here.

Now, if that is to be accepted as valid in the way we pursue our goals, it must be assumed that we are forever going to increase our earnings and that there will never be an adjustment. We used to think about that in Houston, Tex., until the mid-1980s. We thought Houston could never take a backward step economically, and yet we found out that is not the real world. Families do have ups and downs in their earnings. If all you do every time you earn more

money is to increase your debt but not increase it relative to your earnings, and the downturn comes, you are left with that magnificent debt, and you don't have the ability to sustain it.

The country, as we know, through business cycles is the same way, and I would just hope that the administration, while asking us to submit a detailed plan to get to a balanced budget, would do the same thing itself so that we could work together and have this interrelationship.

Now, let me also say that relative to something that was mentioned earlier on in your testimony, that you had runaway deficits and that you have now got them under control. Basically, if I understand what you said—and I have heard the President say, this is the first effort, real effort made at deficit reduction since about 1990?

That probably cost President Bush his reelection because he stood up and said, we have got to reduce the deficits. Why is that ignored? Wasn't that about a $500 billion deficit reduction as it was scored at that time?

Ms. RIVLIN. I would not ignore it, Mr. Chairman. I think the 1990 agreement was a good one. President Bush was right to engage in it and it did help. He didn't get much credit for it largely because the recession reduced revenues, and the deficit, therefore, did not go down. But were it not for the 1990 agreement, the deficit would have been even higher. So I would not be one to ignore the 1990 agreement.

But in 1993 we had to go beyond that and effect additional deficit reduction. We are proposing additional deficit reduction in this budget. That is, as you rightly point out, not the end. We are not satisfied with the deficits as they appear in this budget, and we are not saying that we are satisfied. We are saying that while the situation is a lot better than it was 2 years ago, we have to make more progress. One of the keys to more progress, we believe, is health care reform.

Chairman ARCHER. Well, would you encourage the President to give a little credit to the previous administration for deficit reduction, then, and stop saying that he is the first President to really do anything about deficit reduction? It would be very, very helpful to see that balance coming out of the administration.

Ms. RIVLIN. No one in the administration wants to knock the 1990 agreement, certainly not my good friend and colleague Leon Panetta, who was very much a part of that agreement. It is true, however, Mr. Chairman, that the deficit has come down for 3 years in a row, and that is the first time that that has happened since Harry Truman was President. We are very proud of that.

Chairman ARCHER. Well, I think that is movement in the right direction, and the downward trend is the thing we should try to work together on, but as I understand your budget, it now begins to go up again. It came down for 3 years in a row; and now under your budget, I believe the deficit goes up again. Now, you are going to say, oh, but not relative to the GDP.

Ms. RIVLIN. It goes up slightly in dollar terms but stays under $200 billion. The deficit picture in dollar terms is essentially flat, and in relation to the economy, it comes down. I believe that is a very important measure of how threatening a deficit is. When we

arrived in 1993, we were in very serious trouble. Deficit projections were headed up and the debt was growing faster than the economy. Now we have gotten the situation under control. That does not mean, however, that the outyear deficits are not still a problem. They are.

Chairman ARCHER. Well, I just wish that we could get a statement from one of the administration witnesses to say that we will work with you to get to a balanced budget within the next 7–10 years so that we don't keep adding debt service charges, which will become the largest single expenditure in the Federal budget at $70 billion more per year in debt service charges as contemplated in your budget. This is, I believe, a tolerable situation.

But I have taken up too much time, and I recognize the ranking minority member, Mr. Gibbons, to inquire.

Mr. GIBBONS. Thank you, Mr. Archer. I always want to call you Alice out there, but I will call you Dr. Rivlin.

Ms. RIVLIN. That is OK by me.

Mr. GIBBONS. I feel that I have known you for so long and have followed your distinguished career and have learned a lot from you and expect to still learn a lot from you.

The President has laid out his figures, and we wait with baited breath to see the Republican figures on all of this. I have my own agenda. I look back—I think the worst vote I ever cast was the Gulf of Tonkin resolution, and the second worst vote I have a hard time identifying, but it was allowing somehow the budget deficit to get loose in the early eighties. I will take my share of the responsibility for that. I would like to live down those two votes.

So I am as excited as I can get when I hear tax reduction and all the nice reductions that are in the Contract and the President's tax reductions. I am going to be a deficit hawk this year because, as I look at the situation, never have we been in such a good position to pursue deficit reduction as we are right now, at least not recently. We have full employment or near-full employment, we have heavy factory utilization, the highest factory utilization we have had in 15 years. If we can't make a serious, serious, serious stab at reducing the budget deficit, Dr. Rivlin, I don't know when we can ever do it.

So I salute you for what you have done and for your budget and for everything else, but I am going to be a budget hawk and try to get the deficit down.

Now, in your statement you have a small article called Superfund; and I helped get the Superfund legislation passed, and I made another mistake there that I would like to rectify, and that is the whole idea of retroactive polluter pay. I think when we enacted polluter pay we never paid enough attention to the retroactive feature that was included in it, and I am. As I recall, this year the taxes to fund Superfund run out and this Congress has to renew them; and I told this to the Administrator of EPA, and I want to tell you so it will get right back to the White House, I am not going to support any of those extensions of those taxes unless we work out this retroactive liability provision. I don't know whatever got into us to make people liable for things that they did that were legal at the time they did them, and we could retro-

actively change the law on them and impose in some cases some crushing liabilities upon them.

I helped the administration last year try to pass that tax proposal that you all had, and I think I have been all the soldier on that issue I can be. I am not going to support the extension of any Superfund taxes, or of the Superfund legislation itself, unless we work out a satisfactory solution to that retroactive liability imposition that I think Congress improvidently imposed upon Americans; and frankly, I think the administration of the EPA law has exceeded the parameters that Congress ever envisioned in that regard. I want to clean up the mess, but I think the retroactive provision is just fundamentally and basically unfair.

If you all want to lobby me on that subject, I am laying myself wide open here with you right now. You have a hell of a hard convincing job to do on me, but I don't like political surprises; I didn't want to pull any of them on you all down there. I want to work with you, but I have kind of laid out my specifications, and you can get a copy of the transcript of this when this is all over and tell them, this is where Sam stands, and you all better start working on him if you are going to get his support in extending these taxes.

Ms. RIVLIN. I hear you, Mr. Gibbons, and I think it is a longer conversation than we can have here.

Mr. GIBBONS. I understand that.

Ms. RIVLIN. But we want to have that discussion, and we believe the tax should be extended, but that the Superfund provisions should be reformed. We have some proposals and would be glad to talk further with you about them.

Mr. GIBBONS. Well, thank you.

Thank you very much, Mr. Chairman.

Chairman ARCHER. Mr. Crane.

Mr. CRANE. Thank you.

Dr. Rivlin, is it true that our national debt will get to $5 trillion by the end of this year or very early next year?

Ms. RIVLIN. The gross debt—I am sure you have the number in front of you—I don't, but yes.

Mr. CRANE. Then, under the proposal, you are suggesting by the year 2001 we will be at $6 trillion?

Ms. RIVLIN. Right.

Mr. CRANE. Do you anticipate, or does the administration anticipate, some target date out there when we would round that bend, and instead of adding to it, at least it wouldn't be growing, or ideally it would be getting reduced?

Ms. RIVLIN. The first thing to do is to not have the debt growing faster than the economy is growing, and that is the situation as we look forward. I think it is very important that we have the debt rising slowly and the economy growing fast.

To get to a situation where the debt is actually coming down would require a surplus in the Federal budget. That might be desirable. We are a long way from that now. I think we should move in that direction, but it is really the relationship between the debt and the economy that is important.

At the end of World War II, we had a huge debt. We didn't reduce the dollar amount of the debt, but we didn't increase it very much over the next 25 years. Since the economy grew very rapidly

in the years following the war, the burden of the debt and the debt service came down over a long period.

Mr. CRANE. One of the concerns I have is that debt service cost on an annual basis. What is it right now?

Ms. RIVLIN. Debt service is about 17 percent of the Federal budget. It is a very large portion.

Mr. CRANE. So what does that translate into in dollars?

Ms. RIVLIN. About $230 billion.

Mr. CRANE. About $243 billion. Say our national debt is at $6 trillion by the end of the century and assuming the percentage remains the same, what roughly would the dollar figure be?

Ms. RIVLIN. For debt service at the end of the century? About $300 billion.

Mr. CRANE. About $300 billion. The reason I am concerned about these figures is, if we didn't have debt service, we would be running budget surpluses right now on an annual basis.

When I first came here in 1969, that was the last time we had a surplus, and we have been going progressively deeper into debt every year since that time, and I guarantee you there is no cause-and-effect relationship.

Ms. RIVLIN. That is correct, Mr. Crane. Indeed, if we did not have to pay debt service on the portion of the debt run up between 1980 and 1992, which is most of the debt, we would be in surplus right now.

Mr. CRANE. I have a quote I am going to read to you:

> If the government was borrowing less, even running a surplus, more resources would be available for private investment to increase future productivity. Elimination of the Federal budget deficit would make a crucial contribution to income growth.

Can you attribute the source to that quote?

Ms. RIVLIN. It sounds like something I could have said.

Mr. CRANE. It is. It is out of your book, "Reviving the American Dream," and I salute you on that intent.

Let me ask one final question, and that is, why didn't the President, in his budget proposals, touch upon welfare reform as a means of effecting some economies?

Ms. RIVLIN. For a very simple reason. We have a welfare reform proposal which we put out in the last Congress. We want to work with the Congress on welfare reform. However, we didn't think that putting a particular proposal in the budget was the best tactical way to do that, especially since we were engaged in an active welfare reform discussion with the Congress and the Nation's Governors when the budget was released. But we are in favor of welfare reform, and we want to work with the Congress not only on how to do it but on how to pay for it as well.

Mr. CRANE. Well, thank you very much, Dr. Rivlin. I am consoled. I was worried that maybe the President had discarded that one. Thank you.

Chairman ARCHER. Mr. Hancock.

Mr. HANCOCK. Thank you, Mr. Chairman.

Ms. Rivlin, I am a little concerned about the statements that have been reported in which you said the deficit is down to $200 billion; therefore, we have got it under control.

I am a small businessman. I recently went back home and looked at what was going on in my business. The people that are managing my business, if they had said, well, we are only going to go $200,000 more in debt this year, therefore we have got our indebtedness under control, I would be making some changes, I will guarantee you, because there is no way you can do that.

Now I would like to ask this question. If the President would say to you and to Leon Panetta, we are going to get a balanced budget between now and the year 2000, and we would forget about having it under control just because we are down at $200 billion, we would forget about the GDP and that relationship, can it be done? If we continue to hear from the administration that it can't be done, then we are guaranteed that it won't be done.

Ms. RIVLIN. Oh, I am not sure the last part of the statement is true, because the Congress certainly could balance the budget.

Mr. HANCOCK. In other words, what you are saying is, it is all going to be up to the Congress?

Ms. RIVLIN. No, I am saying it is up to us together.

Could the budget be balanced by 2002? Yes, but it would require very deep cuts in many programs that people care about, and that is why the administration has been saying that those who believe that the budget should be balanced by 2002 have a duty to go beyond merely saying that. They have a duty to put a proposal on the table that shows what it would take to do that. Those who want additional tax cuts, in order to fund those tax cuts and still balance the budget, would have to make even deeper cuts in existing programs.

We have proposed a budget that includes tax cuts and we have shown exactly how we would pay for those cuts. In addition we have shown how we would contribute to additional deficit reduction, and we stand ready to talk about other ways of reducing the deficit in the years to come.

Mr. HANCOCK. If the balanced budget amendment passes through the Senate and is ratified, hopefully within the next couple years, wouldn't that drastically change the budget proposal that the President has submitted? Let's say that we had passed that 2 years ago. Wouldn't that drastically change the budget proposal? Should we have to have the balanced budget amendment to do what is right or to get the administration to do what is right?

Ms. RIVLIN. I don't believe that we should have a balanced budget amendment because the way to reduce the deficit is to do what the Clinton administration and the past Congress did together, enact specific spending cuts or revenue increases that are needed to get the deficit down. We did it, and it worked. I think that together we can do more of that. I would not favor, and the President does not favor, writing balance into the Constitution.

Mr. HANCOCK. You are saying that it has worked in relation to gross domestic product. It has not worked on an actual basis because we are going to be increasing the national debt over the next 5 years by roughly $1 trillion.

Now, if you take the inflationary factor out of it on a real dollar basis, then you have got an even worse scenario of where we are in relation to the gross domestic product. I mean, we can do a lot

of things with inflation, but ultimately it catches us up just like it has in every major civilization.

Ms. RIVLIN. But let me be clear about what I meant when I said it has worked. In any terms you want to pick, it has worked in the last 2 years. In 1992 the deficit was $290 billion. This year it will be under $200 billion. That is real progress.

Mr. HANCOCK. Well, OK. But I don't think merely because we are down to $200 billion we ought to say, well, we are in good shape.

Ms. RIVLIN. No, and I am not saying that.

Mr. HANCOCK. OK, fine. Thank you.

Chairman ARCHER. Mr. Ford.

Mr. FORD. Thank you, Mr. Chairman. Dr. Rivlin, let me also welcome you to the committee, and before I get into the questions, let me make a comment—I might not be recognized anymore on this committee—and say to the chairman that I am awfully sorry if for 1 minute he has any questions in his mind in reference to my respect for him as chairman of this committee and even my respect for him prior to taking over as chairman of the committee.

I have known the chairman for quite some time. I have great respect for his ability as a member of this committee, as a very able legislator in this Congress, and certainly have all due respect for him as the chairman of this committee; and if I have suggested or signaled in any way on this committee that I do not have full respect, Mr. Chairman, I apologize right away, but I do feel that I have a responsibility as a member of this committee and one who represents the ninth district in Tennessee that when there are issues up before this committee, we have every right to discuss those.

As we dealt with tax preferences yesterday—I mean, you chose one that was dealing with affirmative action and I chose one that was dealing with oil and gas—that if we wanted to offset a bill that you pass—and it wasn't personal at all, Mr. Chairman, and I don't want you to feel that way at all. I certainly did not suggest or imply that your feelings on any particular issue—I mean, that issue was not put before this committee by Harold Ford; it was put before this committee by the chairman of this committee.

But, Dr. Rivlin, let me now focus on your statement on this budget. I was looking at the historical budget summary, and if I look back at 1977, 1978, 1979, and 1980, we had over a 4-year period an average budget deficit of about $55 billion a year, give or take, one way or the other, a little bit; and from 1982 through 1986, the deficit jumped from $128 billion, $207 billion, $185 billion, and $212 billion, yielding an average of about $185 to $190 billion, which increased that public debt and brought that public debt so high over a 4-year period.

If you look at the next 4 years, although it reduced somewhat the cost of leveling off of the defense budget, some increases in taxes, we had the deficits running anywhere from about $149, $155, $152 and $221 billion, once again, an average of about $165 billion a year.

Now, the Republican Contract With America is calling for a $196 billion deficit over a 5-year period, $700 billion deficit—not deficit, but to pay for the tax program, tax cut of about $700 billion; and I haven't seen how they are going to pay for that, I guess, through

spending cuts, and we don't know who is going to be harmed by that. But the chairman was raising a question on the GDP.

Let me ask the question to you and maybe you can respond. Could you explain in laymen's terms why reducing the deficit as a share of the GDP is a significant accomplishment?

Ms. RIVLIN. Yes. Because the impact of the deficit on the economy depends on the size of the economy.

If you were comparing two countries and all you knew about them was the dollar amount of their deficit or their debt, you wouldn't really know anything. You would need to know, for instance, what two countries you are comparing. Are we talking about Belgium, or are we talking about the United States? Also, you would need to look at the impact of the deficit or the debt in relation to the size of the economy. If a business owed a debt of $100,000, it would make a difference whether that business was the corner grocery store or General Motors. Any given deficit or debt has to be viewed in relation to the size of the company, its revenues, its debt service, and so forth.

In the last 2 years, we have brought the deficit down in dollar terms. As we look ahead, it will become less of a problem because the economy will be growing and the deficit will not. I am not saying that the deficit isn't a problem, but it is less of a problem than it was 2 years ago.

Mr. FORD. But you find ways to pick up your tax cuts through spending cuts, and you offset it, you sort of pay for it some way, but do you think the American people really want these tax cuts when we are wrestling with the fact that we need to reduce the deficits?

I voted to support the constitutional amendment, which is, I guess, the opposite position of this administration, which I support strongly. I do think that we ought to have a balanced budget, but I don't think the Republicans with the Contract With America have the answer before this committee and this Congress to do that. I don't like the fact that we have to continue to have right at $200 billion deficits per year. I think we ought to take a closer look and not let this committee just think that we know what the American people want. If we are all sincere about it, we don't have to wait until the year 2002. We could find ways now.

The Clinton administration did it in 1993; you reduced those huge deficits that the Bush administration left on the American people, and we have it under control, and I think we ought to go one step beyond that, and we ought to find ways—not to give these tax cuts to satisfy, to please certain people in this country who make large contributions to political campaigns and win through the airwaves of this country the support that they might need. I think we ought to get serious about it and we ought to balance this budget.

Mr. HOUGHTON [presiding]. Thank you very much.

Mr. Zimmer will inquire.

Mr. ZIMMER. Thank you, Mr. Chairman. Ms. Rivlin, I read with interest Saturday's Washington Post, which indicated that you were a lonely advocate of more fiscal responsibility and a deficit that would decline in absolute dollars rather than only as a percentage of GDP in discussions within the White House. According

to the Post, and I don't believe everything that is printed in the Washington Post, but according to the Post it wasn't until a meeting 1 week before the December 15 speech by the President on his Middle-Class Bill of Rights that the question of deficit reduction even came up for serious discussion.

I commend you for your apparent willingness to go it alone to try to convince the President and your colleagues in the administration that it is not good enough simply to reduce the deficit in terms of a percentage of the GDP. Your defense of that proposition today raises a question in my mind as to whether you really believe that this is good enough or whether you think it is preferable for the President to redeem his campaign pledge at least, and that was to reduce by 50 percent the deficit which, according to this article, you said would not be achieved with this policy.

Ms. RIVLIN. Well, we are all proud of our record on deficit reduction, and if you think about what the deficit would have been by now or by 1997 or 1998, it is clear that we are very close to having cut it in half. This is certainly the case if you look at the projections of what the deficit would have been without the deficit reduction plan of 1993.

At that time, the projection was that the deficit would be $387.7 or $388 billion by 1998. Given the track we are on, we will have cut that figure in half—1 year late if the campaign promise was supposed to have meant 1997—but that is still pretty good. We have also cut the deficit in half by 1998 as a percentage of GDP.

However, the President is not saying that he is satisfied with these outyear deficits. What he is saying is here is our plan for making a further contribution to deficit reduction, but we recognize that more is necessary, particularly in the area of cutting health care costs. We want to work with the Congress on that.

Mr. ZIMMER. Well, I admire your courage in arguing behind closed doors for more fiscal responsibility, and I admire your loyalty to the President in touting the company line, so I won't pursue this line of questioning any further.

But I will pick up on the comment that you made in passing that in order to get the deficit to zero, we have got to deal with the question of health care costs. The President's program submitted to Congress to reform health care in this country actually increased the deficit according to the CBO.

Ms. RIVLIN. It did not increase the deficit in the long run.

Mr. ZIMMER. But do you believe—and now the President is talking basically about insurance reform. What do you have in mind as a way to get a handle on health care costs that will actually get our deficit down to zero?

Ms. RIVLIN. That is a conversation we want to have with the Congress. I am not sure you can get the deficit to zero by focusing on health care alone, but you can certainly make a major contribution toward deficit reduction. We did not put proposals in this budget for controlling the costs of Medicare and Medicaid because we don't believe in cutting those programs as a way to pay for tax cuts. We didn't want proposed cuts for those programs to be picked up and used to pay for tax cuts for the rich. But we do believe that we have to talk about serious health care reform that will reduce the growth of health care costs for everyone.

Mr. ZIMMER. Thank you.

Mr. HOUGHTON. Thank you.

Mr. Coyne.

Mr. COYNE. Thank you, Mr. Chairman.

Dr. Rivlin, one of the big issues that is on the agenda here in Washington is welfare reform and certainly a part of the Contract With America; and I think the belief is that if you do reform welfare, you are going to produce great savings in the Federal budget. We have been told by some witnesses who have come here, who have had experience in welfare reform in their States, Governors and others, that if you really want to do welfare reform properly, you have to make an investment, and that it is quite possible that the investment in training and retraining, job placement, and day care may indeed be more expensive than the system we have today.

Could you comment on that?

Ms. RIVLIN. Yes. I think there is a common agenda in welfare reform upon which everyone is in agreement. We want welfare to be a temporary way station for people who are having difficulty making ends meet. We also want to provide training, child care, and other services to ensure that people who would otherwise be on welfare move to self-sufficiency quickly. You are absolutely right. That requires an upfront investment. All of the serious State and Federal welfare reform proposals recognize that.

Other programs can be cut to offset the costs of training, job placement, and child care. Although we may save money in the long run, initially reforming welfare to get people off the welfare rolls and into real jobs requires an investment.

Mr. COYNE. Thank you.

Mr. HOUGHTON. Thank you very much.

Mr. Johnson.

Mr. JOHNSON. Thank you, Mr. Chairman.

Dr. Rivlin, I am reminded of flying airplanes because that is what I did for about 29 years, and still do some, and I am sure you have; and when you talk about glide path to success on the budget, you know you can put an airplane on a glide path, and if you don't correct the glide path enough to make a smooth landing, you are going to crash, and I think that is what you have got us aimed at is a path to total destruction.

I wonder what you would tell a pilot if you said, hey, with reference to the sky we have changed your glide path, but with reference to the ground it hasn't changed at all and you are going to crash. Now, what would you tell the average American citizen if he said, I just can't support my debt any longer? I know what you would tell him, you would tell him to declare bankruptcy, chapter 11 or whatever.

Can I ask you, what would happen if everyone called their notes on the U.S. Government?

Ms. RIVLIN. Well, that is not about to happen.

Mr. JOHNSON. I am what-iffing you.

Ms. RIVLIN. Some people would gain and some people would lose.

Mr. JOHNSON. What would happen to the U.S. Government?

Ms. RIVLIN. Most of these notes are held by other Americans.

Mr. JOHNSON. Aren't there some 13 or 14 percent of them held by foreign countries?

Ms. RIVLIN. Yes, but that is a fairly trivial amount.

Mr. JOHNSON. What is trivial about 14 percent of our debt?

Ms. RIVLIN. I think if you are worried that foreigners will have so little confidence in the U.S. Government that they will refuse to hold U.S. Government securities, you are worrying about something that at the moment is——

Mr. JOHNSON. I am what-iffing you. What happens if someone does call our notes?

Ms. RIVLIN. I don't think this is a serious problem.

Mr. JOHNSON. I am aiming at the deficit. You keep saying it is OK to have an increasing deficit.

Ms. RIVLIN. No, I didn't say that at all. I said that the significance of the deficit has to be viewed in relation to the economy. We have brought the deficit down a lot, but we are not satisfied. We need to do more.

Mr. JOHNSON. Wouldn't you agree with me that you cannot start to get at the debt until you get the deficit to zero?

Ms. RIVLIN. That is right, and I think that the economy of the United States can support the current level of debt and even an increasing level of debt. But that is not to say that an increasing debt is desirable.

We all ought to be looking at what kind of economy we want to have a few years from now. What kind of standard of living do we want for Americans? Now, getting the deficit down will help the future standard of living. Reducing the deficit will also help us to invest in people and enhance our competitiveness in a world economy, and that is what really matters; there is a tradeoff between how much you want to do that and how much you want to reduce the deficit.

Mr. JOHNSON. I think we should try to get at the debt.

Can you tell me—I know in the article that Mr. Zimmer was talking about you were arguing, I believe, against tax reduction and for more deficit reduction, which is kind of appealing. However, the President apparently chose the course of some tax reduction, and can I ask you, what is the difference between a child under 13 and one over 13, and why is it important to have a tax credit for children under 13 but not over 13?

Ms. RIVLIN. We felt that those were the years when families were bringing up young children. We are talking here about working families. This credit phases out between $60,000 and $75,000, so we are not talking about upper income families. We are talking about average people—those were the years that——

Mr. JOHNSON. A guy who makes $80,000 is not average?

Ms. RIVLIN. No, statistically he is not very average.

Mr. JOHNSON. He is not an average American?

Ms. RIVLIN. He is quite high.

Mr. JOHNSON. Anybody who makes over $65,000 a year is not an average American citizen?

Ms. RIVLIN. The people who make $80,000 a year are more privileged than most people. They may not think so, but statistically they are.

But you asked what the difference is between a 12-year-old and a 13-year-old. Not very much, but you have to draw the line somewhere, and our view was that this tax cut should be concentrated

on working families with kids who are having a hard time making ends meet.

Mr. JOHNSON. I would suggest that it probably costs more for teenagers than it does under age 13.

I thank you, Mr. Chairman. My time has expired.

Mr. HOUGHTON. Thanks very much.

Mr. Collins will inquire.

Mr. COLLINS. Thank you, Mr. Chairman.

Ms. Rivlin, I have a great deal of concern about comparing the debt against the gross domestic product. I have concern about the analysis you used of $100,000 debt, whether it is the grocery store or GM. My concern is the comparison of government "investment" or spending money to how a business invests money. If a business invests money unwisely or nonproductively, then they won't get a return to be able to retire that debt. When you go back and you look at the debt that the government has incurred since World War II and the fact that we were able to retire that debt after a certain period of time, I think you will find a great deal of difference in how the government paid off those debts versus how the government operates today.

Is that not a fair statement?

Ms. RIVLIN. How the government was investing funds?

Mr. COLLINS. Yes.

Ms. RIVLIN. Well, government programs have changed over the years, but this administration has emphasized shifting money from less productive to more productive types of expenditures. By this we mean things that will give people more skills in the future, improve science and technology, and improve our infrastructure. We have emphasized those kinds of public expenditures. That does not mean private investments aren't important. That is another reason for reducing the deficit, but what the government does makes a difference. We can help improve the skills of the work force. That is very important to the future of America.

Mr. COLLINS. But we have created so many types of programs, something like 154 different types of work training programs. We have an abundance of things that we have splintered off through government "investments" or expenditures that are not productive. They are not working, and that is one of the reasons why we are considering block grants.

Ms. RIVLIN. You will see that in our budget. It is a common theme.

Mr. COLLINS. You used the word "partnership" versus "block granting." I have been a small businessman, as have several other of our colleagues, for a number of years, and I have had partnerships. I have never had one that succeeded for a long period of time, and it worries me to use that word. I have heard some of my-side-of-the-aisle colleagues use the word "partnership," too.

When we look back at the State governments and the local governments, they are an entirely different entity; they are self-incorporated. When we say we are going to be part of a partnership, we are going to have strings attached, mandates to go along with that partnership. Strings mean we are going to control how they use those funds and, really, funds that we get from the people of those jurisdictions.

The "partnership" word bothers me. That is the reason I like the block grants without so many strings attached or so many mandates and more and more flexibility.

You agreed, too, with Mr. Hancock that we could balance the budget by the year 2000, but to do so would probably threaten a lot of programs that people like. It has been mentioned earlier, too, that a lot of those programs improve people's lives, but is it not true that a lot of those programs, too, make it very difficult on other people's lives? I am referring to the Robin Hood style of government we have where we take from some and give to others.

Ms. RIVLIN. Well, I think lots of people differ on what is an important government program. The programs this administration has emphasized have broad support. For instance, everyone benefits when, in a program like Head Start, we help children get a better start in life and do better in school. That kind of program doesn't hurt anybody.

Mr. COLLINS. My point is, in order to help that family with the Head Start need, you are going to have to take from another family who probably has a need, too, and this will lessen their ability to provide for themselves. That is the Robin Hood style of government that I am speaking of. I think we have created too much of the Robin Hood style, although all of us have compassion and want to help those who are in need, but we have got to go back and redefine what is really need.

Thank you.

Ms. RIVLIN. I think we can agree that not all government programs are as effective as they should be. However, I think what you see in this budget is an attempt to look at what is working, what is not working, and make programs that are not working more effective.

Mr. HOUGHTON. Thank you very much.

Mr. Rangel will inquire.

Mr. RANGEL. Thank you, Mr. Chairman.

Let me thank you, Doctor, once again for being before this committee. I know it sounds like a broken record, but I am going to talk about drug control, and I see that there has been an increase of $1.3 billion in drug control, and that brings it up to $14.6 billion.

The thing that has bothered me over the years is that everyone says, you are right, but no one says what has been done. When Dick Darman was in charge of your office, it took me years to get him to find out what the Nation was losing in the war against drugs. I am going to ask your office, would you be kind enough to take the costs—and I am willing to give you the papers that he shared with us, because at that time he said when you included lost productivity and lost revenues, we lost every year $350 billion. Of course, that was years ago. Now we see that there is a concentration on treatment, but when I ask questions about treatment it seems that we have the block grants, so none of the Federal officials can say that they know what is going on in treatment.

Having been in the State legislature, I know that the Governors normally rely on the members of the assembly and the Senate to determine the quality of treatment, but in all of the treatment centers I have seen that are good, the addicts tell me they are good because they always go there, and they use them all, and there

never seems to be any job training or job at the end of the treatment, and they go into these programs illiterate and they come out drug free and illiterate; and after they are on the streets and there are no jobs and they are depressed, the only friends they sometimes have are those that are in the drug area. So I have always fought for more money for treatment and treatment on demand and all of these things, but nobody ever in any administration has been able to tell me, what kind of treatment are we talking about? Could you?

Ms. RIVLIN. Well, we have put more money into drug treatment programs. We would be happy to talk about exactly what this money goes for, what constitutes effective treatment, and how to fund those programs that are most effective. But you are quite right. Effective treatment programs must be part of a package that includes job creation. I think this budget's emphasis on job creation, training, and making the whole system work better for workers—including ex-addicts—is an important step in that direction.

Mr. RANGEL. Well, Doctor, like I said, the frustration is, everyone says I am right, but I don't think that you have that much control over these block grants.

I mean, we are giving the States flexibility. Everyone wants flexibility. People closer to the problem have the answers, and they don't have the money really to do the job that would be necessary if they have got to educate these people and make them prepared for work. But one thing you could do is you could really provide for this committee the statistical data as relates to the impact on drug addiction, the cost of crime, the cost of the health, and the cost of—economists are always able to measure, I don't know how, the lost productivity as we have with these people, 1 million people in jail, where 70 percent of them could be working, and they are in jail, a number of people in the hospital with drug-related diseases that should be working, that would be very important.

Can your office do that?

Ms. RIVLIN. Yes, we will work with Lee Brown and give you what estimates are possible. Obviously, there is no firm number. But we all know that the costs of drug-related problems are very large and have serious implications for our country.

Mr. RANGEL. But economists have this strange way of doing it all the time, so I don't see what Lee Brown would have to do with it. It would seem to me that you would go to HHS and ask how many of the cases in this hospital are drug related, and then you would go to the criminal justice system and you would ask the Attorney General, because Lee Brown is depending on all these other people.

Ms. RIVLIN. That is absolutely right. I suggested that he and I work together on this because it is a drug-related matter, and that is his job.

[The following was subsequently received:]

COST OF ILLICIT DRUG USE

Government Spending for Drug Control is Substantial

Federal, State, and local governments spend roughly $25 billion on drug control efforts, or $0.50 for every dollar spent by drug consumers in the illicit drug trade. Approximately 63 percent of the Federal drug control budget is directed to law enforcement programs, with the balance directed to treatment and prevention programs. Most State and local government spending is directed to the criminal justice system (79 percent), with the balance going for education and rehabilitation (21 percent).

Total federal spending in FY 1994 was $12.1 billion. The request for FY 1996 is $14.6 billion. A breakdown is found in both the 1995 National Drug Control Strategy and the separate Budget Summary.

The figures for State and local spending come from an Office of National Drug Control Policy (ONDCP) report released in December 1993, titled *State and Local Spending on Drug Control Activities: Report from the National Survey of State and Local Governments*. According to that report, State governments spent $7.45 billion on drug control in 1991. Local governments spent $8.46 billion.

Another Cost Category Relates to the Economic Costs of Money Spent for Illegal Drugs

The illicit drug trade is a drain on the U.S. economy. An ONDCP study titled "What American Users Spend on Illicit Drugs" shows the retail value of the illicit drug business in 1993 totaled $48.7 billion. The bulk of this money goes for cocaine ($30.8 billion). Marijuana and heroin make up the rest. In addition to resources wasted on drugs, drug use leads to many other costs -- welfare for the children of drug users, health care costs, and the costs of crimes related to both drug trafficking and drug use.

Social Cost of Drug Use

A Brandeis University study endorsed by the ONDCP estimates the total cost of drug use at $67 billion annually. Almost 70 percent of this amount is attributable to the costs of crime; the remainder reflects medical and death-related costs. In particular, $3.2 billion (4.8%) was for medical expenses, $8 billion (11.9%) related to the costs of illness, $3.4 billion (5.1%) was related to deaths, and $46 billion (68.8%) fell into the "other related" category (costs of crime, incarceration, and loss of productivity).

Mr. RANGEL. Thank you.

Mr. HOUGHTON. Thank you.

Mr. Ensign.

Mr. ENSIGN. Thank you, Mr. Chairman. I want to take up a couple of the points that have been made earlier and relate it back to business, because I do agree somewhat with the arguments about the deficit as it relates to GDP and that it is better to have it as a lower percentage of GDP than it is. Obviously, the other way around, the way it was back in 1992 is a proper direction to move toward. If you look at businesses, and the analogy has been made that if you look at a business that takes on a certain percentage of debt, as long as that percentage of debt can be serviced, the relative health of the company is good.

But also knowing the public markets and knowing how some companies, how well their stock does, one of the factors that Wall Street looks at is the percentage of debt that they do have on that company; and certainly the lower the percentage, which is the direction that we are going, the better. That means that in general a company's fiscal house is in order.

I think what we saw a lot in the eighties was companies taking on more and more and more debt, but they were growing and so it looked OK; but when it comes down—and that is the fear that we share now. As we are growing it may be looking pretty good, but I think what we need to do is, we need to make the tougher cuts. We have got to not only get to a balanced budget, but we have got to get to surplus budgets so we can start working on the debt, eventually pay off the debt, have a rainy day fund so when you are in trouble in a country, when you have a healthy economy, you can prepare for those times.

Your comments?

Ms. RIVLIN. I think I am on record in a past life of having said that a surplus, on the average, over the business cycle would probably be a good thing for a country such as ours, which has a low private savings rate. To say that you are running a surplus in the Federal budget means that the Federal Government is reducing its debt. Thus, the government is doing its part of saving and redeeming the debt so that there will be more funds available for private investment. As a long-run goal, that is certainly a worthy one. It should happen, but it makes a difference how you get there.

Mr. ENSIGN. How long should that long-run goal be? Are we talking 20, 30, 40 years?

Ms. RIVLIN. I think it is hard to say.

Mr. ENSIGN. The problem I have with that "hard to say"—and Secretary Rubin was here the other day, and the old saying about, "If you don't aim at the target, you are sure not to hit it"; all of us learn the basics: You need to set goals and target dates, and things should be time certain. One of the first things you learn on goal setting is, everything should be date and time certain, and if you don't, you will never get to that, and that is what we are saying and why we have set 2002 as our goal date to get to a balanced budget, so that we can work toward those tough choices that we need to make to get to that balanced budget.

Ms. RIVLIN. Well, the problem is that countries have multiple goals, and it doesn't make sense to sacrifice some important goals for others. The whole——

Mr. ENSIGN. You have to make that choice. You have to make tough choices, even a country.

Ms. RIVLIN. Can I finish the sentence?

Mr. ENSIGN. Yes.

Ms. RIVLIN. You have to make tough choices, but it would not make sense to aim so single-mindedly at balancing the budget that you forgot why you were trying to achieve balance. You attempt to achieve balance in order to get a better economy. But if the way you get to balance is by cutting productive government investments or throwing the economy into recession by moving the deficit down too rapidly, it is self-defeating.

Mr. ENSIGN. I think the other thing we have to keep in mind, one of the reasons that we are doing it is so we don't put this burden on our children and our grandchildren; and that is something that we lose focus on sometimes. We have this debt that has been put on us and if we do not act responsibly, we are just putting it on to future generations to make those tough choices.

Thank you, Mr. Chairman.

Ms. RIVLIN. Reducing the debt is one thing we can do for our children. But we can also make sure our children have good schools, get a good education, and also have an economy that will support higher wages for them.

Mr. HOUGHTON. Thank you very much.

Mr. Christensen will inquire.

Mr. CHRISTENSEN. On that note, it is not the role of the Federal Government to be involved in local school systems. It is the role of the local citizenry and the States; not the role of the Federal Government. There is where we have a real difference.

It is not the role of the Federal Government to set a minimum wage, and that is why we have a big disagreement with the administration. The markets will dictate what the wage should be.

Right now, for example, in Omaha, Nebr., where I am from, the market's prevailing wage is far above the minimum wage, so I guess we would have a real disagreement with that. Earlier, talking to Mr. Johnson, you took a swipe and said "tax cuts for the rich." Mrs. Rivlin, I know you didn't mean to say that. You weren't calling our senior citizens rich, were you?

Ms. RIVLIN. I was referring to the fact that the tax cuts proposed in the Contract With America are much more oriented toward aiding upper income people than those of the Clinton administration.

Mr. CHRISTENSEN. So you were calling our senior citizens rich?

Ms. RIVLIN. I don't remember that we were talking about senior citizens. We were talking about two different kinds of tax cuts.

Mr. CHRISTENSEN. No, you said "tax cuts for the rich," and I just want to make sure we get you on record that you weren't calling all senior citizens rich.

Ms. RIVLIN. Some senior citizens are rich and many are not.

Mr. CHRISTENSEN. Those making above $11,280 would you call rich?

Ms. RIVLIN. Some senior citizens making above that amount are rich and some are not.

Mr. CHRISTENSEN. I am sure you weren't calling our working moms and dads with children rich, were you?

Ms. RIVLIN. I don't know what this line of questioning is for. Rich people are people with high incomes.

Mr. CHRISTENSEN. It was the swipe that you took that I didn't appreciate because of all the various provisions that we have looked at. For example, 60 percent of our capital gains tax cut is going to go to those people that make $75,000 or less. The tax cut that we talked about yesterday and passed in this committee, I am sure you weren't calling self-employed small businessowners rich, because the 25-percent health care deduction is going to go to 3 million of them.

I appreciate the ranking minority member's comment earlier today about how it is going to be everybody's responsibility and the fact that it wasn't just President Reagan or President Bush, but it was the entire Congress that needs to take responsibility for what happened to the debt.

I want to find out what happened behind closed doors when you and the President and the other people on his task force were making decisions on not to seek a balanced budget. What was said? Was there ever anything said that, well, let's let the majority put their bill out there; let's let them do the heavy lifting and make the major cuts so that they take the hit. Was there any comment made to that area?

Ms. RIVLIN. I am not going to discuss internal discussions that took place in the White House. The President likes to listen to all the different views. The difficult questions that were being discussed were——

Mr. CHRISTENSEN. Mrs. Rivlin, I am not asking for you to divulge any secrets. I just want to know, was there any discussion brought up to the fact that let's try to balance the budget by the year 2002——

Ms. RIVLIN. I said I am not going to talk about internal White House discussions. The important thing for us to be focusing on today is the tradeoff between reducing the deficit faster and sharing the benefits of recovery with average families. We believe that our budget is a compromise on that tradeoff. It reduces the deficit further and emphasizes the need for sharing the benefits of recovery with average families, both now and in the future.

Mr. CHRISTENSEN. I appreciate some of the things that you have stood for in the past and the fact that you have been on the cutting edge of trying to get the administration to go further, but I have to tell you that $200 billion a year deficits, adding $1 trillion to our debt, is not an example of being a deficit hawk. I would encourage you to continue to prod the administration toward a balanced budget.

We have our own problems to get a balanced budget amendment. We need your help in this area because the American people want to see their government live on a balanced budget, and I truly believe that you want to see that, too, and maybe your hands are tied. I would like to know what is going on, though, behind closed doors and who they are setting up to take the fall.

Ms. RIVLIN. Well, we would like to see how those who favor both getting to balance by the year 2002 and offering much larger tax cuts are going to pay for it.

Mr. HOUGHTON. Thank you very much.

Mr. Levin.

Mr. LEVIN. Hello, Dr. Rivlin. You were kind of pushed on some of your statements. Just so the record is clear, Mr. Christensen, I think Dr. Rivlin was referring to a Treasury study of all the tax proposals in the Contract, and I would like to just read to you the Treasury analysis, Mr. Christensen.

Mr. CHRISTENSEN. What is that?

Mr. LEVIN. I will just put them in the record. I just wanted to read to you the Treasury analysis of the Contract proposals because you implied that Dr. Rivlin's facts were wrong: 27.3 percent would go to families with income over $200,000 and more, 24.8 percent to families $100,000 to $200,000, and 23.7 percent to families $75,000 to $100,000; so that means 52 percent would go to people $100,000 or more, and if you add those $75,000 and more, that is the upper quintile, that would be about 70 percent.

Mr. CHRISTENSEN. Would the gentleman yield?

Mr. LEVIN. Sure.

Mr. CHRISTENSEN. My comment was that for the last 3 weeks we have heard a lot of class warfare talk and we have heard about tax cuts for the so-called wealthy. Being a new member on this committee, I just wanted to make sure that some of the areas that I outlined here were not her description of tax cuts for the rich.

Mr. LEVIN. But two things: To point out an income distribution isn't class warfare. Is income distribution irrelevant?

Mr. CHRISTENSEN. For the last several months we have heard nothing but demagoguery on the part of a few members about how it is terrible and it is rotten and it is evil for people to be successful in life and to create jobs and to earn a better living, and I guess it just gets a little tiring on our side to hear that.

Mr. LEVIN. That isn't my position. I don't think it is the position——

Ms. RIVLIN. It is certainly not my position.

Mr. LEVIN. I will ask Dr. Rivlin her attitude about growth, but I don't think it is irrelevant to look at a distribution table.

Mr. PORTMAN. Will the gentleman yield for a moment?

Mr. LEVIN. Yes.

Mr. PORTMAN. I believe what Mr. Christensen was referring to—and I believe the record will support this—in response to a question from Mr. Johnson, I think Dr. Rivlin said that the administration didn't want to use Medicare savings to support tax cuts for the rich. I guess my only comment to that would be that the administration made a much broader decision, which was not to support it for deficit reduction generally, much less for tax cuts for anybody. I think that was the context—I believe.

Mr. LEVIN. No, but what Dr. Rivlin—I will give her a chance to speak herself—is saying is that they don't want Medicare cuts going for tax proposals that primarily benefit upper income families.

Mr. PORTMAN. If the gentleman would yield. Of course you are describing the administration's tax proposals in that way because that would have been the offset in its budget, of course.

Mr. LEVIN. But it isn't. I mean, Dr. Rivlin, there is a tax cut proposal in the President's proposal, right, aimed at middle-income families?

Ms. RIVLIN. Yes.

Mr. LEVIN. Is it paid for by Medicare savings?

Ms. RIVLIN. No, it isn't.

I was really making two simple points. One is that our tax cut is much more limited than the tax cut proposed in the Contract With America. The administration's tax cut focuses more on average families and on encouraging education and training; we did not put Medicare cuts in our budget, and we did not pay for our tax cut by Medicare cuts. We don't think that is a good thing to do.

Mr. LEVIN. Let me just ask you, it will take you more than 30 seconds, but the deficit does stay—I am going to ask you, I think, a somewhat tough question—at kind of a stationary level; not in terms of GDP, it goes down. Give us a 1-minute or a 30-second answer, if the chair will indulge, in why it is worthwhile to take the $60 to $70 billion in tax cuts and apply them to tax cuts for middle-income families instead of reducing the deficit over 5 years.

Ms. RIVLIN. Well, one of our goals is raising living standards for average people. Now, bringing the deficit down helps to do that because it fosters investment generally, but there are other ways of raising living standards. Our proposals to change the Tax Code to give some immediate relief to working families with young children and to foster investment in the education and training of people so they have better jobs and higher wages in the future provides another means for raising living standards. We believe that our tax deduction for education and many of the spending programs that are in the budget, especially the GI bill for American workers, would all help to achieve our goal of improving living standards for average people.

Mr. LEVIN. Thank you.

Thank you for the indulgence of the Chair. Thank you.

Mr. HOUGHTON. Thank you.

Ms. Dunn will inquire.

Ms. DUNN. Thank you very much, Mr. Chairman, and Dr. Rivlin, welcome to this panel. I would like to take advantage of your background to ask you a couple of questions, the first one being very, very general; and the second one, far more specific to my part of the country, which is the Northwest.

I am as worried as everybody is about the size of the interest payment on our debt. During a campaign I ran a couple of years ago, I got questions from folks about why we couldn't add to the budget a payment on the principal of the national debt. Could you talk to me a bit about that, the pluses, the minuses, why, why not, the general thinking?

Ms. RIVLIN. Well, the debt is simply the sum total of government borrowings. As many people have pointed out here today, while the government still runs a deficit, it is still borrowing additional money which causes the debt to grow. The first step in reducing the debt, therefore, is to get the deficit to zero. If you establish a

fund now to reduce the debt, while the government is still borrowing money, it would essentially be meaningless. The debt will grow as long as there is a deficit.

Now, as I pointed out, the seriousness of the debt problem depends on whether the economy is growing. If the economy is growing faster than the debt is growing, it is a much less serious problem.

Ms. DUNN. Thank you.

The second question, I am interested in your thinking on the Bonneville Power Administration mentioned in the budget. You suggest turning it over to a government corporation. There has been talk about privatizing the BPA. Those of us in the Northwest are very concerned about that talk because we believe that it results in false revenue estimates, something like $7 billion that we can't count on because we can't count on a buyer for the Bonneville Power Administration; and the President in his budget has said that it should be turned into a government corporation.

Could you give me the background on that?

Ms. RIVLIN. Yes. We are not proposing privatizing Bonneville for the reasons to which you allude. While Bonneville has heavy debt, we think it would run more efficiently as a government corporation. It is not a massive change and I think it would allow Bonneville to do some things more effectively. The change to a government corporation also would not increase rates for customers.

We are proposing gradual privatization of some other power marketing authorities, but not Bonneville.

Ms. DUNN. I had thought that it would increase the rates in a minor way, but not the way that privatization would; but the reason it would increase the rates is because we would be refinancing the long-term debt from the 3-plus percent that it was originally funded under to 6.7 percent, and also making a $100 million downpayment in order to—a premium that would allow us to go through that refinancing. Is that what——

Ms. RIVLIN. Well, if I may, I would like to give you a more detailed answer on Bonneville for the record or subsequent to the hearing.

Ms. DUNN. Thank you.

Thank you, Mr. Chairman.

[The following was subsequently received:]

May 25, 1995

Answer to Congresswoman Dunn's Question on Bonneville Power

In his fiscal 1996 budget, the President recommended that the Bonneville Power Administration (BPA) be changed into a wholly-owned Government corporation so that it can operate in a more business-like way.

Currently, BPA is subject to many Department of Energy, General Services Administration, Office of Personnel Management and other agency requirements that, BPA says, impedes its operational efficiency. BPA believes that, free from many of these requirements, it will have the autonomy and flexibility to operate more efficiently and at lower costs. BPA and the Energy Department estimate that this change could save $15 to $20 million annually.

The Administration's support for any government corporation proposal is dependent on its review of the draft BPA legislation. This review is now under way.

As I indicated in my testimony, this change should not involve any additional cost to BPA ratepayers. Indeed, the objective is to allow BPA to operate more efficiently so it can lower ratepayers' costs.

With respect to refinancing BPA's existing appropriation debt, the Administration proposed such legislation last year and endorsed it this year.

You mentioned that last year's "refinancing" legislation would have required BPA to pay $100 million above the net present value of BPA current appropriation debt repayment requirements. This was deemed the minimum equitable consideration due the Treasury in return for the Treasury's allowing BPA to "lock in" below-cost Treasury financing that BPA and its customers enjoy. This Treasury financing subsidy costs taxpayers more than $300 million every year. Most of it results from the difference between the extremely low interest rates that BPA used on its appropriation debt and the Treasury's much higher cost of borrowing at the time BPA borrowed the funds.

Mr. HOUGHTON. Thank you.

Mr. English.

Mr. ENGLISH. Thank you.

Dr. Rivlin, I want to briefly revisit something that I think Mr. Johnson touched on in his questioning and perhaps was not in a position to amplify on, and again I don't want to intrude into any administration council fires, but I would like to get an explanation from a public policy standpoint of why the administration chose to limit its child tax credit specifically to families with children under 13, because I have been puzzling through what the distinction is between providing this credit for younger children as opposed to teenagers, and I haven't been able to come up with a meaningful public policy way of distinguishing those families, No. 1.

No. 2, I believe that the costs are substantially larger for teenagers—I know that was my parents' expert finding with me—and so I wonder if you could give us what the rationale of the administration was, apart from revenue. I understand there is always a need to shape a proposal to resemble the revenue available, but apart from the revenue, is there a solid reason for targeting the tax credit this way?

Ms. RIVLIN. Well, it was really a way of targeting the tax credit at younger families who are just getting started. Teenagers are very expensive. Mrs. Clinton actually pointed that out, as she is the mother of a teenager. Nobody is saying that it is cheaper to have a 16-year-old than an 11-year-old. It is not. But the effort was to target young families struggling to get started. It was our feeling that a focus on young families with younger children at income levels that made it difficult to make ends meet was the most effective way to target the tax credit.

Mr. ENGLISH. OK. So ultimately this was at least partially revenue driven, given the fact that you had a certain amount of money, but this was a better way of targeting the available revenue; is that fair to say?

Ms. RIVLIN. That is right.

Mr. ENGLISH. OK.

On a second point, with regard to the design of your tuition and training tax deduction, did you look at the possibility of providing a limited targeted tax credit as an alternative, and would the administration be receptive to that kind of an approach?

Ms. RIVLIN. We talked about the possibility of doing a credit rather than a deduction and would be happy to talk about it further. The point is to get money to people who want to invest in themselves and their education.

Mr. ENGLISH. Another question I had had to do with testimony before our Social Security Subcommittee by Dr. Shirley Chater, the Commissioner, who argued that the Clinton administration would be receptive to the idea of raising the earnings limitation on Social Security, but only to what she described as a moderate amount, an increase of $1,000 per year for 5 years.

Now, raising the income threshold from $11,000 to about $17,000 seems to me to be a very modest proposal. Would the administration—given the fact that we can, I suspect, address the revenue side of the equation, be receptive to a more substantial raising of the threshold as the Contract proposes?

Ms. RIVLIN. We are very wary of raising the threshold too much because it costs a lot of revenue and it doesn't necessarily——

Mr. ENGLISH. In the short term, but in the long term there is a recapture.

Ms. RIVLIN. There is some recapture in the long term, but it certainly costs revenue in the near term. The notion of Social Security was that it was to be for people who are retired. The amount of money you are earning determines whether you are retired.

Mr. ENGLISH. So we have a philosophical disagreement on that probably?

Ms. RIVLIN. We may have.

Mr. ENGLISH. Thank you very much for your testimony.

Ms. RIVLIN. Thank you.

Mr. HOUGHTON. Thank you.

Mr. Payne.

Mr. PAYNE. Thank you very much, Mr. Chairman.

Dr. Rivlin, thank you very much. I suppose I may be the last or almost the last person who will question you today.

I first wanted to comment on what Ms. Dunn said earlier in her concern about Bonneville. My folks are concerned about SEPA, the Southeastern Power Administration, but rather than get into that here, I would rather work with the administration as we move forward to try to better understand that proposal and to make sure that it is one that is both fair and equitable for the taxpayers as well as the customers.

Ms. RIVLIN. As well as the ratepayers. We very much agree with that.

Mr. PAYNE. Thank you. I am one of the people who supported the balanced budget amendment. I am very interested in seeing us get on a glide path where we can, in fact, by the year 2002, find our way to no budget deficit.

I am concerned, though, in this committee, the discussions that we have had thus far this year have centered around the Contract With America, and both the Joint Tax Committee and the Treasury have suggested that if we implement all of the tax provisions that are being put forth, we will add to the deficit some $200 billion over 5 years or $700 billion over 10 years; and the budget that is being submitted by the administration, as I understand it, would have for the middle-income tax cut other savings provisions, some $63 billion in potential increase in the deficit.

Ms. RIVLIN. The tax cut will cost that much, right.

Mr. PAYNE. Now, that proposal versus the Contract With America, as I understand it, which would cost comparably $200 billion, means that the difference, or $137 billion, would have to be found in savings and various cuts over the 5-year period just for us to stay exactly where the administration's budget is now before we begin any kind of deficit reduction. Is that an accurate depiction?

Ms. RIVLIN. If the majority comes up with only enough offsets to pay for their tax cuts, then they will have a budget that does not reduce the deficit at all.

Mr. PAYNE. I think that there are many of us who see many of these items in the Contract With America as desirable, but are very concerned about the cost and are looking at the deficit reduc-

tion as being extremely important and something that we need to address ourselves to first.

Let me move very quickly, since I have a limited amount of time, to something that I am trying to understand better. In the President's budget, HCFA has looked at the baseline for our government health care programs. As I understand it, the Medicare baseline has been reduced from 11.9 to 9.9 percent growth rate, Medicaid has been reduced from 13.7 to 8.2 percent in terms of the growth rate; and yesterday Secretary Rubin said that what all this meant was that in terms of the 5-year budget that we had actually saved some $212 billion, or had potentially reduced the deficit by that amount as a result in the change of the baseline that had been set forth by HCFA.

I have several questions. No. 1, is this driven to some extent by the private sector reductions that we have learned about? No. 2, is it driven to some extent by the move to HMOs or policy driven? No. 3, might we expect further reductions in that baseline over a 5-year period given the course that we are on now?

Ms. RIVLIN. You are right, for government the baseline health care programs have come down. We did that to reflect what the actuaries told us about their extrapolation of the recent changes, that health care costs will grow less rapidly. But the costs are still growing rapidly. Nine percent is still a very rapid rate of growth.

There are several reasons for the change in the growth rate of health care costs. In Medicare, the growth rate has slowed primarily because hospital costs are not growing as rapidly. The slowdown in the growth of hospital costs reflects, in part, lower general inflation and, in part, greater efficiencies in the private sector.

Medicare's slower rate of growth does not have much to do with HMOs, however, because HMOs do not play a big role in Medicare.

With Medicaid, the change in the growth rate is due, in part, to the Federal Government having closed down the devices that the States were using to load more Medicaid expenses on the Federal Government. Everybody is struggling with these costs, and the States had been using various devices to load more of the costs on the Federal Government. The changes in the law enabled us to stop much of that from happening.

Mr. PAYNE. Are we now on a track where HCFA is likely in the next 5 years to come back, relook at this, and say that the rate of growth is even lower than what we are on now?

Ms. RIVLIN. I don't think we know the answer to that. We could hope that many of the changes that are going on in the private sector would be reflected, in part, in the government costs. I do think, however, that we need to look at Medicaid and Medicare in the context of overall health care reform and see if we can ensure a lower rate of growth in the future.

Mr. PAYNE. Thank you very much.

Mr. HOUGHTON. Thank you.

Mr. Portman.

Mr. PORTMAN. I thank the chairman. Dr. Rivlin, thank you for your willingness to stick it out here; your stamina is impressive. I think I am the last questioner you have to deal with.

I want to put a plug in quickly for unfunded mandate reform. Sally Katzen, a senior member of your staff, has been working with

us closely on the conference; and I would hope the administration would support a meaningful proposal coming out of the conference.

The House bill, as you may know, was passed with an overwhelming majority; I think two-thirds of the Democrats in the end supported it. We would have liked to have had your support on that legislation and on the amendments, and we understand you are generally supportive. We hope to have the strongest bill possible coming out of conference after a 360-to-70 vote in the House of Representatives. Again, Ms. Katzen is to be commended for her work and interest in this.

Ms. RIVLIN. I am glad to hear this, and the administration is supportive of the unfunded mandates legislation.

Mr. PORTMAN. I am pleased to hear that. I would say, just in general, in listening to not only testimony but the questions and answers today, my largest concern is of course that the administration has not aggressively approached the deficit with this budget.

I looked at your objectives even before you came here today—and you have repeated them many times, including recently with Mr. Payne, that a better standard of living for the future—higher wages, those objectives are of course entirely consistent with aggressive deficit reduction as you have in a former life emphasized.

You talked about the problem you found in 1993, I think your quote was something like the use of the Nation's savings to finance the debt and the deficit led to a crisis situation that you came into in 1993. Again, I would say that both your objectives, as so stated in the budget and your analysis of 1993, would lead to very aggressive deficit reduction. I just don't see it here.

Two things in particular concern me about that. One is, this was your last chance. This was the last administration budget that you would have full control over, conceivably; and second, as the vice chairman of the committee, Mr. Gibbons has pointed out, this is the time to do it. We have relatively good economic times.

You talked about the recession after the 1990 budget deal and the impact that had on revenues and, therefore, the increase in the deficit. Well, now we have just the opposite situation. I hoped that the administration would have been far more aggressive in approaching the deficit. We talked about specifically your response being that as a percentage of the GDP, the deficit is not increasing. One figure I haven't heard yet, and I just wonder if you could answer quickly, is what is the percentage of GDP that the debt would represent over the next 5 years?

Ms. RIVLIN. While somebody is getting me that, let me comment on some of your other points.

I don't think this budget is our last chance or your last chance for deficit reduction. We will be working with the Congress not only on the budget, but on other items which are important to bringing the deficit down. One of those items is health care. We have put together a budget which contains aggressive cuts in discretionary spending. They don't get much attention up here, but we believe we have taken drastic steps to come up with proposals that would give us a leaner and more effective government. The deficit-reducing measures in this budget certainly move toward that direction.

Mr. PORTMAN. My question specifically would be, what does the debt—as a percentage of GDP, does that percentage figure also decline over the next 5 years and through the 10-year cycle?

Ms. RIVLIN. It stays about even.

Mr. PORTMAN. About even. You said in response to your questioning with Mr. Ford that both the deficit and the debt were being reduced over time as a percentage of GDP. So I think that is a significant figure. It is one that a lot of members have focused on, but we haven't heard the specific numbers. It is, I think, over——

Ms. RIVLIN. It is approximately flat.

Mr. PORTMAN. OK. After the 5 years you have about $70 billion per year in addition to the roughly $200 billion per year in debt service, of course.

Mr. ENSIGN. Would the gentleman yield?

Mr. PORTMAN. If the chair will indulge.

Mr. ENSIGN. Just real quickly, you may want to check with Secretary Rubin. He said the other day that it would also decrease.

Ms. RIVLIN. Well, logically it must, so I want to look at these figures. If the deficit is not rising as fast as the GDP, the debt must not be, either.

Mr. PORTMAN. It would depend on whether GDP increases over $1 trillion in the next 5 years. It seems to me that would be the key.

Will the chair indulge one more specific question?

Mr. HOUGHTON. Sure. You bet.

Mr. PORTMAN. Again in that context, I just wanted to ask you briefly on the Medicare front, that is a program under the jurisdiction of this committee, one we will be grappling with. I have looked at your testimony, you have talked about the rapid growth—you have talked about the fact that Medicare and Medicaid will double in the next 8 years from 3.4 percent of GDP to almost 5 percent in 10 years. Those two together are 40 percent of the increase in total outlays in the next 5 years.

Can you tell me what Medicare alone is as a percentage of the increase in the deficit over the next 5 years?

Ms. RIVLIN. I can certainly supply that figure for the record. But Medicare and Medicaid together are really the only items in the budget that are increasing rapidly. Medicare accounts for a significant increase in any future growth of spending.

Mr. PORTMAN. A substantial majority of that is Medicare, of course, in the next 5 years?

Ms. RIVLIN. Right.

Mr. PORTMAN. The absolute figures for the next 5 years for Medicare spending alone are roughly $1.2 trillion?

Ms. RIVLIN. We can supply that figure very easily.

Mr. PORTMAN. I think that figure, $1.2 trillion was something that came up in the Budget Committee testimony in absolute terms. It is over 9 percent per year increase in Medicare, and I would just say again, if you are going to get aggressive about deficit reduction, which I know you believe in and you have been a champion for in the past, not touching Medicare, it seems to me, is not a responsible approach.

You made the point again with Mr. Johnson that you didn't believe that there should be any reform of Medicare. We are not talk-

ing about cuts, remember, we are talking about reducing cost increases. You said that there shouldn't be any reforms of Medicare because we don't use Medicare to offset tax cuts—I think you said "for the rich," but even tax cuts, I think, are not intellectually honest. Certainly you could have had Medicare reform in here and had the other savings that you mentioned in the discretionary account for your tax reform measures. I would hope that the administration would be going to work with us not in the long term on health care reform, but in the short term on deficit reduction because it is such a huge part of the deficit problem. You are more familiar with that probably than anyone in this town, and I would have hoped that you could have come up with some specific ideas—whether it is means testing, whether it is increasing copayments, whether it is more HMOs, more managed care, whether it is just larger systemic change in the Medicare system, which clearly is out of control in terms of the 9-percent-per-year cost increases.

So my final point—Mr. Chairman, I appreciate the indulgence—is just to say that I hope that you wouldn't put that off until some possible health care debate in the future which may be very limited to insurance reform.

Ms. RIVLIN. We don't want to put it off. We do want to look at Medicare and Medicaid in the context of reforming the whole health care system. We did that last year. But Congress didn't exactly like what we did. We believe, however, that reforming Medicaid and Medicare has to be done with a view toward reforming the whole health care system. If we just reform Medicare and Medicaid, by cutting the programs and passing the costs on to the private sector, that won't do anybody any good.

Mr. PORTMAN. Well, I would disagree with that. I think the cost shifting involved in cutting reimbursements is one way to approach it. That is how you chose to approach it last year. There are lots of other more creative ways to do so, and again I think even when you talk to the administration about health care reform, people seem to be focused on the insurance reforms. There is nothing at all inconsistent with systemic change in the Medicare program, which again is under this concern, and I would hope that we could work together on that.

Thank you, Mr. Chairman.

Mr. HOUGHTON. Thank you, and thank you, Dr. Rivlin. You are a distinguished public servant. We thank you for your time. The committee will be in recess until 1 p.m.

Ms. RIVLIN. Thank you, Mr. Chairman.

[Whereupon, at 12:04 p.m., the committee recessed, to reconvene at 1 p.m. the same day.]

[Recess.]

Chairman ARCHER. This afternoon I believe we will complete our testimony on the President's budget and, looking at the number of the people in the room, apparently people have lost interest in the budget that has been submitted by the President. I am delighted to have you before our committee, and I think all of us realize this could be your final appearance before the committee.

We are particularly aware of that and also aware of the really fine service that you have given your country over the years, particularly through that most difficult exercise of all, the health care

revisions last year. CBO has continued to serve Congress in their new roles and I feel certain that whatever your new role is, we will be hearing from you again.

So with great respect, welcome to the committee and we will be pleased to hear your testimony. As usual, anything you want to tell us verbally, go right ahead. If you have got something in writing that is longer, that will be submitted in full for the record.

STATEMENT OF ROBERT D. REISCHAUER, PH.D., DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. REISCHAUER. Thank you very much, Mr. Chairman.

I think this is my last testimony before a congressional committee as the Director of the Congressional Budget Office, and it is fitting in a way to appear with this committee that I have worked with very closely over the last 6 years. I hope to continue to have a close relationship with you when I am in the outside world.

I appreciate the opportunity to appear before you here this afternoon. With your permission, I will submit my prepared testimony for the record.

I will briefly compare CBO's latest views of the committee and the budget proposal of the administration and then I am going to describe to you the challenges involved in balancing the budget by the year 2002, which could be required if the Constitution is amended along the lines that were called for in the Joint Resolution that was adopted by the House on January 26.

With respect to the economy, CBO expects the strong growth that we experienced through 1994 to continue only slightly abated in the first half of this current year. Because the economy is operating at close to its potential, that growth is going to increase inflationary pressures a bit. But as a result of the monetary tightening that the Federal Reserve has engaged in over the last year, and any further monetary restraint that might be imposed, we believe that the economy will begin to slow down in the second half of 1995 and slow further in 1996.

On a fourth-quarter over fourth-quarter basis, real economic growth was 4 percent in 1994, and CBO expects growth to slow to 2.5 percent this year and then to 1.9 percent in 1996. The administration expects growth this year to be marginally slower than CBO does, but it expects growth in 1996 to be at about 2.5 percent or 0.6 of a percentage point faster than is projected in the CBO forecast.

Over the longer run, and by that I mean from 1997 through the year 2000, the administration projects that the economy will grow at 2.5 percent a year in real terms. That is about 0.2 of a percentage point faster than we had built into our economic projections. CBO expects the unemployment rate to average about 5.5 percent during the current year, 1995, and then to edge up a bit to 5.7 percent in 1996 as the economy begins to slow down.

The administration expects the unemployment rate to be at about 5.8 percent this year. In other words, a little bit higher than we do, and also following the path that we had suggested to tick up another 0.1 of a percentage point in 1996. The estimates of the unemployment rate that we have built into our forecast and that the administration has built into its forecast are all above the CBO

estimate of 6 percent of the rate of unemployment that is compatible with nonaccelerating inflation.

In other words, we think the economy is operating a little bit above capacity and that will generate additional inflationary pressures.

Chairman ARCHER. Bob, if I may interject right there, do you mean the unemployment rate is actually going to be lower rather than higher than the 6-percent unemployment?

Mr. REISCHAUER. CBO's estimate of the unemployment rate that is compatible with inflation not beginning to increase is about 6 percent. Economists will disagree on that. Since we are projecting that the unemployment rate this year will be only around 5.5 percent, next year will go up to 5.7 percent. That means inflationary pressures——

Chairman ARCHER. What I wanted to clear up, I think you used the adjective "higher," and I think really it will be lower; will it not?

Mr. REISCHAUER. I am sorry, the unemployment rate will be lower than this nonaccelerating rate.

Chairman ARCHER. Thank you.

Mr. REISCHAUER. I am sorry if I misspoke.

Although inflation has been quite subdued over the past 2 years, it has been perking along at about 2.8 percent, CBO expects that the CPI will pick up modestly to 3.2 percent this year and then to 3.4 percent in 1996 as a result of the low unemployment rates that we were discussing. The administration expects the CPI to rise in 1995 at about the same rate that the Congressional Budget Office expects, but thereafter its inflation outlook is a bit more optimistic.

By the end of the decade, the administration has the CPI growing at 0.3 of a percentage point slower each year than does the Congressional Budget Office. Both CBO and the administration expect interest rates to rise this year and then fall a bit in 1996 as the economy slows. CBO expects higher short-term rates but lower long-term rates than the administration does.

Over the 1997–2000 period, the administration expects somewhat higher interest rates and lower unemployment rates than does CBO. Both the CBO and administration forecasts imply that the Federal Reserve's effort to restrain the economy will slow it down without causing a recession. Other outcomes are possible.

This is a very uncertain business. If the economy overshoots its potential by a wider margin than CBO expects, the Federal Reserve could take more drastic action that could presage a recession next year or in the following year. Alternatively, the rise that we have already experienced in interest rates could have been sufficient to slow the economy down, so we could have a very slow economy over the next few years.

Our forecast is really a compromise between these two different outlooks. With respect to the budget outlook, CBO expects the deficit in the current fiscal year to fall to $176 billion or 2.5 percent of GDP, gross domestic product, in dollar terms. That is going to be the lowest deficit we have experienced since 1989. In terms of a percent of GDP, it will be the lowest figure we have experienced since 1979; in other words, a full 16 years.

If further policies are not adopted to reduce the deficit, the 3 consecutive years of declining deficits that we have enjoyed will come to an end and the deficit will begin to rise in 1996. The mounting deficits will be fueled primarily by increases in Medicare and Medicaid, which we expect to grow by about 10 percent a year; CBO projects that all spending other than that for Medicare and Medicaid will grow at only about half that rate.

By 2005, the deficit is projected to reach $421 billion or 3.6 percent of GDP if one assumes that discretionary spending is adjusted for inflation after the discretionary caps expire in 1998. The administration is more sanguine about the baseline budget outlook; that is, the budget outlook that will occur under a continuation of current policies rather than under the tax and spending changes that have been recommended in the President's budget.

For the current fiscal year, the administration expects the baseline deficit to be $17 billion higher than does CBO, $193 versus $176 billion. However, it expects the baseline deficit to be lower than CBO's estimates by growing amounts over the 1996–2000 period. In fact, the administration's estimate for the deficits under a continuation of current policy is some $55 billion below CBO's estimates by the year 2000. All told, the administration expects baseline deficits over the 1996–2000 period to be $112 billion lower than does CBO.

The administration projects that baseline discretionary spending will be about $36 billion higher during the next 5 years than does CBO. The difference arises primarily because the administration has used a different method to adjust the discretionary spending caps for unanticipated inflation, and in the questions I can pursue that issue if you have any interest in that.

During the 1996–2000 period, the administration expects over $70 billion more in baseline revenues than does CBO. The difference is largely attributable to the administration's higher projections of nominal GDP. The administration's estimates for Medicare and Medicaid spending over the 1996–2000 period are about $70 billion less than CBO's estimates. The administration expects these programs to grow at a rate of about 1 percentage point slower than does CBO.

The comparisons I have been discussing relate to the budget outlook under a continuation of current policies, and, Mr. Chairman, CBO will be analyzing the policy proposals that the President has put forward and will be issuing a report to the Congress some time in early March.

Let me turn to the last issue.

Chairman ARCHER. Bob, can I ask you to suspend? I am sorry to do this. I only have a little time to get over and vote. With your indulgence, I am going to vote and the first Republican that comes back will continue the hearing until I can get back.

Mr. REISCHAUER. Fine.

[Recess.]

Mr. CHRISTENSEN [presiding]. Mr. Reischauer, you want to continue? This might be the only time I get to do this.

Mr. REISCHAUER. Let me say, Mr. Chairman,——

Mr. CHRISTENSEN. About 30 years from now, maybe?

Mr. REISCHAUER. I think whoever sits in the seat is Mr. Chairman.

Let me turn now to the last question that I said I would talk about, which is what it would take to balance the budget by the year 2002. What would be required if the constitutional amendment passes and is approved by three-quarters of the States? According to CBO's projections, some combination of spending cuts, tax increases, and reduced debt service that total $322 billion in the year 2002 would be needed to eliminate the deficit in that year. There are many possible paths to that objective, one of which I have laid out on the last page of my prepared statement.

In that particular path we have first frozen discretionary spending through the year 2002 at the level of the 1998 cap. That action, together with the resulting debt service effects, would produce $89 billion of the $322 billion in savings that is needed to balance the budget by 2002.

If we were to pursue that policy, the buying power of the discretionary appropriations in 2002 would be about 20 percent less than it is in 1995. The illustrative path toward a balanced budget next assumes further savings from policy changes, the pattern of which is similar to that of the mandatory program savings that were contained in the reconciliation bills of 1990 and 1993. If these savings were achieved entirely out of entitlement and other mandatory programs, but we exempted Social Security, they would represent about a 20-percent reduction from the current policy levels for those programs.

The responsibility for making those types of cuts, of course, would fall largely to this committee. Looking over the period from 1996–2002, the savings in the CBO illustrative path that result directly from policy changes total more than $1 trillion and the associated debt service savings amount to about $175 billion, but this picture probably overstates the severity of the policy-related cuts that would be needed to balance the budget.

If the necessary policies were enacted into law soon and financial markets were convinced that policymakers would stay the course, CBO expects that interest rates would fall below those that are contained in its forecast. This would increase the debt service savings and reduce the amount of savings needed from policy changes.

If interest rates were to fall by as much as 1 percentage point below the levels that are assumed in the CBO forecast for the year 2002—and this, I think, is a plausible order of magnitude of the possible reduction in interest rates—the amount of savings that would be needed from policy changes over the 7-year period to balance the budget would be almost $140 billion less than the $1.035 trillion that are shown in the last table of my handout.

Lest I sound too negative, let me remind you that there are significant, long-run economic benefits to be gained from reducing the deficit. Productivity would increase. Living standards would rise.

We would be less dependent on foreigners for future investment funding and our debt-to-GDP ratio would begin to decline. But the road to a balanced budget will be one we have never traveled before. It would involve sustained fiscal restraint that would average about 0.4 of a percentage point of GDP each year and that would have a contractionary effect on the economy.

To some degree, that contractionary impact would be offset by lower interest rates that would result from the reduction in Federal credit demands and some possible monetary easing by the Federal Reserve. It would also be offset by stronger exports that would be brought on by reduced exchange rates. Nevertheless, there could be a few bumps along the road that I have laid out.

Let me conclude by noting that the magnitude of the discretionary and mandatory cuts contained in the illustrative path to a balanced budget are large but they are not unattainable. Their size could be reduced, of course, if tax increases were considered as part of the equation.

If taxes are reduced, on the other hand, deeper spending cuts will be required. These are the issues that this committee will play a major role in deciding and they will determine the future course of our fiscal policy.

With that, let me conclude. I will be happy to answer any questions that members of the committee might have.

[The prepared statement and attachments follow:]

STATEMENT OF ROBERT D. REISCHAUER
DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Chairman Archer, Congressman Gibbons, and Members of the Committee, I am pleased to be with you this afternoon to review the state of the economy and the budget. Last week, the Congressional Budget Office (CBO) published *The Economic and Budget Outlook: Fiscal Years 1996-2000*, which describes our current views in considerable detail. My testimony summarizes that report. It also briefly compares CBO's outlook with the economic forecast and budget projections in the President's budget released earlier this week.

No fundamental change in the economic or budget situation has occurred since CBO published *The Economic and Budget Outlook: An Update* in August 1994. The economy may be a bit more robust in 1995 than had been anticipated at that time, but a likely slowdown in growth in 1996 leaves the long-term economic outlook little different from last summer's. CBO expects that the high levels of business investment and purchases of durable goods that spurred the economy to a 4.0 percent real rate of growth in 1994 will continue into the first part of 1995. Because the economy is already operating close to its potential (the level of gross domestic product, or GDP, consistent with a stable rate of inflation), that growth is expected to result in somewhat higher rates of inflation and interest. In turn, those higher interest rates are likely to slow growth by the end of 1995--cutting it to 2.5 percent in 1995 and 1.9 percent in 1996 and dampening inflationary pressures. In CBO's longer-term projections, average annual growth after 1996 is close to the 2.4 percent rate of growth estimated for potential GDP, over the 1997-2000 period covered by those projections, inflation averages 3.4 percent and interest rates drift down.

CBO projects that the deficit will decline from the $203 billion registered in 1994 to $176 billion in 1995, the lowest level since 1989 and the lowest as a percentage of GDP (2.5 percent) since 1979. After reaching a trough in 1995, the deficit will rise to $207 billion in 1996 (2.8 percent of GDP), grow again in 1997, and then level off in 1998. Those projections assume no change in current policies governing taxes and mandatory spending; they also assume compliance with the limits on discretionary appropriations that are in place through 1998. Under the assumption that spending for discretionary programs increases at the rate of inflation after 1998, deficits will grow to $284 billion (3.1 percent of GDP) in 2000, the last year of CBO's regular projections. Under an alternative baseline that assumes that discretionary spending remains frozen at the dollar level of the 1998 caps, deficits increase only to $243 billion in 2000.

CBO's extended projections for 2001 through 2005, which are less detailed than those through 2000, show deficits continuing to mount in dollar terms through 2005 if discretionary spending is adjusted for inflation after 1998 (see Figure 1 at the end of this statement). Deficits also grow as a percentage of GDP--to 3.6 percent in 2005. There is no reason to believe that this trend will be reversed in the years after that; indeed, the growth in the deficit is likely to accelerate in the second decade of the 21st century as large numbers of baby boomers become eligible for Social Security and Medicare benefits. Extended baseline projections that assume that discretionary spending is frozen at the 1998 level show deficits that are nearly constant from 2000 through 2005. As a percentage of GDP, the deficit in that baseline shrinks from 2.7 percent in 1998 to 2.1 percent in 2005.

Higher-than-anticipated interest payments and lower revenues, which are only partially offset by lower spending for medical care programs, have pushed up CBO's deficit projections for fiscal years 1995 through 1999 from last August's estimates by an average of almost $25 billion a year. After 2002, however, the deficits in the new extended projections are a little lower than the deficits projected in August.

The Administration's economic assumptions are not dramatically different from CBO's, but its baseline deficit projections for fiscal years 1995 through 2000 (generally based on the assumption that current laws and policies are unchanged) are almost $100 billion lower than those of CBO. It will take several weeks to analyze the President's budget thoroughly, but a quick assessment suggests that seemingly small differences in economic assumptions are likely to account for a significant

amount of the discrepancy between CBO's and the Administration's baseline deficit estimates. Divergent estimates of discretionary spending and expenditures for Medicare and Medicaid also contribute to the difference in deficit projections.

The Congress is considering a constitutional amendment, which could go into effect as early as 2002, requiring a balanced budget. CBO currently projects a deficit of $322 billion for that year (assuming that discretionary spending is adjusted for inflation after 1998), which is only $3 billion more than the amount estimated last August. To illustrate the magnitude of the task facing those who would have to enact policies to comply with the balanced budget requirement, CBO has constructed an illustrative path leading to a balanced budget in 2002 that entails deficit reduction of $1.2 trillion over the 1996-2002 period. Major changes in current policies would be required to achieve deficit reduction on that scale.

THE ECONOMIC OUTLOOK

CBO forecasts that the strong economic growth that the nation experienced throughout 1994 will continue into the first part of 1995. Because the economy is operating close to its potential, that growth will increase inflationary pressures and is likely to trigger additional efforts by the Federal Reserve Board to rein in the economy with higher short-term interest rates. In the CBO forecast, the resulting moderate slowdown at the end of 1995 and during 1996 will gradually bring GDP back in line with potential output without seriously disrupting the economy. Even with somewhat higher short-term growth and the slowdown in 1996, the current economic projections for 1997 through 1999 are little different from those CBO made last August.

The Forecast for 1995 and 1996

The robust growth that the U.S. economy experienced in 1994 is likely to continue through the first part of 1995 but will fade by the end of the year. The 4.0 percent increase in real output (on a fourth-quarter-to-fourth-quarter basis) and the creation of over 3 million new jobs in 1994 were achieved without an increase in inflation, but that performance is not likely to be repeated in 1995 (see Table 1). Because the economy is already operating close to its potential, it cannot persistently expand faster than the growth of potential output--estimated at 2.4 percent a year by CBO--without triggering modestly higher inflation.

The Federal Reserve, which is determined to avoid any significant increase in inflation, raised the federal funds rate by 250 basis points (2.5 percentage points) in 1994 and boosted it an additional 50 basis points last week. CBO forecasts that 90-day Treasury bill rates will average 6.2 percent in 1995--up from 3.2 percent in the first quarter of 1994. Rates for 10-year Treasury notes are expected to increase more modestly. The high rates of business investment and personal consumption of durable goods that drove the economy forward in 1994 apparently have not yet declined and will keep growth strong in the first part of 1995. However, by 1996, the cumulative effect of past and future hikes in interest rates should begin to bring the economy back in line with potential output. As a result, CBO expects that growth of real GDP will slow to 1.9 percent in 1996.

Unemployment will remain low in 1995--it is forecast to average 5.5 percent, compared with 6.1 percent in 1994--but will climb to 5.7 percent in 1996. Even at 1996's slightly higher level, unemployment will be below CBO's estimate of 6.0 percent for the nonaccelerating inflation rate of unemployment (NAIRU). A sustained unemployment rate below the NAIRU indicates a future increase in wage inflation. With unemployment below the NAIRU and GDP exceeding potential output, inflation

is expected to rise in 1995 and 1996. Because the economy has not become too overheated and is expected to cool down later this year, the forecast upswing in the consumer price index for all urban consumers (CPI-U) is modest--from 2.7 percent in 1994 to 3.2 percent in 1995 and 3.4 percent in 1996 (see Table 1).

CBO's forecast assumes that the recent and anticipated future increases in short-term interest rates engineered by the Federal Reserve will restrain the economy to an appropriate degree. If the continuing strong growth that CBO foresees in early 1995 does not take place--if the economy has already started to cool off--the expected additional monetary tightening will slow growth sooner and more sharply than anticipated. Alternatively, if the economy proves stronger and more resistant than expected to the anticipated increases in interest rates and it surges well above potential output, the Federal Reserve will probably respond with even higher interest rates to combat the risk of inflation. That stronger-than-expected growth and the Federal Reserve's response to it could usher in a cycle of boom and bust for the economy.

Some economists argue that potential output may be greater than CBO estimates, in which case the economy could grow at its current rate for some time without triggering higher inflation. The Federal Reserve, however, is unlikely to allow such growth unless the evidence for a shift in potential output is more compelling than it currently is.

The Administration foresees somewhat slower real growth during 1995 than does CBO, but does not forecast as much of a slowdown in 1996. Compared with CBO's forecast, the Administration assumes the consumer price index rises more rapidly in 1995 and more slowly in 1996; the implicit GDP deflator rises faster in both years. Interest rates on three-month Treasury bills are lower in the Administration's forecast, but rates on 10-year Treasury notes are higher. The Administration's unemployment rate is higher in both 1995 and 1996.

Projections for 1997 Through 2000

CBO attempts to forecast the cyclical fluctuations in the economy only for the next two years. Beyond 1996, its projections are based on trends in fundamental factors that determine the potential growth of the economy, including growth in the labor force, productivity, and national saving.

CBO's projections follow a path that has the gap between GDP and potential GDP reaching its historical average level--with GDP 0.6 percent below potential--at the end of the projection period in 2000. Because CBO estimates that the level of GDP will exceed potential output in 1996, the average annual real growth projected for 1997 through 2000 is slightly below the estimated 2.4 percent rate of growth of potential output (see Table 2). Unemployment is expected to increase slightly to 6.0 percent, the estimated level of the NAIRU. Projected consumer price increases are assumed to average 3.4 percent a year over the period, with projected interest rates declining from the levels associated with efforts to slow the economy in 1995 and 1996.

The Administration also assumes that real growth will average 2.5 percent a year in 1997 through 2000. It assumes that over that period the consumer price index will grow more slowly--less than 3.2 percent a year--than CBO projects, but that the implicit GDP deflator will increase at an average rate of 3.0 percent a year, higher than the 2.8 percent average annual increase projected by CBO. The Administration assumes a lower rate of unemployment in 1997 through 2000 but higher short- and long-term interest rates.

THE BUDGET OUTLOOK

Although CBO now projects that the deficits for fiscal years 1995 through 1999 will be almost $25 billion a year higher, on average, than it anticipated last August, the fundamental budget outlook is not very different from the one CBO projected then. Moreover, there has been no substantial change in CBO's deficit projections since its report in September 1993, which for the first time reflected the more than $400 billion in deficit reduction enacted in the Omnibus Budget Reconciliation Act of 1993 (see Figure 2). The deficit is still expected to fall in 1995 to its lowest level since 1989--and its lowest point as a percentage of GDP since 1979. As was also the case in August, the deficit is projected to begin rising again in 1996. CBO's extended budget projections show that trend continuing through 2005 if spending for discretionary programs increases at the rate of inflation after 1998. After 2002, currently projected deficits are slightly lower than the deficits forecast in August.

The Outlook for the Deficit

Since 1992's record-high shortfall of $290 billion, the deficit has declined to $255 billion (4.0 percent of GDP) in 1993 and $203 billion (3.1 percent of GDP) in 1994. (Although a record in dollar terms, the 1992 deficit as a percentage of GDP was far short--at 4.9 percent--of even a postwar record.) CBO projects that the deficit will decline for a third straight year to $176 billion (2.5 percent of GDP) in 1995 (see Table 3). That gratifying trend is expected to end next year, however, with the deficit climbing under current laws to $207 billion (2.8 percent of GDP) in 1996 and $224 billion (2.9 percent of GDP) in 1997 before leveling off in 1998.

The standardized-employment deficit, which is an estimate of the deficit that would occur if the economy was operating at its potential, is of interest because it is a measure of the fiscal posture of the federal budget without the cyclical effects of the economy. When the economy is operating below potential, the deficit swells as a result of reductions in revenues and increased spending for programs such as unemployment insurance. When the economy is operating above potential, revenues are increased and spending is lower. Because in CBO's forecast the economy will be operating close to potential throughout the 1995-2000 period, the projected standardized-employment deficits differ little from the projected total deficits. Despite that, a look at the standardized-employment deficit as a percentage of potential GDP is still illuminating. That measure varies only slightly from year to year during the 1994-1998 period, which makes it clear that the fiscal stance of the budget changes hardly at all during that time.

CBO's baseline projections for mandatory spending programs and taxes represent the outlays and revenues that will result if no changes are made in the laws governing those parts of the budget. The projections for discretionary spending (spending controlled by annual appropriations) assume compliance with the discretionary spending limits for 1996 through 1998 established for general-purpose appropriations in the Balanced Budget and Emergency Deficit Control Act of 1985 and for specific anticrime appropriations in the Violent Crime Control and Law Enforcement Act of 1994. Because no level of discretionary spending is set by law for the years after 1998, CBO makes two different projections of the deficit for 1999 and later years. In one projection, discretionary spending grows at the rate of inflation; the purchasing power of the appropriations is thus held constant at the 1998 level. In the other, discretionary spending is frozen at the 1998 dollar level.

In the baseline projections with discretionary spending adjusted for inflation after 1998, the deficit resumes its upward path after the pause in 1998. By 2000, the last year of CBO's regular projections, the deficit of $284 billion is almost back to the record level of 1992 (although at 3.1 percent, it is well below the 1992 deficit as a percentage of GDP). CBO's extended projections show deficits that continue to climb

after 2000, reaching $421 billion (3 6 percent of GDP) in 2005. The mounting deficits continue to be fueled primarily by increases in Medicaid and Medicare, even though projected costs for those programs are somewhat lower than CBO had estimated last August. All spending other than that for Medicaid and Medicare is projected to grow at an average rate of about 5 percent a year between 1998 and 2005, slightly slower than the rise in revenues. Projected spending for the two big federal health programs, however, increases at an average rate of almost 10 percent a year after 1998.

In the baseline projections without inflation adjustments for discretionary spending after 1998, deficits level off at around $240 billion a year from 1999 through 2005. (The projected deficit of $242 billion for 2005 is equal to 2.1 percent of GDP.) Freezing discretionary appropriations at the 1998 dollar level through 2005 would result in funding for discretionary programs in 2005 that had about 27 percent less purchasing power than the 1995 appropriations. If total discretionary spending was frozen at the nominal 1998 level but defense spending was preserved at the 1995 funding level adjusted for inflation, the money available for all other discretionary programs in 2005 would have less than half the purchasing power of the 1995 appropriations for those programs.

All mandatory spending is the same in both baselines, except that interest payments reflect the lower deficits and debt in the version that does not adjust discretionary spending for inflation after 1998.

The Administration's baseline deficits are almost $100 billion less over the 1995-2000 period than the deficits in CBO's baseline with discretionary inflation after 1998 (see Table 4). The 1995 deficit is $17 billion higher than CBO projects, but in every other year the Administration's estimate is lower--in fact, by as much as $55 billion in 2000. The Administration's baseline concept is similar to CBO's, but differences between the Administration's and CBO's method of adjusting the discretionary caps for inflation account for the Administration's projection of baseline discretionary spending that is as much as $9 billion higher than CBO's in 1998. The Administration projects that revenues under current law will be more than $60 billion higher than CBO estimates in 1995 through 2000. A significant part of that difference is the result of the higher levels of nominal GDP projected by the Administration. The Administration also projects outlays for Medicare and Medicaid that are around $70 billion lower than CBO estimates for 1995 through 2000. CBO's detailed analysis of the President's budget, which should be available in March, will provide a much more thorough explanation of the differences between the Administration's and CBO's projections than we can give now based on our initial look at the budget.

According to the Administration, the policies proposed in the President's budget would reduce the deficits over the 1995-2000 period by about $80 billion, with $136 billion in spending cuts more than offsetting a $56 billion reduction in revenues. CBO's analysis of the President's budget will include CBO's estimate of the effects of the policies proposed by the Administration. However, we are not yet able even to hazard a guess about whether our estimate will be significantly different from the Administration's.

Changes in the Projections

The deficits that CBO currently projects for 1995 through 1999 are almost $25 billion a year higher, on average, than those projected last August (see Table 5). Yet despite those increases, there has been no fundamental change in the deficit outlook. In fact, by 2003, the deficits in CBO's current extended projections are slightly lower than the deficits CBO projected in August.

Legislation enacted since then has had very little effect on the deficit outlook. The two most significant laws were an act making major changes in the federal crop insurance program in hopes of avoiding future ad hoc disaster assistance to farmers and an act implementing the Uruguay Round of the General Agreement on Tariffs and Trade (GATT). The crop insurance legislation increased estimates of the deficit by almost $1 billion a year. Because CBO's baseline projections were made on the basis of current law, they did not include any spending that might result from the enactment of future ad hoc disaster bills. Therefore, reducing the likelihood of such legislation did not produce savings that could offset the higher spending for crop insurance. The GATT implementing legislation added almost $3 billion to deficits over the 1995-1999 period because losses in revenues from lower tariffs were not completely offset by other revenue increases and spending cuts.

Changes in the economic forecast since August have had a greater effect on deficit projections than has legislation. Economic changes have pushed down projected revenues by $9 billion in 1996 and $8 billion in 1997, largely because of lower wage and salary income than had been forecast in August. More significantly, the higher interest rates in the new forecast have driven up projected federal interest payments by more than $15 billion a year, on average, in 1996 through 1999.

Taken altogether, technical reestimates--those changes that cannot be attributed to legislation or revisions in the economic forecast--have had little impact on projections of the deficit. But looking only at the total effect masks some significant changes. Projected Medicaid spending is lower in every year--by as much as $13 billion in 1999--than was estimated in August, reflecting actual 1994 outlays that were lower than expected and evidence that the rapid growth in that program has slowed. Medicare expenditures are down only slightly over the 1995-1999 period, but CBO's extended forecasts have significantly lower spending for Medicare as well as Medicaid in the years after 2000. The Medicaid reductions in 1995 through 2000, however, are more than offset by technical reestimates that bring down projected revenues to reflect smaller-than-anticipated tax collections in 1994 and increased spending for a variety of programs other than Medicare and Medicaid.

ILLUSTRATIVE PATH TO A BALANCED BUDGET

A constitutional amendment requiring a balanced federal budget will be considered during the early days of the 104th Congress. If the Congress adopts such an amendment this year and three-quarters of the state legislatures ratify it over the next few years, the requirement could apply to the budget for fiscal year 2002. If the budget is to be balanced by 2002, it is important that the Congress and the President begin immediately to put into effect policies that will achieve that goal. According to CBO's latest projections of a baseline that adjusts discretionary spending for inflation after 1998, some combination of spending cuts and tax increases totaling $322 billion in 2002 would be needed to eliminate the deficit in that year. The amounts of deficit reduction called for in the years preceding 2002 depend on both the exact policies adopted and when the process is begun.

For illustrative purposes, CBO has laid out one of many possible paths to a balanced budget in 2002 (see Table 6). Starting from a baseline that assumes that discretionary spending is adjusted for inflation after 1998, that path first shows the savings that would be achieved by freezing discretionary spending through 2002 at the dollar level of the 1998 cap. Such a freeze, along with the resulting debt-service effects, would produce $89 billion of the required savings of $322 billion in 2002. Under the freeze policy, the buying power of total discretionary appropriations in 2002 would be approximately 20 percent less than in 1995.

CBO also built into its illustrative path a possible course of savings from further policy changes. The amounts of those savings are not based on the adoption

of any particular set of policies; they do assume, however, that policy changes are phased in between 1996 and 1999 in a pattern that is similar to the changes in mandatory spending enacted in the last two major efforts at deficit reduction in 1990 and 1993. After 1999, the assumed savings increase at the baseline rate of growth for entitlement and other mandatory spending, excluding Social Security--implying that the cuts implemented in earlier years have a permanent effect but no additional policy changes have been made. If those savings were achieved entirely out of entitlement and other mandatory programs (excluding Social Security), they would represent about a 20 percent reduction from current-policy levels for those programs.

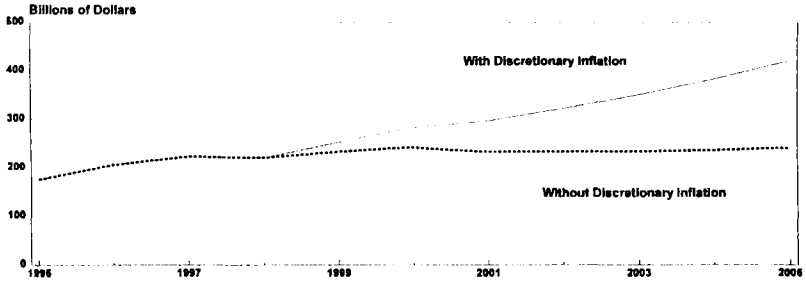
Over the entire 1996-2002 period, the savings in CBO's illustrative path that result directly from policy changes total more than $1 trillion (in relation to a baseline that adjusts discretionary spending for inflation after 1998). When the resulting savings in debt-service payments are included, the total exceeds $1.2 trillion. As noted, this path and the resulting $1.2 trillion in savings are illustrative only; the actual amount of cumulative deficit reduction over the 1996-2002 period will depend on the timing and exact nature of the policies enacted to achieve balance in 2002.

The required savings from policy changes would be smaller and the debt-service savings greater if, as CBO anticipates, ongoing deficit reduction efforts over this period result in lower interest rates. CBO believes that by 2000, interest rates could be as much as 1 percentage point lower than it currently forecasts if spending cuts and tax increases that would lead to a balanced budget have been enacted and the financial markets are convinced that policymakers will maintain those policies. CBO estimates that such a drop in interest rates would lower projected federal interest payments--and the amount of savings from policy changes needed to balance the budget--by almost $140 billion over the 1996-2002 period.

CONCLUSION

CBO's most recent economic and budget projections underscore the challenge facing policymakers who may have to enact the spending cuts or tax increases needed to balance the budget by 2002. Although the long-term budget outlook is no worse now than it was last August, the new projections emphasize that the deficit can be eliminated only through major changes in current policies.

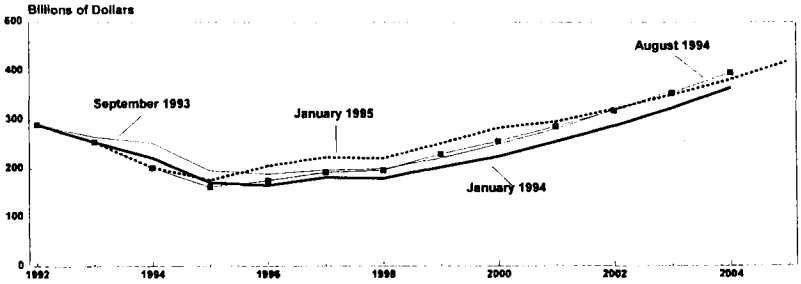
Figure 1.
Comparison of CBO Deficit Projections With and Without Discretionary Inflation After 1998 (By fiscal year)



SOURCE: Congressional Budget Office.

NOTE: Caps on discretionary spending are set by law through 1998. Measures of the deficit "with discretionary inflation" assume that discretionary spending grows at the rate of inflation after 1998. Measures of the deficit "without discretionary inflation" assume that discretionary spending remains frozen in dollar terms at the level of the 1998 caps.

Figure 2.
Comparison of CBO Deficit Projections (By fiscal year)



SOURCE: Congressional Budget Office.

NOTE: The projections assume that discretionary spending rises with inflation after the caps expire in 1998.

Table 1.
Comparison of Forecasts for 1995 and 1996

	Actual		Forecast	
	1993	1994	1995	1996
	Fourth Quarter to Fourth Quarter (Percentage change)			
Nominal GDP				
CBO	5.0	6.3	5.3	4.7
Administration	5.0	6.3	5.4	5.5
Blue Chip	5.0	6.3	5.7	5.4
Real GDP[a]				
CBO	3.1	4.0	2.5	1.9
Administration	3.1	4.0	2.4	2.5
Blue Chip	3.1	4.0	2.5	2.2
Implicit GDP Deflator				
CBO	1.8	2.3	2.8	2.8
Administration	1.8	2.3	2.9	2.9
Blue Chip	1.8	2.3	3.1	3.2
Consumer Price Index[b]				
CBO	2.7	2.7	3.2	3.4
Administration	2.7	2.7	3.3	3.2
Blue Chip	2.7	2.7	3.5	3.5
	Calendar Year Averages (Percent)			
Civilian Unemployment Rate				
CBO	6.8	6.1	5.5	5.7
Administration	6.8	6.1	5.8	5.9
Blue Chip	6.8	6.1	5.6	5.7
Three-Month Treasury Bill Rate				
CBO	3.0	4.2	6.2	5.7
Administration	3.0	4.2	5.9	5.5
Blue Chip	3.0	4.2	6.2	6.1
Ten-Year Treasury Note Rate				
CBO	5.9	7.1	7.7	7.0
Administration	5.9	7.1	7.9	7.3
Blue Chip[c]	5.9	7.1	7.9	7.6

SOURCES: Congressional Budget Office; Office of Management and Budget, *The Budget of the United States Government, Fiscal Year 1996*; Eggert Economic Enterprises, Inc., *Blue Chip Economic Indicators* (January 10, 1995); Department of Commerce, Bureau of Economic Analysis.

NOTE: The *Blue Chip* forecasts are based on a survey of 50 private forecasters.

a. Based on constant 1987 dollars.

b. The consumer price index for all urban consumers (CPI-U).

c. *Blue Chip* does not project a 10-year note rate. The values shown here for the 10-year note rate are based on the *Blue Chip* projections of the Aaa bond rate, adjusted by CBO to reflect the estimated spread between Aaa bonds and 10-year Treasury notes.

Table 2.
The Economic Forecast and Projections (By calendar year)

	Actual	Forecast		Projected			
	1994	1995	1996	1997	1998	1999	2000
Nominal GDP (Billions of dollars)	6,737	7,127	7,456	7,847	8,256	8,680	9,128
Real GDP (Billions of 1987 dollars)	5,342	5,505	5,602	5,736	5,870	6,004	6,141
Real GDP (Percentage change)	4.0	3.1	1.8	2.4	2.3	2.3	2.3
Implicit GDP Deflator (Percentage change)	2.1	2.6	2.8	2.8	2.8	2.8	2.8
CPI-U (Percentage change)[a]	2.6	3.1	3.4	3.4	3.4	3.4	3.4
Unemployment Rate (Percent)	6.1	5.5	5.7	5.8	5.9	6.0	6.0
Three-Month Treasury Bill Rate (Percent)	4.2	6.2	5.7	5.3	5.1	5.1	5.1
Ten-Year Treasury Note Rate (Percent)	7.1	7.7	7.0	6.7	6.7	6.7	6.7

SOURCE Congressional Budget Office

a CPI-U is the consumer price index for all urban consumers

Table 3.
CBO Deficit Projections (By fiscal year)

	1994	1995	1996	1997	1998	1999	2000
	In Billions of Dollars						
Baseline Total Deficit							
With discretionary inflation after 1998	203	176	207	224	222	253	284
Without discretionary inflation after 1998	203	176	207	224	222	234	243
Standardized-Employment Deficit[a]							
With discretionary inflation after 1998	187	200	216	223	221	247	273
Without discretionary inflation after 1998	187	200	216	223	221	228	233
	As a Percentage of GDP						
Baseline Total Deficit							
With discretionary inflation after 1998	3.1	2.5	2.8	2.9	2.7	3.0	3.1
Without discretionary inflation after 1998	3.1	2.5	2.8	2.9	2.7	2.7	2.7
Standardized-Employment Deficit[b]							
With discretionary inflation after 1998	2.8	2.8	2.9	2.9	2.7	2.9	3.0
Without discretionary inflation after 1998	2.8	2.8	2.9	2.9	2.7	2.6	2.6

SOURCE Congressional Budget Office

NOTE Caps on discretionary spending are set by law through 1998. Measures of the deficit "with discretionary inflation" assume that discretionary spending grows at the rate of inflation after 1998. Measures of the deficit "without discretionary inflation" assume that discretionary spending remains frozen in dollar terms at the level of the 1998 caps.

a Excludes the cyclical deficit and spending for deposit insurance

b Shown as a percentage of potential gross domestic product

Table 4.
CBO and Administration Budget Projections (By fiscal year, in billions of dollars)

	1995	1996	1997	1998	1999	2000
CBO's Baseline with Discretionary Inflation After 1998[a]						
Revenues	1,355	1,418	1,475	1,546	1,618	1,697
Outlays	1,531	1,625	1,699	1,769	1,872	1,981
Deficit	176	207	224	222	253	284
Difference from CBO's Baseline						
Revenues	-9	1	7	13	20	31
Outlays	8	-6	1	b	-12	-23
Deficit	17	-6	-6	-13	-32	-55
Administration's Budget Baseline[a]						
Revenues	1,346	1,418	1,482	1,560	1,638	1,729
Outlays	1,539	1,620	1,700	1,769	1,860	1,958
Deficit	193	201	218	209	221	229
Difference from Administration's Budget Baseline						
Revenues	b	-3	-10	-11	-14	-18
Outlays	b	-7	-15	-24	-37	-53
Deficit	b	-4	-5	-13	-24	-35
Administration's Budget Policy						
Revenues	1,346	1,415	1,472	1,549	1,625	1,711
Outlays	1,539	1,612	1,685	1,745	1,822	1,905
Deficit	193	197	213	196	197	194

SOURCES: Congressional Budget Office, Office of Management and Budget, *The Budget of the United States, Fiscal Year 1996*.

a. Assumes discretionary spending complies with caps through 1998 and grows at the rate of inflation after 1998.

b. Less than $500 million.

Table 5.
Changes in CBO Deficit Projections (By fiscal year, in billions of dollars)

	1995	1996	1997	1998	1999
August 1994 Baseline Total Deficit with Discretionary Inflation After 1998	162	176	193	197	231
Changes					
Policy changes	2	2	2	3	3
Economic assumptions					
Revenues[a]	2	9	8	3	b
Net Interest	8	16	17	15	15
Other outlays	b	b	1	2	2
Subtotal	10	25	27	20	17
Technical reestimates					
Revenues[a]	6	5	6	9	11
Deposit insurance[c]	1	3	b	b	1
Medicaid and Medicare	-7	-6	-8	-11	-15
Net interest[c]	b	-1	b	b	1
Other outlays	b	5	4	3	5
Subtotal	1	5	2	2	2
Total	13	31	31	26	22
January 1995 Baseline Total Deficit with Discretionary Inflation After 1998	176	207	224	222	253

SOURCE Congressional Budget Office

NOTE Caps on discretionary spending are set by law through 1998. Measures of the deficit "with discretionary inflation" assume that discretionary spending grows at the rate of inflation after 1998.

a. Revenue reductions are shown with a positive sign because they increase the deficit.

b. Less than $500 million.

c. Excludes changes in interest paid by deposit insurance agencies to the Treasury. These interest payments are intrabudgetary and do not affect the deficit.

Table 6.
Illustrative Deficit Reduction Path (By fiscal year, in billions of dollars)

	1995	1996	1997	1998	1999	2000	2001	2002	1996-2002
CBO January Baseline Deficit with Discretionary Inflation After 1998	176	207	224	222	253	284	297	322	n.a.
Freeze Discretionary Outlays After 1998									
Discretionary reduction	0	0	0	0	-19	-38	-58	-78	-193
Debt service	0	0	0	0	-1	-2	-6	-10	-19
Total Deficit Reduction	0	0	0	0	-19	-40	-63	-89	-212
CBO January Baseline Deficit Without Discretionary Inflation After 1998	176	207	224	222	234	243	234	234	n.a.
Additional Deficit Reduction									
Policy changes[a]	0	-32	-65	-97	-145	-156	-168	-180	-843
Debt service	0	-1	-4	-10	-18	-28	-40	-54	-156
Total Deficit Reduction	0	-33	-69	-106	-163	-184	-208	-234	-998
Resulting Deficit	176	174	155	116	71	59	26	b	n.a.
Total Change from Baseline Deficit with Discretionary Inflation After 1998									
Policy changes	0	-32	-65	-97	-164	-194	-225	-259	-1,035
Debt service	0	-1	-4	-10	-19	-31	-46	-64	-175
Total Deficit Reduction	0	-33	-69	-106	-182	-225	-271	-322	-1,210

SOURCE: Congressional Budget Office.

NOTES: Caps on discretionary spending are set by law through 1998. Measures of the deficit "with discretionary inflation" assume that discretionary spending grows at the rate of inflation after 1998. Measures of the deficit "without discretionary inflation" assume that discretionary spending remains frozen in dollar terms at the level of the 1998 caps.

n.a. = not applicable.

a. These changes represent only one of a large number of possible paths that would lead to a balanced budget. The exact path depends on when deficit reduction begins and the specific policies adopted by the Congress and the President. The path illustrated in this table is not based on any specific policy assumptions but does assume that policies are fully phased in by 1999.

b. Surplus of less than $500 million.

Chairman ARCHER [presiding]. Bob, thank you very much for, as usual, your very concise and explicit presentation. There are innumerable questions that the members of the committee would like to ask and I just got a question here myself.

Other than population growth, why does Federal spending have to increase at so much more than the rate of inflation? Let me exempt the medical programs from that which seem to follow a course of their own. But if you exempt the medical programs, I believe your testimony was you project an average of 5 percent increase in the rest of the programs and yet inflation is projected at somewhere considerably below that, if I am not correct. Why does government——

Mr. REISCHAUER. About 3 percent.

Chairman ARCHER. Yes. Why does government spending at the Federal level, aside from population increases, have to increase at so much more than the rate of inflation?

Mr. REISCHAUER. I think you have to go at this program by program, and one big program, of course, would be Social Security, and with Social Security you have, as you say, population changes. More people are on Social Security each year. But let's abstract from those changes.

But you have to remember that the new people coming on to Social Security have histories of higher earnings and because they have higher earnings histories, they receive higher benefits than those who are leaving the system because they are dying. So that would be one source of growth.

Chairman ARCHER. Right. Are there any others you can think of? I know that is a big program, but that is still relatively small compared to the rest of all the spending outside of medical programs.

Mr. REISCHAUER. Another big chunk of our spending goes for interest, and interest is driven by interest rates and the size of the Federal debt. As long as the Federal debt grows because we have deficits, it is going to rise at whatever rate you have programmed in for the increase in overall debt.

Chairman ARCHER. Do you project that the interest on the debt will rise more rapidly than inflation as a government expenditure?

Mr. REISCHAUER. Yes, I think it rises as a percent of GDP, so it is rising more rapidly than GDP.

Chairman ARCHER. That I think becomes very important because it relates to the testimony the administration has been giving us in which they insist that we didn't need to worry about the fact that we aren't getting to a balanced budget because we were restraining increases in the deficit relative to GDP. If interest is still going to continue to rise higher than the rate of inflation, it seems to me it is something we do need to be concerned about. I want to ask you this.

Do you think that for the best interest of the country that the deficits projected in the President's budget should be lower?

Mr. REISCHAUER. I think it would be desirable to bring the deficit down substantially over the next 5 years, and the President's budget basically holds the line on the deficit.

Chairman ARCHER. I don't want to put words in your mouth, but would you agree with me that we should be concerned that the debt at the end of 5 years under the President's budget, as they

project, it would be $1 trillion more than it is now and as you project it? I suppose it would be a trillion, one hundred-and-some-odd billion more or maybe even more than that.

Mr. REISCHAUER. More than that.

Chairman ARCHER. What would it be under your projections?

Mr. REISCHAUER. I will have somebody find that out.

Let me say that I think we should be most worried about the debt in relationship to the size of the economy, the debt-to-GDP ratio. Under our baseline projections, that debt rises from roughly 52 percent, the ratio rises from 52 up to 53, 54 percent, roughly, under the President's proposal. I think the increase isn't great, but we should be designing our fiscal policy in such a way as to make that ratio decline, as it did steadily from the end of World War II to the beginning of the seventies.

Chairman ARCHER. So if I understand you correctly, under your projections, the deficit grows relative to the GDP?

Mr. REISCHAUER. Yes.

Chairman ARCHER. Under the President's budget.

Mr. REISCHAUER. We have not analyzed the President's budget, his proposal. We will be doing that over the course of the next month.

Chairman ARCHER. Oh, I understand. You were just comparing baseline.

Mr. REISCHAUER. Our baseline to his view of what the baseline is.

Chairman ARCHER. OK. Assuming that their budget estimates are accurate and that they fit with yours when you do examine the impact of their budget, we would have $1 trillion more debt at the end of 5 years, which if the interest rate was 7 percent averaging between long-term and short-term debt, 7 percent would add $70 billion a year of extra debt service obligation. If it is only 6 percent, it would be $60 billion a year of extra debt service charges. The average person in my district is very concerned about that, and I wonder if you have any concern about that also.

Mr. REISCHAUER. I do, as I expressed. I think we should be on a path toward a declining deficit. Our projections under a baseline policy suggest that the net interest costs—these aren't gross—will be $235 billion this year and will grow to $310 billion by the year 2000. So we are talking about a substantial increase, well above inflation in interest costs.

Chairman ARCHER. Let's move off of budget now and on to the estimating process, which is being more talked about all the time. I think you would agree with me that whatever model we use for estimating should be refined and updated regularly to attempt to be as accurate as possible, and that our goal should be accuracy without getting into the argument of dynamic and static. We should always be shooting for accuracy.

In that regard, it is my understanding that under the current budget estimating process, the CBO issues a baseline twice a year and that irrespective of what happens in the interim, that baseline remains constant until the next estimating period. Well, that is a sine qua non.

If you only do it twice a year, it is going to stay the same until the next 6-month period occurs. We could make a massive change

in the way we collect taxes 2 months into your 6-month estimating period and there would be no change whatsoever relative to the macroeconomic impact on that in the estimating, as I understand it today. Only at the end of the next 4 months when you once again reestablish your baseline, in hindsight you would then work that into your baseline?

Mr. REISCHAUER. That is true. But I think the real situation is even worse than you have portrayed it, Mr. Chairman, and that is that you adopt a budget resolution by April 15 in theory. That budget resolution is accompanied by a set of economic and technical assumptions.

All of the scorekeeping that is done for the ensuing year is done on the basis of those economic and technical assumptions, even if they appear to be out of date, which is an unfortunate necessity. You have to have some kind of accounting framework in which to judge whether you have complied with the plan that you approved for yourself in the spring of each year.

We will update our forecast, as you say, in August, and if massive policy changes are enacted that would affect the course of the economy, they would be reflected in the economic assumptions that we publish in August, but that would not change the set of economic assumptions underlying the budget resolution.

That is the bad news. The good news is that in theory, if you are going to pass a massive set of policy changes, those policy changes are discussed during the process of formulating the budget resolution. Then when the economic assumptions of the budget resolution are put together, they are not necessarily our numbers. The Budget Committee decides on these assumptions.

They incorporate the assumed policy changes that are going to be passed in the course of the next year. So if you have some massive reform, it would be embodied in that budget resolution and would be reflected in the economic assumptions of the budget resolution. So the totals wouldn't be misestimated.

Chairman ARCHER. I am not sure I follow the latter part of it. I follow the former part.

Mr. REISCHAUER. I am saying that the policy will change the economy but the assumptions that underlie the budget resolution will have assumed that the effect has taken place. So when estimates of the deficit or total revenues or spending are made for the budget year or the following years, they will be accurate in the aggregate.

Chairman ARCHER. Well, I don't want to belabor this, but I think it is very, very important to the entire process by which we operate here. If the assumptions on which we establish a budget resolution are those that predate the policy changes in the budget resolution, it must be because we have a baseline in place.

Mr. REISCHAUER. Let me give you an example. In 1990 when you and others were part of the summit negotiations during our first meetings in the Capitol, I was given a set of instructions: go back to CBO, assuming we are going to do 500 billion dollars' worth of deficit reduction over the next 5 years, and produce an economic forecast, not the one you have given us that assumes a continuation of current policy but an economic forecast that reflects the deficit reduction. We went back and changed our forecast and

brought it to you, and that was basically the forecast that was used to underlie all of the estimating for the deficit reduction measure that was cobbled together in October.

Chairman ARCHER. But is that standard operating procedure?

Mr. REISCHAUER. No, it is not standard operating procedure because you don't make 500 billion dollars' worth of policy changes as standard operating procedure. Whenever you have made massive changes, these changes have been reflected in the budget resolution economic assumption. It was done that way in the early eighties when the Reagan policy changes were instituted. But most of the time Congress is really fine-tuning, not making massive changes.

Chairman ARCHER. I understand that. But let's update for today.

We are contemplating the possibility of $200 billion in changes which I have some problems with the scoring, but nevertheless that is the way it is scored as a $200 billion revenue loss. So, we are contemplating having spending reductions that will be equal to $200 billion. All of the estimates are overlaid over an existing baseline. Now the net impact on the deficit, if that hypothesis is correct, is zero; $200 billion revenue loss, $200 billion revenue gain.

Mr. REISCHAUER. Right.

Chairman ARCHER. However, the makeup of those items and the impacts on the economy vary differently.

Mr. REISCHAUER. Yes.

Chairman ARCHER. None of that is in any way factored into the baseline assumptions except in hindsight after it occurs.

Mr. REISCHAUER. That may or may not be true. I mean, if you had a particular policy that left the aggregates—the total deficit unchanged but the composition of policy changed radically, as you are suggesting, and we and other economists thought that this would affect the economy over the next 5 years and we were asked to do a forecast, which you would then use for your budget resolution, we would factor that in.

The little pamphlet that the Joint Tax Committee put out about the tax proposals in the contract has two very good pages at the end discussing the possible effects of the contract's proposals on the economy. By and large, I think they concluded that these would be slight over the next 5 years. I mean, if we are looking out over a decade or so, you might reach a different conclusion.

Chairman ARCHER. I would like to explore this further but I will do it privately some day when you and I can sit down and have a cup of coffee.

Mr. REISCHAUER. Be glad to.

Chairman ARCHER. Not having the whole committee sit here.

In your opinion, is the CPI estimated accurately under the current method that is used by the Bureau of Labor Statistics?

Mr. REISCHAUER. We issued a report last fall that said we thought that the current methodology, probably through no fault of the BLS, Bureau of Labor Statistics, overstates the cost of living by between 0.2 of a percentage point and 0.8 of a percentage point. Since we issued that report, the BLS has made one methodological change—or several methodological changes—that should lower that range that we produce to probably 0.1 of a percentage point to 0.7 of a percentage point. There are other aspects of the CPI which

probably cause it to be an overstated measure, and the BLS and others are working to isolate these and modify their methodologies.

Chairman ARCHER. Well, whether it is overstated or understated, it seems to me that the same standard should apply and that is one of accuracy, to move toward accuracy because it is a thread that is woven through the fabric of all of our lives in so many different ways.

Mr. REISCHAUER. I think that is right.

Chairman ARCHER. I would be interested as to whether what I have been told is accurate or not. I am told that the basket which is used to develop the CPI, the items that go into the basket, and the interrelationship of those items is adjusted only once every 10 years. It is clear to me the changes that go into this basket and that are interrelated change every year at least. Would you agree with me that we ought to provide the wherewithal, computers or whatever else is necessary, to update this annually rather than every 10 years?

Mr. REISCHAUER. I think doing it annually would probably make it a very difficult and expensive task, but certainly we ought to do it every few years. In this issue we have been penny-wise and pound-foolish over the last few decades. We haven't invested enough in data collection and statistical analysis in our government agencies to save us the money that we should be saving, and I think you are going in exactly the right direction.

Chairman ARCHER. Thank you very much.

Mr. Rangel.

Mr. RANGEL. Mr. Chairman, I enjoyed your exchange with the doctor. I hope you might consider having the members together where we can have an informal exchange like that because it is very helpful and educational.

Doctor, I see that the budget increases the money for drug treatment from 13.3 to 14.6 and it is abundantly clear to me that the administration, like those before it, haven't the slightest idea as to what is happening with that money. Having said that, has your office ever prepared any paper to suggest what economic impact this drug situation is having on our overall economic situation, that is, the loss of moneys for law enforcement and drug treatment?

Mr. REISCHAUER. No, we haven't. We have had some discussions with your staff in an attempt to isolate sources of information and data that might shed some light on that question. I think it is a very complicated question, a very serious and important one.

Mr. RANGEL. Well, everyone seems to agree that as we move forward in international trade and see the gap widening between the skills that are available and those that are going to be needed, that drugs impact on the education we receive and the number of people that are able to be in the work market. From an economist's point of view, I just don't see how that doesn't factor into everything that we talk about.

Whether you are talking about trade or health or crime or productivity, it just never seems to come up. It is as though this is something we shouldn't talk about. It is not in the State of the Union. It is not in any of the statements of Cabinet officials. Maybe the question should be how important is it to the type of work that you do when you present to us an overview of the budget and you

can't see your way clear to mention the drug epidemic, which worsens every year.

Is it really not important enough to be mentioned? Or is it the other similar type situations that we just accept and would not normally expect that would be included in a report such as this that you give?

Mr. REISCHAUER. I share your concern for this problem and I think it is an important one. But it is one about which there is very little information that could be used to estimate the impact on the economy. We know that the U.S. economy is not as productive as it might be if the country's drug problem—substance abuse broadly speaking—were not so serious.

If anything would affect our forecasts, it would be the reflection that the problem was worsening or getting better in a significant way. Otherwise, it is in a sense built into the base set of numbers, the base set of relationships that we use to forecast where the economy is going.

Mr. RANGEL. Well, I don't know whether it would be just a blip on the screen, but if we started in 1960 and you project that the drug problem would be going up, interest rates would go up and the impact this would have on the budget, our revenues, our productivity, I mean to me it is a national crisis, but I am just trying to figure what type of a similar situation that would have a similar impact on your forecast would you include. I mean, you can't project epidemics.

You can't project disasters in certain parts of our country that causes hundreds of billions of dollars' worth of damage. But it just seems to me that when you have an epidemic of this size that impacts on everything that we do, that somehow it would be mentioned, if not by you then by somebody. It is not even in the State of the Union Message.

It could very well be that it is not that important, that it is just something we have to live with. We don't talk about AIDS, either. If that is the way economists look at it, then I will just have to change my way in what I expect from a government and from the offices that monitor what we do. I don't mean to be critical of you.

Mr. REISCHAUER. No, I know.

Mr. RANGEL. It may be outside of your scope, but I don't know where to go.

Mr. REISCHAUER. I think the appropriate place to go is to the executive branch on these types of questions, because they have a responsibility and a set of programs that are designed to deal with this problem.

Mr. RANGEL. That wasn't really my question and my time has expired. My question was as relates to your forecast and the economy whether or not the drug problem and the impact on the things that you suggest may or may not happen as you see it and whether dramatic changes in that would change your reports to us in any way.

Mr. REISCHAUER. If we saw dramatic changes about to occur as part of baseline policy, I think it would affect how we looked at the economy, the costs of certain kinds of programs. But as we look into the future, we don't see that kind of dramatic change built into current policy.

Mr. RANGEL. You mean this thing about addiction going up from 1950, the way it is going up, that if you had known it was going to do that that it would not have changed your forecast?

Mr. REISCHAUER. We didn't begin forecasting until 1975, so we came in half way up the slope that you are talking about. If we had had perfect foresight, we might have expected productivity to grow less rapidly.

Mr. RANGEL. Thank you.

Mr. THOMAS [presiding]. The gentleman's time has expired.

The chair recognizes the gentleman from California, Mr. Thomas. Thank the chair. We have to learn how to do these things.

For the record, I really want to thank you and your shop. For folks who are not in the middle of the requirements placed on you and your people during the 103d marathon on health care reform, in which we labored long and we got nothing except knowledge about how to do it, that work is going to pay off in the long run. We had never really done that kind of macro stuff that quickly in as many ways before, I believe. But most people do not realize the time constraints, the pressure constraints, the stress constraints. You folks did a marvelous job, and I just want to give you as much credit as I can and I will be doing so in the future. I want to thank you for the effort you folks carried out.

Mr. REISCHAUER. Thank you.

Mr. THOMAS. The gentleman from New York in his early initial comments mentioned getting together and talking about some of these things I think are absolutely essential. Wherever you go, I want to make sure that we try to have these conversations. He made one point and, given his background, his knowledge and concern, he is focusing on the drug problem and the enormous negative drag on the economy that it is, that it would be a mistake not to talk about human suffering and the wasted human opportunity, potential from an economic point of view.

My problem is, I am now sitting here looking, for example, in my narrow subcommittee responsibilities, at the health insurance fund on Medicare part A. We have already lifted the total income cap, we are at 1.45 and you are sitting here looking at what you have got to do to avoid bankruptcy by 2001.

You say, gee, let's double the tax and then you look at how meager the results are in terms of having bought some time. You realize you have to probably triple it and then take a look at what you do to the employment rate and the economy to do that, or you have got to cut benefits by two-thirds to live with the old structure. We talk about the underground economy. Just this morning IRS is leaving $5 billion on the table because they simply haven't been matching up Social Security numbers with people, and it is a great new advancement in terms of what we are doing.

The CPI index is not accurate and even if you get it accurate for one group, it is significantly different for another. You begin looking at all of these things that we have got to do and the thing that comes to mind initially to me is that when I first came back here and they told me let's go eat some Chesapeake crabs, I went out and I started doing that. I looked at all of this labor that I was putting in to get this very minuscule amount of crab meat and they said have a cracker. I said well, I want to eat the crab meat. I

began to realize if you don't eat crackers periodically, there is a net deficit in terms of nourishment versus labor on this.

Mr. REISCHAUER. That is why Ms. Johnson and I, coming from New England, would argue that you should eat lobster.

Mr. THOMAS. There is the point. What we have been doing recently is kind of Chesapeake Bay crab eating on playing with how we adjust this stuff. I look at your numbers in terms of holding the discretionary inflation rate to zero, a drop in the bucket with enormous pain and the rest. Don't we need to rethink the way this Federal Government gets the resources necessary to do its job? Couldn't we, if we focus on the way in which we raise the revenue fundamentally, rethink it so that we can accomplish more than all of the little adjusting that we intended to have gotten into?

Or is that a fallacy and it is not an easy way out, the idea of a flat tax or pure consumption tax or some other kind of a change in relationship between getting revenue and spending it?

Mr. REISCHAUER. I didn't expect that question to end where it did, because I thought you were going to talk about fundamentally restructuring the spending side of our budget.

Mr. THOMAS. Why don't you do that after you tell me there is no way you can really do it on the revenue side?

Mr. REISCHAUER. I was going to tell you that on the revenue side, revenues under the current structure are growing at about the same rate as the economy as a whole. There might be dead weight losses and costs that could be reduced by changing the nature of our tax system, but there are other changes that——

Mr. THOMAS. Would that hit some of the underground economy, all of these suggestions about tapping sources that are not tapped in the system or counting trends that are not now in the system? Isn't that marginalized and working on the margin?

Mr. REISCHAUER. I think it is. I think even the large-scale adjustments that you are talking about, substituting consumption tax for tax on labor, income, or whatever would not resolve the problem that we are talking about. I think there is a desire among people to keep taxes about constant as a percent of income. If that is the case, you have to look at the spending side and say what can we do to make sure that spending rises no faster than gross national product or the income of the Nation?

Mr. THOMAS. So despite some of the politics going on now and perhaps the imperfectness of the recent Republican or majority approach, that if we are going to get the fundamentals in balance, I guess I am asking you, we really do have to address the spending.

Mr. REISCHAUER. You must not just address spending, but of course the extremely rapid growth on the spending side is concentrated in the medical programs.

Mr. THOMAS. One of my major disappointments is that this is the last year the President really has control of his budget and he had been bold, as I said yesterday, flawed but bold, in his plan last year with a $124 billion reduction in Medicare over 5 years. But he doesn't really offer anything this year except a receptiveness to work together.

That scares me because in a receptiveness to work together without a plan, we are going to be driving it and we are going to be coming up with a plan but we lose another year. Folks just aren't

focused on the fact that 2001, 2002 are not just the balanced budget years we are talking about. It is the bottom dropping out, bankrupt years on programs that are going to take years of adjustment to make in terms of denying people benefits they think they are going to get now.

If you don't start now, you can't get to where you need to go on a glide slope that will be acceptable to people. I am looking forward. We will find out where you are and what you are doing. Just some short-term guidelines.

For example, a very interesting discussion with Chairman Archer. Do we compound some of the problems you were talking about by going to a 2-year budget cycle or are there internal adjustments going to a 2-year budget cycle that will not exacerbate the problems that we have in a 1-year budget cycle that you had discussed?

Mr. REISCHAUER. I have never been a fan of a 2-year budget cycle. When we are as far out of equilibrium as we are right now, I think these issues should be on the table every year because some years the economy won't be right or the politics won't be right. I think that cutting in half the number of years in which you have an opportunity to raise fundamental issues would be a mistake.

If we were operating with a balanced budget, that might be fine. But that isn't where we are right now. We are trying to grab whatever opportunity we have to make changes, and I think reconsidering everything every year is the appropriate schedule.

Mr. THOMAS. Thank you very much, Dr. Reischauer.

Once again I really do want to thank you folks for an effort that was just extraordinary over an extraordinarily long period of time. We can all gear up for something if we think it is going to be 2 weeks or 1 month. I don't think any of us thought it was going to last as long as it did.

Thank you very much, and the American people will eventually understand what a contribution you and your folks made.

The gentleman from Nebraska, Mr. Christensen, may inquire.

Mr. CHRISTENSEN. Thank you, Mr. Chairman, and thank you, Dr. Reischauer, for coming. I do appreciate your testimony and your work here. I wanted to briefly visit with you about the President's budget, as well as some things about CBO.

But I wanted to first bring your attention to what is happening in middle America concerning the President's budget. This was yesterday's lead editorial in the Omaha World Herald. It said, "Clinton's poor excuse for a budget makes deficit cutting claim a joke." This is a paper that is not overly conservative. They didn't endorse me in the campaign. They have given a lot of credit to what has gone on here recently.

This was today's editorial. "White House budget abdication passes the buck to Capitol Hill."

So the Omaha World Herald has some pretty good editorials. As far as I am concerned, the President's budget didn't go nearly far enough.

My concern is that we are going to rack up $1 trillion of debt with the President's budget over the next 5 years. You talked a little bit about CPI, and Senator Kerrey this week talked about reexamining the CPI to see if it remains accurate, especially given the

great impact it has on the cost of Medicare, Medicaid, and pensions for the military.

Could you share with us your thoughts, and rationale behind those thoughts, as well as if that is something we should do?

Mr. REISCHAUER. As I said before, we have done a study that suggests that the CPI has some bias in it, and is an overestimate of the change in the cost of living.

Mr. CHRISTENSEN. If it does have some bias in it, do you have any estimate on how many billions of dollars that might be costing us if it is off a little bit?

Mr. REISCHAUER. Yes, I do, and I will mention that in 1 minute.

As I said in answer to the chairman's question, right now our best judgment would be that the overestimate is somewhere between one-tenth of a percentage point and seven-tenths of a percentage point per year. That is a considerably lower range than was provided by the Chairman of the Federal Reserve.

As I said, this is not of a new discovery. Economists and the people at BLS have known about this for a long time. A lot of effort has been put into trying to improve the CPI, and it is continually being improved, but it takes a lot of resources which the Bureau of Labor Statistics hasn't had, to make these improvements, and they take time.

If the CPI were overestimated by half a percent and you lopped it off by half a percentage point over the next 5 years—through the year 2000—that would reduce the deficit by $64 billion.

Of that $64 billion, $6 billion would be debt service. Because we have lower deficits, we would have lower interest payments.

Of the $64 billion, $22 billion would be higher revenues, because we use the CPI to index the parameters of the tax system every year. The $26 billion would be from the Social Security system.

So it is largely Social Security and revenues that would account for three-quarters of the adjustment here.

Mr. CHRISTENSEN. Do you have any estimation or any idea for the new CBO Director to follow and the administration if they look at it as if it is going to be a long process? We are talking about just under one-third of that—you said about $64 billion?

Mr. REISCHAUER. Over a 5-year period. In the last year, the year 2000, it would be about $25 billion.

Mr. CHRISTENSEN. That would be a significant——

Mr. REISCHAUER. That is real money, yes.

Mr. CHRISTENSEN. It would be nice to see the CBO move in that direction if the figures back that up.

Mr. REISCHAUER. There are two directions in which you can go. One is that you can provide BLS with a lot more money, a lot more resource, and some direction to proceed as fast as it can to make whatever improvements can be made.

But these will occur gradually over a decade-long period. There is no question about that at all. You might never be able to isolate and correct some of the misestimations. That is one direction.

The other is to say that academicians and economists have told us that a misestimation exists. We are therefore going to change Social Security law, the Internal Revenue Code, and so forth, to make indexing the CPI minus three-tenths of a percentage point, or four-tenths of a percentage point, or something like that.

Those are the two directions. The latter direction is more sure, and it would be scored by the Congressional Budget Office and the budget process. You would get credit for it. But you would also get the other side of that coin, which is objections by all of those people who will be paying higher taxes or receiving less in the way of index benefits.

Mr. THOMAS. The time of the gentleman has expired.

Mr. CHRISTENSEN. Thank you, Dr. Reischauer.

Thank you, Mr. Chairman.

Mr. THOMAS. In addition to the political problem of giving somebody something minus something, if you readjust the CPI, you are giving them the new CPI instead of minus, from the political point of view.

Mr. Ensign.

Mr. ENSIGN. Thank you, Mr. Chairman.

Dr. Reischauer, there has been a lot of talk about dynamic and static scoring. I know that Mr. Christensen has talked about some uses already in place of dynamic scoring in the budget process. In your opinion, do we use any dynamic scoring right now?

Mr. REISCHAUER. We take into account behavioral responses. So the estimates that are done now, both on the outlay side and on the revenue side, are in no way static estimates. They assume that when gasoline taxes rise, people buy less gasoline. I should say that the Congressional Budget Office does not provide revenue estimates. They are done by the Joint Committee on Taxation.

The issue that has really been debated is whether changes in policy could have macroeconomic implications; could they change labor supply, saving, and investment, in such a way that economic growth might be increased or decreased as a result of the policy?

Those types of effects have not been built into the estimating process for a number of reasons, one of which is that there is a good deal of debate in the economics community about the size, magnitude, timing, and even the direction of these kinds of effects.

Some economists will say that this will strengthen the economy, and others will say that this will weaken it. It is not clear that you want the estimators to have a lot of latitude in which they could come up with numbers that were plus or minus. The numbers would then be subject to a lot of criticism.

These effects are really very small over the 5-year period that we are providing estimates for, and it is important to realize that if you were going to move in this direction, you would want to do it in an evenhanded manner. You would want to deal with spending as well as revenues. There are various spending programs that arguably could slow down or energize the economy.

It is a very complicated issue.

Mr. ENSIGN. Right. I agree with Chairman Archer, whether there are or aren't, I think what we need to be looking for, as much as we can, is accuracy. Before my term here I was just obviously a normal, average, everyday businessperson and citizen, hearing not only a lot of criticism of estimates from CBO, but from practically anybody else who does estimating.

Has CBO analyzed itself or has an outside agency analyzed CBO to measure how accurate you are on a year-to-year basis, on a 5-year basis? How close do you come to your projections over time?

Mr. REISCHAUER. We publish, as an appendix in one of our annual volumes, an analysis of our economic forecasts and how well they have done in comparison with the Blue Chip Consensus and the administration's forecasts.

Mr. ENSIGN. How about relative to what happened?

Mr. REISCHAUER. That is what I mean. We compare all three to what happened. I mean not CBO versus the profession, but CBO versus the other alternatives you have versus what actually occurred.

Mr. ENSIGN. OK.

Mr. REISCHAUER. We also include in each of our updates an analysis of the change in our budget numbers, outlays, and revenues; how much of the change that we are projecting now is attributable to changes in economics; how much in turn is attributable to changes in policy; and how much is attributable to technical and other factors, which include errors on our part.

We also include an appendix in these volumes that compares our budget estimates with the administration's budget estimates versus what actually happened. So we have been pretty straightforward and laid this information out for a long period of time.

Mr. ENSIGN. But how accurate are you?

Mr. REISCHAUER. You want to know how accurate we are? We are not very good but we are better than the alternatives.

Mr. ENSIGN. I would like a number. Are you within 10 percent? Are you within 5 percent? 50 percent? Overall, on average, what would you say your error margins were? When you give us a number, is it within plus or minus 2 percent, plus or minus 10 percent?

Mr. REISCHAUER. Below 10 percent for sure. These are done in absolute dollar terms, and the economic differences are done with absolute values. To really examine these, you'd need to look at various statistical measures.

Mr. ENSIGN. If you get into standard deviations, you are going to lose me. Thank you.

Mr. REISCHAUER. Then I will start.

Mrs. JOHNSON. Thank you, Mr. Ensign.

Mr. Coyne will inquire.

Mr. COYNE. Thank you, Madam Chairman.

Director, over the last month or so we have heard an awful lot of testimony from economists, executives, Governors, mayors, a lot of people, and all too often it seems to me that when they refer to the unemployment rate, they consider 5.6 percent as being full employment.

Is that where we are at in this country today that with 12 or 14 or 15 million people unemployed, we are at full employment?

Mr. REISCHAUER. I would rather not use the term "full employment," because that makes it sound like everybody who wants a job can have a job, and that is certainly not the case.

We refer to it as the natural rate or the nonaccelerating inflation rate of unemployment, which simply says that when the unemployment rate is lower than it is now, inflationary pressures will build. That is a very neutral statement with respect to whether everybody has a job who wants a job or should have a job. It is not saying anything about that. It is saying that if you push the unemploy-

ment rate down much below 6 percent, inflationary pressures are going to build.

There will certainly be people looking for jobs, but there may be a mismatch of skills in relation to the jobs that are available.

Mr. COYNE. Is that to say, then, we ought not to do anything to get the economy moving to take care of the others?

Mr. REISCHAUER. Economists feel that if you adopted fiscal policies that would stimulate the economy, in other words, increase total demand by tax cuts or spending increases, the Federal Reserve, which is responsible for trying to maintain a steady rate of inflation at a low level, would tighten monetary policy and offset any of the expansionary impact that your fiscal policy steps might have taken.

Mr. COYNE. From your reviews, is there any evidence that most of those 12, 14, 15 million unemployed people are just people in transition from job to job?

Mr. REISCHAUER. First of all, it is not as many people as you are suggesting. The unemployment rate right now is 5.7 percent, and the labor force is roughly 125 million people. So we are talking about 8 or 9 million people.

That group is made up of some people who are entering the labor force and are looking for a job; some who have voluntarily quit jobs and are looking for a new job; and some who have been laid off or lost jobs involuntarily and would like to find another.

Mr. COYNE. But it does not include the discouraged workers?

Mr. REISCHAUER. No, it doesn't. The 5.7 percent doesn't, although there is an additional measure that does include them. We count them on, I believe, a quarterly basis, so we have some idea of how many discouraged workers there are, as well.

Mr. COYNE. You were asked about the accuracy of the CPI index, and whether that is really being estimated in the most accurate way that it can. How do you feel about the way the Department of Labor makes its estimates about unemployment? Are we doing the best job we can there?

Mr. REISCHAUER. They have tried to improve and expand that survey, and major changes were made in it 1 year ago, in January. We used a new survey instrument that attempted to find some of the people who were thought to be unemployed who were not being recorded, and the feeling was that the unemployment rate jumped several tenths of a percentage point as a result of this improved survey instrument. I think they are continually doing that, and also doing special studies to find answers to the kinds of questions you have been asking, about discouraged workers and the composition of the unemployed.

Actually, the total number of unemployed last month was about 7.5 million people.

Mr. COYNE. Thank you very much.

Mrs. JOHNSON. Thank you.

Thank you, Mr. Coyne. Mr. Reischauer, I was pleased you included in your testimony a section on the illustrative path of the balanced budget. I want to take my time to see that I understand it correctly.

I am sorry I missed the actual presentation of your testimony, but I have read some of it now and will read it all. I welcome you

back and admire your work and look forward to working with you in this very difficult time.

But through a period when I think we do have a chance to address some of the problems that we have not addressed in recent years.

My understanding of this section is that in order to reach a balanced budget by the year 2002, we have to cut $322 billion, effectively, that year.

Mr. REISCHAUER. That year, you would, if you followed the path that we laid out; if you followed some other path, you might have to cut more.

Mrs. JOHNSON. Let me see if I get the outlines of that path correctly. You say if we freeze discretionary spending at the 1998 level——

Mr. REISCHAUER. In nominal terms.

Mrs. JOHNSON. Which you point out is a 22-percent real cut by the year 2002.

Mr. REISCHAUER. In current 1995 appropriations levels, right.

Mrs. JOHNSON. Which is substantial. We are talking quite a few years out, now. But if we freeze discretionary spending, then my understanding of your testimony is that of $322 billion, we save $89 billion. Am I relating the right numbers here?

Mr. REISCHAUER. Yes. That includes the savings from freezing discretionary spending, plus the debt service associated with it.

Mrs. JOHNSON. Right. Then later on you mention that if by the year 2000 the market is convinced that we are committed, that you would anticipate there could be a drop of as much as 1 percent in interest rates which would by the year 2002 save $140 billion.

Now, is it correct to interpret your testimony that if we add together the $140 billion and the $89 billion, that is $229 billion of the $834 billion? So what we are looking at is the policy changes that would accomplish the other $93 billion?

Mr. REISCHAUER. Yes. You would subtract. In that table there is a total of 1.035 trillion dollars' worth of policy changes.

Mrs. JOHNSON. How many?

Mr. REISCHAUER. Over this whole period, $1.035 trillion. You can subtract from that the savings that you would get from discretionary spending, which would be $212 billion, up in the right hand top corner. This is over the 5-year period.

You were mixing a single year's number with a 5-year number, and just now I was translating everything into 5-year terms. Would you like to stay on just the year 2000?

Mrs. JOHNSON. I am trying stay on the year 2000 and look at what besides freezing at the 1998 level plus the interest rate benefit that you expect to get? What are the dimensions of the remainder?

Mr. REISCHAUER. OK. You can add to the $89 billion roughly $38 billion in additional interest savings. In other words——

Mrs. JOHNSON. So you can't add the $140 billion?

Mr. REISCHAUER. No. The $140 billion is summed over 5 years.

Mrs. JOHNSON. Do you go on elsewhere and enumerate——

Mr. REISCHAUER. This really means that in that table, rather than having to take $180 billion from policy changes in the manda-

tory or entitlement area, you would only have to take about $142 billion.

Mrs. JOHNSON. Your policy options here are, if you freeze discretionary at the 1998 level, which means taking a 20-percent reduction in real costs from the 1995 level, then the remainder of the problem is basically 140 billion dollars' worth of policy changes in the entitlement area or tax areas.

So the defense cut would be the freeze?

Mr. REISCHAUER. The defense——

Mrs. JOHNSON. The impact of the defense budget——

Mr. REISCHAUER. Would be part of the freeze, yes.

Mrs. JOHNSON. So the remainder of the $140 billion is entitlement plus any revenue freezes?

Mr. REISCHAUER. Yes.

Mrs. JOHNSON. If you were to take that all in entitlements, have you looked at what would be your policy options, including also tax entitlements, tax expenditures?

Mr. REISCHAUER. No, we haven't gone beyond this total level to propose policy changes. We present to the Congress a large options book each year of various ways to reduce the deficit by cutting spending on both discretionary and entitlement programs and raising taxes.

Can you go through that volume and make up a particular package?

Mrs. JOHNSON. Thank you very much.

The gentleman from—Mr. Portman will inquire.

Mr. PORTMAN. I thank the Chair, and I thank you for being here, Dr. Reischauer. I have a few questions to relate really to the general issue of how serious is our debt and deficit problem.

I wanted to get your sense of, first, with regard to the issue I raised with Mr. Archer of the ratio of our debt to the GDP. In your testimony over the last few days from CBO and Treasury, we have talked about the fact that the President's budget decreases the deficit as a percentage of our GDP and supporters of that budget have said that is a significant measure.

Later in this afternoon's testimony, we asked Dr. Rivlin about the percentage as it relates to debt. I just wonder two things.

No. 1, do you think that the debt as a percentage of GDP is a significant economic indicator? As I assume you would agree, the deficit figure is.

No. 2, in your analysis, and I realize yours is not the President's analysis, although it is actually somewhat close because theirs is a more or less static budget, do you have any sense of what the debt as a percentage of GDP would be over the next 5 years? Would it decrease or would it increase?

Mr. REISCHAUER. First of all, I think that the debt-to-GDP ratio is a very important indicator. We came out of World War II with a debt-to-GDP ratio of about 120 percent. That fell steadily to about 25 percent in the early seventies. It didn't fall because we were running surpluses most of those years. It fell because we were adding to our debt at a slower rate than the economy was growing.

So, a falling ratio is compatible with continued deficits. During the seventies, that debt-to-GDP ratio bounced around in the 25-percent to 27-percent range.

Then it began zooming up. It is now 52 percent. In other words, we have doubled it in the last decade and a half. If we do not change our budget policies, it is going to continue to creep up over the next 5 years.

I think the administration's budget proposal, if it does what it says it is going to do—and CBO has evaluated it yet—appears to stabilize that ratio. It doesn't start bringing it down, it doesn't bring us back into the world we lived in for 20 or 30 years after World War II.

Mr. PORTMAN. From what you understand, you would do your analysis to take a look——

Mr. REISCHAUER. We will evaluate the President's budget and provide estimates for what we think will happen to that debt-to-GDP ratio under his policies.

Mr. PORTMAN. That would be very interesting, I am sure, to a lot of us. Second, and this is a very general question, if you could give us your normally succinct answer, and this is to focus on the importance of this issue, what is wrong with the deficit spending we are doing, and having $200 billion deficits as far as the eye can see? What impact does that have on the economy?

We have heard about 16 cents on $1 going for interest on the debt. We have heard about unavailable capital. What is the problem with it?

Mr. REISCHAUER. The problem is that we are a nation that doesn't save very much. We don't save much as individuals or as businesses. When the public sector runs a deficit, it absorbs some of that saving to use for goods and services that the government is providing.

Less saving is therefore available for private productive investment, from which comes economic growth. To some extent that lack of available saving can be made up by an inflow of foreign money, but then you are dependent on capital flows into your country to sustain economic growth.

If the government were using the resources that it was absorbing from the private capital markets to invest, to expand in, let's say, government programs that arguably might strengthen the economy over the long run—education, training, research and development, certain kinds of infrastructure that have been shown to make the private sector economy more productive—then you wouldn't be tremendously worried about this deficit.

But that is not what has happened over the last 20 years. The growth of the deficit has been accompanied, not by an expansion of investment-oriented spending that the government does, but rather by consumption-oriented spending.

We are basically reducing the expansion of the capital stock of our country; therefore, future living standards and wages won't be as high as they would otherwise be. It is not that they will be lower than they are now, given current policies. It is just that they won't grow as rapidly as would otherwise be the case.

Mr. PORTMAN. Thank you. Mr. Chairman, I want to thank the Director for his help on the unfunded mandate front. Tell him that I apologize for adding to his already burdensome task, but I appreciate the support.

Mr. REISCHAUER. I am going to escape this task.

Mr. PORTMAN. Is it because of unfunded mandates that you are leaving?

Thank you, Mr. Chairman.

Mr. REISCHAUER. My staff, by the way, appreciated very much the work that they did with your staff. They found your people very good.

Mr. MCCRERY [presiding]. Thank you, Mr. Portman.

Mr. Payne.

Mr. PAYNE. Thank you very much, Mr. Chairman. I want to associate myself with Mr. Thomas' remarks and commend you and your staff for the work that you did in 1994, certainly in health care reform, as well as in OBRA 1993, OBRA 1990, and other important bills.

Mr. REISCHAUER. A lot of sleepless nights.

Mr. PAYNE. A lot of sleepless nights. I do think that Congress is becoming increasingly responsible as it relates to matters of fiscal policy. I certainly think you and others at CBO are an important part of making that happen.

Thank you for that.

Mr. REISCHAUER. Thank you.

Mr. PAYNE. I am one of those who signed onto the balanced budget amendment, maybe out of frustration, but feeling that we had to find a way to get our deficits down and do it at a time certain. I am concerned about the President's budget.

I am feeling more concerned because I see you have even higher deficit numbers in the year 2000 than the President's budget, and I understand that is because of some differences in assumptions about growth and differences in terms of the health care growth rates as opposed to what HCFA has done.

As it relates to what we have been doing on this committee, we have been talking a lot about the Contract With America, much of which I agree with, and much of which is very popular in my district. I am concerned that we on this committee may be put in a position where we have to make a decision about substantial tax cuts without knowing how they are going to be paid for.

If you would perhaps comment on your thoughts about the advisability of these tax cuts being approved before there are specific funding sources, I would appreciate it.

Mr. REISCHAUER. You established in 1990 and reaffirmed in 1993 a set of procedures that in fact should not allow you to adopt tax cuts that are not paid for. If you do adopt tax cuts that are not paid for, under existing law the administration will be required to impose sequestrations, that is, across-the-board cuts on Medicare, farm price supports, student loans, a number of entitlement programs that many might think should not be subject to arbitrary, last-minute cuts.

So I think that if you just stick with the rules that you have established for yourself, fiscal responsibility should reign.

Mr. PAYNE. As I understand it, that is exactly what we intend to do——

Mr. REISCHAUER. That, by the way, is the law of the land. So in a way it doesn't depend on whether you are fiscally responsible or not. The administration is required to take steps if you present them with unpaid-for tax cuts.

Mr. PAYNE. I think the process is for this committee, which typically or generally has been very conscientious in terms of making sure that it pays for its tax cuts——

Mr. REISCHAUER. Very.

Mr. PAYNE. That instead of us acting at this committee level, we will act and cut taxes and send those along and expect them to be joined up with some spending cuts that would happen in other areas at a later time, as I understand it.

Do you have any advice or thoughts about that particular procedure? I, as one member, have concerns about voting, not knowing exactly what it is that would be done to offset the cost.

Mr. REISCHAUER. But remember that this committee has jurisdiction over a very substantial portion of the entitlements spending package. You can't expect committees that have very small amounts of entitlements to cough up the money to pay for a large tax cut offered by this committee.

So this committee is going to have to do some heavy lifting on its own, although, as you suggest, the Agriculture Committee, the Veterans Committee, Energy and Commerce, other committees with entitlement jurisdiction might have to bear or will be asked to bear some of the burden.

But I would urge you to be very, very cautious. The Congress over the last 4 years has been extremely responsible in adhering to the rules and limitations that it created for itself. It would be a shame to go off the wagon at this point.

Mr. PAYNE. Mr. Chairman, could I ask one other question?

Mr. MCCRERY. Be my guest.

Mr. PAYNE. Thank you.

Dr. Reischauer, I guess this question goes to the whole notion of tax cuts in general. As a matter of public policy, we have stated we are trying to get to a deficit of zero by the year 2002, which CBO said will cost $1.2 trillion. The Treasury has said if we pass all the tax cuts that are in the Contract With America, it will add an additional $400 billion, so then it becomes a $1.6 trillion exercise.

Considering the magnitude of those numbers, would you comment on the advisability of tax cuts given those conflicting objectives. Also, given this kind of economy, where we have full employment, should we be doing something that might be stimulative?

Mr. REISCHAUER. Well, you used precisely the right word. Reducing tax burdens and reducing the deficit are both desirable objectives, but they are in conflict. When you do some of one, it makes doing the other harder. The Congress has to decide which it gives higher priority to. It has to ask the American people which they are most interested in, and I think pursue that one so that you achieve the goal. Then you must ask yourself, can you go further to achieve the other goal?

But every dollar that you provide in tax relief is going to require a spending cut just to keep the deficit from increasing. In other words, you are just treading water. If you also decide you are going to balance the budget, it means the spending cuts that you are going to make to bring the deficit down once you have brought it level again will be that much harder.

Mr. PAYNE. Thank you very much.

Thank you, Mr. Chairman.

Mr. MCCRERY. Thank you, Mr. Payne. I can assure the gentleman from Virginia that over the next 2 years he is going to have plenty of opportunity to vote for spending cuts that will more than outweigh the taxing increase that this committee will vote for. So don't worry, we are going to be able to cut spending a heck of a lot more than——

Mr. PAYNE. I am not worried. I would just feel better if I did the spending cuts first, as we have always discussed we felt was the best way to proceed, and then have the tax cuts second.

Mr. MCCRERY. I will assure the gentleman again that he is going to have an opportunity to vote on a package that will include as many spending cuts as we have tax reductions, at the same time.

Mr. PAYNE. In this committee?

Mr. MCCRERY. No, sir, not in this committee. I don't think that is necessary, nor desirable. But on the floor of the House where it counts, you will have an opportunity.

Dr. Reischauer, in responding to Mr. Portman's inquiry on why it is bad to continue having $200 billion deficits, I appreciated your answer, but it is my impression, and I want you to comment on this and tell me if I am wrong and explain why. It is my impression that it is not only bad for the reasons you stated, but also, if you look beyond the 5-year window, or even the 10-year window that we often look down or look through, there are some events likely to occur, absent congressional action, that compound the problem, such as the Medicare Hospital Insurance Trust Fund going dry around the year 2001 or so.

That is more of a relative problem than it is an absolute problem, because we will have to take resources from education, training, research and development, whatnot, and supplement that fund in order to pay the bills. That is a relative problem.

But then further down the road, 2016, 2017, we will face an even bigger problem when the baby boom generation retires and starts calling on the Social Security trust fund and we are no longer able to use the surplus, so to speak, for education, training, and all these other things we would like to do.

To me that says that we need to start taking very serious actions today, this year, to account for those problems that are down the road. Do you agree with that? Am I off base on this? Can you expound on it?

Mr. REISCHAUER. No, I think you are right on the money. We have a short-run problem, namely, that we are running deficits and we would like to have a balanced budget.

The demographic situation in this country means that starting in the second decade of the next century, our programs devoted to the elderly—and those are Medicare, Social Security, and some of the other programs, too—are going to explode. Their spending is going to rise as the numbers of beneficiaries increases.

We as a society, as a nation, are going to have to redirect resources one way or another to provide the retired population with the income they need to live and the income that we have promised them.

There are two things we can do about that now. One is that we can begin scaling back our commitments to future retirees by

changing the retirement age, and making other modifications in the Social Security system or the Medicare systems.

The other is that we can strengthen the economy, run surpluses, or lower our deficits so that the total wealth of our economy expands, and there are more resources to channel in the direction of the growing retired population. We probably should be doing both.

Mr. McCRERY. Thank you. Again, it seems to me that with those problems looming out there, we ought to be thinking in terms longer than 5 years or even 10 years. We ought to be thinking of the problems that are further down the road, and how if we don't start doing some things now to prepare for those problems and prepare to be able to cope with those problems better than we would be if we stayed on the present course, we are going to have a heck of a time. We are going to be even more dependent on foreign capital to finance our standard of living in this country.

Won't that put us somewhat at the mercy of the rest of the world if we get to that point?

Mr. REISCHAUER. The rest of the world is going to be in the same shape that we are in. So I wouldn't count on them coming to our rescue. I think the point you made is worth reemphasizing, and that is that you can take modest steps now that will improve things 20 years from now, and will preclude the possibility that you might have to take radical, drastic, and inequitable steps in 2015 or 2020. So there is good reason to act now, even though the crisis isn't looming right in front of us.

Mr. McCRERY. Well, thank you very much for your responses to our inquiries and your testimony of today and for your service to the country and to the Congress. My view is, and it is only my view, that this Congress is going to take some bold steps, or attempt to take some bold steps to address those long-term problems.

It is not going to be particularly popular, I predict. Although I know how the game works, I am disappointed that the President did not come forward in his budget with suggestions for some bold steps so that we could do this in tandem. I am hopeful, I am still hopeful that the administration will accept our proposals, which will come, despite the cynicism of the few. We are going to come forward with some proposals.

They may not be the exact proposals that you would like to see or the President would like to see. But I am convinced that this Congress or a majority of this Congress is very serious about cutting spending for the short term and for the long term to get us to a balanced budget and perhaps even run a surplus so that we will be better prepared to meet those problems when they arise in the next century.

Now I am informed Mr. Houghton would also like to inquire.

Mr. HOUGHTON. I was not going to ask a question, but I can't resist. Mr. Reischauer, great to see you here.

You may not want to answer this, but I am going to ask it anyway. The problem that we are facing is we are putting so much off the table, we put Social Security off the table, we put our interest off the table, we put virtually Medicare off the table, we are putting the military off the table, everything like that.

I mean, the big items, the big money items, we are not really wrestling with, although that may not be so with Medicare and

Medicaid programs. How would you go about wrestling with those things so that we do the steps that are moving toward the solution in 2010, 2015, 2020, rather than moving away from it? What are those specific actions or the areas that you would be working toward in those big money items?

Mr. REISCHAUER. I think I benefit from not really understanding your question, so I have a hard time answering it. I have always been a believer that everything should be on the table, and that people who want to take things off the table maybe ought to be forced to come up with substitutes.

You could pass a bill that cut everything by a flat percent—Social Security, you name it—absolutely everything. Then, if you want to take Social Security off the table, here is a proposal that cuts something else or raises a tax to allow you to take it off the table.

In other words, impose a price on those who want to take some large spending item off the table. That is, to find their proportionate share of the savings to do that.

Mr. HOUGHTON. Well, in other words, you are saying that it may be easier——

Mr. REISCHAUER. I think——

Mr. HOUGHTON. To just take a scythe right across the budget and then start putting things back according to what the specific need is; is that right?

Mr. REISCHAUER. Yes. I mean, this is not a well thought out plan. I have just come up with this right now.

But I think you are in an impossible situation when you say we want to balance the budget but we don't want to increase taxes. We want to take Social Security off, and we want to make sure defense doesn't decline in real terms from where it is now, and we can't touch civil service and military pensions, and we really can't touch veterans, and we probably can't touch unemployment compensation because it is really State money.

Of course, you can't do much about interest. At this point the game is over, because the implied cuts on everything else in the budget are so draconian that no one will agree to cooperate. I am saying that it is very easy to take things off the table if there is no price imposed on you when you take it off. All you do is receive thank-you letters from the Social Security recipients: thank you for taking this off the table.

Mr. HOUGHTON. Just one other question: capital budgeting. As industry does it, not throwing in human resources and things like that, when we are talking about investing it is very difficult for a government agency to invest it. What do you think about that?

Mr. REISCHAUER. As an institution, we have never been enamored with the idea. Most people bring it forward as a proposal that they believe would mean that the amount of deficit reduction that we had to do was reduced. The analysis we have done of it suggests that that is not the case, that if you correctly counted the depreciation of the existing capital stock of the Federal Government and included that as an expenditure item in the budget, the deficit would in fact look a lot different from what it appears to be right now.

There are some very difficult issues, of course, about the definition of capital, and there is concern that the definition would be abused by the Congress and the executive branch.

Mr. HOUGHTON. Thank you.

Mr. MCCRERY. Thank you, Mr. Houghton. Thank you, Dr. Reischauer, very much for your testimony.

Mr. REISCHAUER. Thank you.

[Whereupon, at 2:50 p.m., the hearing was adjourned.]

[A submission for the record follows:]

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Executive Secretary
Jon H. Mielke

February 10, 1995

The Honorable Bill Archer
Chairman
Committee on Ways and Means
Room 1102, Longworth House Office Building
Washington, D.C. 20515

Dear Congressman Archer:

I would like to comment for the printed record of the February 7, 1995 hearing on the President's fiscal year 1996 budget. I know there are many items to discuss on the budget, but there are several areas I believe your Committee also should consider.

In most of the public comments made so far regarding the 1996 budget and future budgets, there is much discussion about down-sizing government, eliminating waste, bringing the annual budget deficit under control, and, hopefully, starting to pay down on the national debt. All of this is fine, but generally missing is any serious discussion on reining in the enormous amounts of money spent to operate the Central Intelligence Agency.

We are a democracy, and the Cold War is over. I believe an Intelligence Agency can be justified in the national interest. I also believe reasonable spending for its operation is justified, but the Agency should be made more efficient and open much of its actions to the public. Democracies need open government--not a bunch of "spooks" who often try to oppose changes in the governments of other countries rather than truly just being an information gathering Intelligence Agency. I am sure billions of dollars could be saved annually by reducing the Central Intelligence Agency budget if you are serious about making government more efficient and balancing the budget.

The Ways and Means Committee should also look at military pensions. It makes no sense to me to allow someone to enter the military in their teens, finish service in their 30s, and begin to draw a pension. Military pensions should begin at age 65. A second problem with pensions, as I understand it, is that the funding for pensions comes right out of the general funds of the United States. Does the military have a

pension fund that they contribute to from day-one of their service just like other government employees? If not, why not?

I believe where our government provides a service, a better effort should be made to recover the costs for that service. For example, fees for use of our national parks and the concessions in them should cover the cost of maintaining and improving our parks.

There is a huge amount of government subsidies, special tax benefits, to many special interests. To be fair, all of them should be on the table. For example, as I understand it, our tax system subsidizes Sunkist, Gallo, and McDonald's to advertise their products abroad; some private forestry companies owe tax payers for timber purchased but not paid for; and some mining companies pay pennies for title to the United States people's land that is worth millions.

There is a lot of discussion in Congress about reforming "welfare" to cut off benefits to millions of poor children. I believe Congress also should reform the benefits given to corporations that receive special tax benefit welfare.

Your Committee has a difficult task, but I sincerely believe the annual budget of the United States should be balanced right now and everything should be on the table. A balanced budget amendment is a cop-out for balancing the budget in the future instead of just doing it now.

We live in a great, free, open democracy and a government of the people, by the people and for the people. The American people want a fair system where the poor and middle class are not ignored by Congress and get as much consideration as corporations that are on welfare.

Thank you for the opportunity to present my views.

Sincerely,

Bruce Hagen

Bruce Hagen
Commissioner

BH/cm

REPORT OF THE TRUSTEES OF THE FEDERAL HOSPITAL INSURANCE TRUST FUND

HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

May 2, 1995

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REPORT OF THE TRUSTEES OF THE FEDERAL HOSPITAL INSURANCE TRUST FUND

TUESDAY, MAY 2, 1995

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, DC.

The Committee met, pursuant to call, at 10:08 a.m., in room 1100, Longworth House Office Building, Hon. Bill Archer (Chairman of the Committee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE
April 18, 1995
No. FC-6

CONTACT: (202) 225-1721

ARCHER ANNOUNCES HEARING ON MEDICARE HOSPITAL INSURANCE TRUST FUND

-Report Shows Trust Fund Will Start Going Broke In 1996-

Congressman Bill Archer (R-TX), Chairman of the Committee on Ways and Means, today announced that the Committee will hold hearings to review the Report of the Trustees of the Federal Hospital Insurance Trust Fund and the recommendations of the Trustees. **The hearing will take place on Tuesday, May 2, 1995, in the main committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m.**

The Committee will receive testimony from Federal Hospital Insurance Trust Fund Trustees and expert witnesses.

BACKGROUND:

The payroll taxes paid by working Americans and employers into the Federal Hospital Trust Fund (HI Trust Fund) pay for about sixty percent of the medical care for Medicare beneficiaries. The Hospital Insurance program (Medicare Part A) is obligated to cover the costs of inpatient hospital care and other related services for those Americans who are entitled to insurance coverage under Medicare Part A.

The 1995 report of the Trustees of the HI Trust Fund indicates that the fund is in financial imbalance for both its short and long range projections. Beginning in 1996, the HI Trust Fund will for the first time, spend more in outlays than it receives in income. According to the Trustees report, if payroll taxes alone were raised to ensure fund balance into the future, those taxes would have to be nearly tripled from current levels.

Currently, payroll taxes from about four workers cover the Medicare Part A costs on average for each beneficiary. This ratio worsens over time, and drops precipitously when the baby boomers become eligible for Medicare after the year 2010. It is noteworthy, however, that the financial imbalance in the HI Trust Fund occurs prior to the eligibility of baby boomers. As the Trustees report states: "Not only are the anticipated reserves and finances of the HI program inadequate to offset the demographic change, but under all of the sets of assumptions the HI Trust Fund is projected to become exhausted before the demographic shift has even begun to occur."

"The report on the HI Trust Fund is an early warning signal that cries out for immediate Congressional attention. Despite the fact that President Clinton ignored the precarious state of the Trust Fund in his budget, it is now time for him to join with the Congress and face this issue squarely. We need to work together to keep the promises of the past while meeting the needs of the current and future Medicare beneficiaries," Archer said.

FOCUS:

This hearing will review the Report of the Trustees of the Federal Hospital Insurance Trust Fund and the recommendations of the Trustees.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit at least six (6) copies of their statement, with their address and date of hearing noted, by the close of business, Tuesday, May 16, 1995, to Phillip D. Moseley, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Committee office, room 1102 Longworth House Office Building, at least two hours before the hearing begins.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages including attachments.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. A witness appearing at a public hearing, or submitting a statement for the record of a public hearing, or submitting written comments in response to a published request for comments by the Committee, must include on his statement or submission a list of all clients, persons, or organizations on whose behalf the witness appears.

4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and the public during the course of a public hearing may be submitted in other forms.

Note: All Committee advisories and news releases are now available over the Internet at GOPHER.HOUSE.GOV, under 'HOUSE COMMITTEE INFORMATION'.

*****

Chairman ARCHER. The Committee will come to order.

Will guests and staff please take their seats? The Committee will commence just as soon as everybody is seated and audible conversation ceases. Surely everyone can find a seat and not continue to walk around in the middle of the Committee room.

Today, the Ways and Means Committee conducts one of its most important hearings of the year because we will examine the financial condition of the Federal Hospital Insurance Trust Fund Medicare Part A. The report we will examine today is essentially a Clinton administration document.

Three trustees are Cabinet secretaries. Their very own report shows that the trust fund will begin to go broke next year and will be bankrupt by 2002. Their report provides a wake-up call that this Committee and the Congress must not ignore.

Madam Secretary, welcome again to the Committee and I hope the administration also will not ignore its own report. Thirty-seven million Americans depend upon the trust fund for hospital care and the other part A benefits covered under Medicare.

At the same time, working Americans are paying hard-earned dollars in payroll taxes to finance Medicare and they rightfully expect that Medicare will be there for them when they retire or become disabled. It is essential that we begin today a conversation with the American people about the condition of their Medicare and the dire necessity to work together to make it solvent.

Frankly, it will not be easy to bring Medicare finances in line. The trustees' report tells us that simply to ensure solvency for the next 25 years, Congress would have to immediately increase payroll taxes by 44 percent or reduce growth in expected spending by nearly one-half. For the trust fund to remain solvent through the retirement years for the baby boom generation, the trustees' report indicates taxes would have to be tripled; that is, if restraint in spending increases does not occur.

Raising taxes would only postpone the need to curb medical cost growth and would simply pour fuel on the fire of medical cost inflation. Besides, it is bad economics and plain wrong to raise taxes further on this generation of working Americans.

It is our responsibility to begin the task of tempering growth in Medicare costs to preserve the program for current and future beneficiaries. I know the American people expect us to meet this challenge in a bipartisan manner. Medicare solvency is neither a Republican issue nor a Democrat issue and I will work to seek solutions for the full participation of Democrats on the Committee and with the administration, along with our Republican Members.

We begin today a two-part process to save Medicare. The first part is a careful examination of the causes behind Medicare's looming insolvency. Only after we understand the problem can we begin to advance solutions, and that will be the second part of the process.

Madam Secretary, I am growing increasingly concerned about the administration's lack of an approach to saving Medicare. The administration's public pronouncements appear to say that since the American people rejected a big government solution to health care reform last year, the administration will refuse to talk about

the unique problems of Medicare this year. I hope I am wrong in my understanding of those pronouncements.

This morning, I call upon the administration to join us in saving Medicare. I hope the mistakes of last year will not be compounded by an even bigger mistake this year. Let's not hold America's seniors hostage to an administration-failed, big government health care program.

Today, at the start of the 1995 White House Conference on Aging, I hope the administration will advance proposals so we can seek a consensus with the elderly and all Americans on positive solutions. We are ready to work with you.

I will now yield to Mr. Gibbons for an opening statement.

Mr. GIBBONS. Thank you, Chairman Archer, and I will yield my time to Mr. Stark, former Chairman of the Health Subcommittee and now Ranking Member on the Health Subcommittee.

Mr. STARK. Thank you, Mr. Gibbons and Mr. Chairman. You know, the Republicans holding this hearing to save Medicare reminds me of the man who murdered his parents and begged for mercy as an orphan. The hearing really is a blatant attempt to distract the public from a Republican tax bill that takes $87 billion out of the Medicare Part A Trust Fund over the next 10 years and gives it to the rich. Republicans are crying crocodile tears about the trust fund being in danger. Talk about wake-up calls. I would say, "hello, Earth to the Committee." The Republican hypocrisy is showing.

I urge the Committee Republicans to reread their minority views on H.R. 3600, last year's health reform bill. In that bill, Democrats saved the Medicare Trust Fund by getting all health spending under control. The billions we saved in Medicare helped the uninsured, expanded Medicare benefits, and provided a prescription drug benefit for everyone. Democrats used Medicare savings to improve the entire health care system.

Where were the Republicans? Every one of you on this Committee voted against any and all Medicare savings. In your dissent 10 months ago, Mr. Chairman, you said reimbursement levels had reached potentially disastrous levels and additional massive cuts in reimbursement to providers will reduce the quality of care for the Nation's elderly.

Now the radical right wants to cut three or four times more than we did. How can they now say it will not hurt quality? I'm sorry, folks, but massive cuts in Medicare without expanding coverage, will shift cost onto younger workers and destroy the quality of medical care.

Speaker Newt talks about reforming the system with more managed care and vouchers. I must say, I resent the Republicans suggesting that my mother and the Nation's seniors are either senile or so stupid they cannot see through that double-talk. Mother knows that managed care costs more and it means less choice of doctors and hospitals. She also knows that the vouchers being suggested by Republicans to buy private insurance will not ever be worth enough to pay for reasonable health care.

The Republican plan to push American seniors into plans with less choice saying it would give them more choice is a dog who just will not hunt. Republicans intend to disrupt people's health plans

and push them into managed care, and they know it will save little or nothing. Last week, the CBO, Congressional Budget Office, told the Committee that under the current laws, quote, "it is believed that Medicare spends more for managed care enrollees than it would have spent on them had they remained in the fee-for-service sector, about 5.7 percent more."

Until we know more about how to pay for seniors in managed care, you are just whistling in the dark and playing fast and loose with the sacred trust of Medicare. We Democrats have always worked with responsible Republicans to improve Medicare and reform the entire health care system. But $300 billion in cuts for the sake of tax cuts for the rich not only destroys Medicare, but harms the entire system.

We are about to hear from Secretary Shalala. I expect, she will ask to work with all of us to reform the U.S. health care system. We must not only preserve Medicare, but we must provide coverage to 42 million Americans who are today without coverage. Nobody is thinking about them on the Republican side of the aisle.

You proved your political dominance over the House in the past 4 months. Why not show us you stand for something besides insurance company profits and tax cuts for the very rich? You are in complete control of this Committee and you will be judged by your ability to legislate fairly for all Americans.

Thank you, Mr. Chairman.

[The opening statement of Mr. Christensen follows:]

OPENING STATEMENT OF HON. JON CHRISTENSEN

Medicare is going broke. It is on a crash course with reality and we've got to turn it around. We must have the courage to transform it.

It is a little-reported fact that Medicare's roaring growth has left a 1960s program on the verge of disaster in the 1990s. Medicare grew by almost 11 percent last year, more than twice as fast as private-sector health care spending. That gap alone is proof that something is dreadfully wrong with the program.

That is not the worst news. According to the Trustees of the Medicare Program, including three Clinton cabinet secretaries, the Medicare Program will spend more than it takes in next year—and by 2002 the Federal Hospital Insurance Trust Fund established to secure Medicare's future will be bankrupt. Worse still, by law, no disbursements may be made for Medicare if that fund is emptied. President Clinton's own officers admit that Medicare is going bankrupt—and will cease to exist when it collapses. To make sure our nation's seniors have access to adequate health care, we simply must save Medicare.

How much do we have to cut? Not a dime. The way to save Medicare is to allow the program to continue to grow, just at a slower rate. After we reform it, Medicare will still be growing faster than any other program in the Federal Government. Many groups, including tax-and-spend liberals seeking to relive the school lunch debate and score political points, will argue that Medicare is being "cut." Only in Washington can letting a program growing faster than any other government program be called a cut.

The Clinton administration's lack of any plan to salvage the broken program is unacceptable to our seniors. In his disastrous attempted government take-over of the Nation's health care system, Bill Clinton called for $118 billion in changes to Medicare, knowing that the program was headed for fiscal disaster. However, since his proposal was rejected the president has been silent on how to save Medicare. His marathon State of the Union Address did not even mention the Medicare crisis. His budget also ignores the problem altogether. Seeing the program was about to crash, he has taken his hands off the controls, forcing Republicans to take the leadership role once more.

I care deeply about our seniors, and so I will fight to defend Medicare. We need to work together in a bipartisan fashion to transform Medicare from an inefficient,

waste-ridden program to a secure, strong program for today's seniors and those of tomorrow.

Chairman ARCHER. Madam Secretary, welcome again to the Committee. We will be pleased to receive your presentation. Should you wish to restrict it in your oral comments, your entire printed statement will be entered into the record.

You may proceed.

STATEMENT OF DONNA E. SHALALA, SECRETARY, HEALTH AND HUMAN SERVICES

Secretary SHALALA. Thank you, Chairman Archer.

Let me say, Mr. Chairman, Members of the Committee, I will put my complete statement in the record with your permission and read a much briefer statement.

Thank you for the opportunity to testify this morning on the HI, Hospital Insurance, Trust Fund. I would like to begin by quoting the words of Franklin Delano Roosevelt who gave voice and vision to America's desire to provide income and health security to older Americans. Roosevelt said, "We always hope there is a better life, a better world beyond the horizon." It is reaching that horizon and protecting our older Americans that brings us here today.

As you know, my fellow Medicare trustees and I recently reported that the HI Trust Fund will be depleted in 2002. The Clinton administration believes that this is a major problem that deserves serious bipartisan attention. Let me begin by describing the HI Trust Fund and the services it supports for older Americans.

The HI Trust Fund primarily pays for inpatient hospital care. It also covers expenditures for home health services, for skilled nursing care, and for hospice care. In 1994, it paid for $104.5 billion in services for 32 million aged and 4 million disabled beneficiaries. The trust fund is financed primarily by payroll taxes.

Employees contribute 1.5 percent and there is a matching contribution by employers. However, in the years to come, trust fund expenditures are projected to rise more rapidly than trust fund revenues. This is because of a current and anticipated future increase in the number and complexity of medical services. Driving the expected imbalance between expenditures and revenues is the demographic shift that will occur with the aging of the baby boom generation. As that shift occurs, a larger percentage of our population will be eligible for Medicare and a correspondingly smaller percentage will pay the taxes that support the trust fund.

What does all of this mean? The 1995 HI trustees' report projects roughly another 7 years of solvency; the fund is exhausted in 2002. These are well understood trends. Over the past 15 years, the trustees have projected the date of insolvency to be anywhere from 1987 to 2005, and each year they recommended that Congress take action to protect the fund.

When the President took office on January 20, 1993, he inherited an escalating deficit and a Medicare Trust Fund that was projected to be insolvent in 1999. Twenty-seven days later, he proposed and then helped to pass a historic deficit reduction plan, the Omnibus Budget Reconciliation Act of 1993.

That included several strong policies to strengthen the economy and the trust fund. Indeed, these proposals pushed out the insol-

vency date by three full years. Unfortunately, the only proposal in the Contract With America that specifically addresses the Medicare Trust Fund would weaken it and undo some of the progress made in OBRA 1993. It is ironic that those who are suddenly interested in the plight of the Medicare Trust Fund have advocated policies that exacerbated the insolvency of the fund.

The fact is, any significant changes in Medicare, whether in the financing eligibility, in the benefit provisions or in payment rates, will affect the entire health care system. Therefore, this administration believes that strong action to avoid depletion of the HI Trust Fund should not be undertaken by looking at Medicare alone. Instead, we must consider the issue of the larger context of health reform as the trustees recommend.

We need an approach to protecting Medicare that is both bold and balanced. The President has repeatedly called for a meaningful bipartisan action on health reform, but so far, the reply from the Republicans has been only silence. Let there be no mistake. Solutions focused solely on Medicare could cause great harm. Let me give you a few examples.

Reductions in payments to health professionals would have significant effects on their overall financial condition. This is particularly true for care givers whose patients are predominantly Medicare beneficiaries or uninsured persons, whether located in inner cities or in rural America. In fact, large reductions in Medicare payments would have a devastating effect on urban public hospitals that already are providing a disproportionate share of uncompensated care.

In the 1994 special report of the National Association of Public Hospitals, it was reported that in 1991, Medicare accounted for a bigger share of net operating revenues than private payers for these hospitals. The Association further reported that while Medicare was the payer for only 11 percent of discharges in these institutions, it accounted for almost 20 percent of the net operating revenues.

Large reductions in Medicare payments should—could also endanger rural hospitals. Nearly 10 million Medicare beneficiaries, 25 percent of the total, live in rural America where there is often only a single hospital in their county. These rural hospitals tend to be small and serve primarily Medicare patients. Significant reductions in Medicare revenues will cause many of these hospitals, which already are in financial distress, to close or to turn to local taxpayers to increase what are often substantial local subsidies.

Rural residents are more likely than urban residents to be uninsured, so the practice of offsetting the effects of Medicare cuts by shifting costs to private payers is much more difficult for small rural hospitals. Moreover, rural hospitals are often the largest employer in their communities. Closing them will result in job loss and physicians leaving these communities.

Other providers may shift their costs on to payers who do not have the market power to negotiate advantageous rates. This means that ultimately many small businesses and individuals, those Americans who are already paying the highest health insurance premiums, will shoulder even larger shares of health care costs. Large cuts in Medicare could also hurt beneficiaries. About

75 percent of homes have incomes below $25,000. Let me repeat that. About 75 percent of Medicare beneficiaries have incomes below $25,000.

For the typical Medicare beneficiary, out-of-pocket health costs represent 21 percent of income. Increasing out-of-pocket costs would be the equivalent of reducing their Social Security. Attempts to restore the solvency of the trust fund cannot undermine our commitment to providing health security for older Americans right now and in the future.

The administration takes seriously its responsibility to current and future Medicare beneficiaries to insure the solvency of the trust fund. The Health Care Financing Administration continues to make many program changes to improve the efficiency of the Medicare system. As a result, on a per enrollee basis, Medicare grew at a slower rate than the private sector between 1994 and 1991; 7.7 percent compared to the private sector's 9.8 percent.

As we address these issues, we must remember that Medicare does not stand alone. It is an integral part of a larger health care system, a public/private health care system, as well as the Federal budget.

For this reason, if the Republicans are truly serious about strengthening the Medicare Trust Fund, they must first pass a budget resolution that specifies how they plan to balance the budget and pay for their proposed tax cuts. They must decide whether they want to pursue the reported $300 billion in Medicare cuts over 7 years, the largest cut in Medicare in American history to pay for a 7 year, $345 billion tax cut that goes predominantly to the well to do Americans, and they must acknowledge that the only way to resolve the problem surrounding Medicare is within the context of health care reform.

The administration looks forward to working with the Congress to develop lasting solutions to Medicare's fiscal problems, to reaching for a horizon in which all Americans enjoy long term health security.

Thank you and I would be happy to answer any questions you may have.

[The prepared statement follows:]

STATEMENT OF DONNA E. SHALALA
SECRETARY OF HEALTH AND HUMAN SERVICES

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

Thank you for the opportunity to testify before you on the Hospital Insurance (HI) and Supplementary Medical Insurance (SMI) trust funds.

As you know, my fellow Medicare trustees and I recently reported that the HI trust fund will be depleted in 2002. While the HI trust fund financial balance is a significant problem and deserves our serious attention, let me also remind you that (1) this is not a new problem and (2) the projected life of the trust fund has been extended for three years since 1993.

Due to the actions taken in the Omnibus Budget Reconciliation Act of 1993 (OBRA 93) and a stronger-than-expected economy in 1994, Trust Fund depletion has been delayed from 1999 to 2002. Even with these improvements, however, the Trustees continue to foresee financial problems in the future for the HI Trust Fund.

As I noted, the Trustee's trends and projections have occurred before and are not surprising. In the course of the past 15 years, the Trustees have predicted near-term financial problems for the trust funds and recommended that Congress take action to slow the growth of Medicare spending to assure trust fund solvency. While we have worked with Congress to improve the outlook of the trust fund, broader issues of health care cost and access limit how much more we can accomplish through Medicare reductions in growth alone.

We are concerned solutions focused solely on Medicare would severely strain many of our fragile health care delivery systems in rural and inner-city communities and could result in cost shifting to small businesses and individuals. We must therefore consider this issue in the context of health reform.

Today, I will focus primarily on the solvency of the HI trust fund. Although the Trustees Report addresses cost growth in both the HI and the SMI trust funds, the issue of greatest concern is the HI trust fund's solvency. I look forward to working with Congress to strengthen the Medicare program in the context of broader reforms to assure that Medicare remains stable now and in the future.

Description and Background Information on the Trust Funds.

Let me begin by describing the HI trust fund and the services it supports for Medicare beneficiaries. The HI Trust Fund primarily pays for inpatient hospital care, but it also covers expenditures for home health services, skilled nursing care, and hospice care. In 1994, the HI Trust Fund paid for $104.5 billion in services for 32 million aged and 4 million disabled beneficiaries.

The HI Trust Fund is financed primarily by payroll taxes. Employees contribute 1.45 percent of wages, and there is a matching contribution by employers. Self-employed individuals contribute 2.9 percent of self employment income. OBRA 93 removed the ceiling on the amount of earnings that are taxable; consequently, this tax applies to all earnings. The Trust Fund also receives income from interest earnings on its assets, revenue from taxation of Social Security benefits, and from miscellaneous sources.

Trust Fund expenditures are projected to rise more rapidly than Trust Fund revenues. Anticipated increases in the number and complexity of medical services are expected to continue to increase expenditure growth rates. Driving the expected

imbalance between expenditures and revenues is the demographic shift that will occur with the aging of the baby boom generation. A larger percentage of our population will be eligible for Medicare, and a correspondingly smaller percentage will be paying the taxes that support the Trust Fund.

What does this mean? The 1995 HI Trustees Report projects roughly another 7 years of solvency. The fund is exhausted in 2002. Over the 75 year long-range projection period, the income as a percent of taxable payroll remains relatively level while the cost rate rises steadily.

These are well-understood trends; there is nothing new in this most recent Trustees Report. Over the past 15 years, the Trustees have projected the date of insolvency to be anywhere from 1987 to 2005, and each year they recommend that Congress take action to protect the fund. As I noted earlier, in part due to provisions in OBRA 93, Trust Fund depletion has been delayed to 2002.

OBRA 93 eliminated the maximum earnings cap for the HI program, so that the HI tax now applies to all earnings. It also achieved $55 billion in savings from the Medicare program, about $30 billion of which came from providers who are paid through the HI Trust Fund. In addition, OBRA 93 increased the maximum proportion of Old-Age, Survivors, and Disability Insurance (OASDI) benefits subject to Federal income taxes from 50 percent to 85 percent, for only those beneficiaries with the highest incomes. Revenues generated by this provision are dedicated solely to the HI Trust Fund. Unfortunately, as part of its Contract with America, the House has voted to repeal the change in the taxation of OASDI benefits. It is ironic that those who are suddenly interested in the plight of the Medicare trust fund have advocated policies that exacerbate the insolvency of the Medicare trust fund.

Effective Solutions Require Broader Health Care Reform

Any significant changes in the Medicare program, whether in the financing, eligibility, benefit provisions or payment rates, will effect the entire health care system. Therefore, this administration believes that strong action to avoid depletion of the Hospital Insurance Trust Fund should not be undertaken by looking at Medicare alone.

Reductions in payments to providers would have significant effects on providers' overall financial condition. This is especially true for providers whose patients are predominantly Medicare beneficiaries or providers who also treat uninsured persons, whether located in inner cities or rural areas.

- Large reductions in Medicare payments would have a devastating effect on a significant number of urban safety-net hospitals. These hospitals already are bearing a disproportionate share of the nation's growing burden of uncompensated care.

  - For large urban public hospitals, which are heavily used by Medicaid and self-pay patients, Medicare is an important source of adequate payment. According to the 1994 Special Report of the National Association of Public Hospitals, while Medicare in 1991 was the payer for only 11 percent of discharges in these institutions, it accounted for almost 20 percent of net operating revenues.

  - For these hospitals on average, in 1991 Medicare accounted for a bigger share of net operating revenues than private payers.

- Large reductions in Medicare payments could also endanger rural hospitals.

  - Nearly 10 million Medicare beneficiaries (25 percent of the total) live in rural America where there is often only a single hospital in their county. These rural hospitals tend to be small and to serve primarily Medicare patients.

  - Significant reductions in Medicare revenues will cause many of these hospitals, which already are in financial distress, to close or to turn to local taxpayers to increase what are often substantial local subsidies.

  - Rural residents are more likely than urban residents to be uninsured. As a result, offsetting the effects of Medicare cuts by shifting costs to private payers is more difficult for small rural hospitals.

  - Rural hospitals are often the largest employer in their communities; closing these hospitals will result in job loss and physicians leaving these communities.

Other providers may shift their costs onto payers who do not have the market power to negotiate advantageous rates. This means that ultimately many small businesses and individuals -- those Americans who are already paying the highest health insurance premiums in the nation -- will shoulder an even larger share of health care costs.

Large reductions in Medicare reimbursements to providers could also hurt beneficiaries. Significantly cutting payment rates to providers might restrict access for beneficiaries as providers would be less willing to provide services to them. Further, low income beneficiaries would be the hardest hit. According to AARP, out-of-pocket health costs represent 21 percent of income for those over 65 years. In addition, over 75 percent of Medicare beneficiaries have incomes below $25,000. Medicare reductions could increase the cost burden of the nation's most vulnerable elderly -- the low-income. Such increases become the equivalent of reducing their Social Security.

Attempts to restore the solvency of the trust fund cannot undermine Medicare's commitment to access to care for elderly persons. We should take care that any efforts to extend the solvency of the trust fund do not put Medicare beneficiaries at undue risk, but at the same time protect the program for them in the future.

Only through focusing on the entire health system will we be able to address issues within Medicare and preserve access for Medicare beneficiaries and underserved populations.

The Administration takes seriously its responsibility to current and future Medicare beneficiaries to insure the solvency of the trust fund. The Health Care Financing Administration (HCFA) continues to make many program changes to improve the efficiency of the Medicare system. For example, hospital prospective payment has contributed to slowing the increase in Medicare expenditures for hospital services. As a result, on a per enrollee basis, Medicare grew at a slower rate than the private sector between 1984 and 1991 -- 7.7 percent compared to the private sector's 9.8 percent.

As we address these issues, we must remember that Medicare does not stand alone. It is an integral part of a larger health care system, and its solvency should be addressed only in the context of that larger system. Broader health care reform will occur only if we work on a bipartisan basis. The Administration looks forward to working with the Congress to develop lasting solutions to Medicare's fiscal problems.

Chairman ARCHER. Thank you, Madam Secretary. And I must say, I am not surprised at your presentation. It has the tone of a very appealing political ring to it. We could go into a long debate about comprehensive health reform, which you mention is the answer to Medicare problems, but the American people turned thumbs down on your plan for the Federal Government to take over the entire health care system in this country in the last Congress.

I think it should be clear to you and to the President that, that is not going to occur again in this Congress. Therefore, we are confronted directly with the problems of the Medicare Trust Fund, which will begin to run short of money next year and according to your trustees' report, will go broke in 2002.

Isn't that your interpretation of your actuary's same conclusion to the trustees' 1995 report where he states, "although the assumptions used are reasonable, much of the available evidence suggests that they may not be optimal. In particular, the likelihood of a future result that is more adverse than the intermediate projection may exceed the likelihood of a more favorable result. Similarly, an outcome more adverse than the high cost projection may be more probable than one that is better than the low cost projection."

In other words, you are more likely to err on the losing side rather than on the gain side. The crisis we face could happen before 7 years are up, and that is very troubling to me. It tells me that we need to act soon to respond to this threat, to the insurance coverage retired Americans and the disabled now depend on, and workers paying payroll taxes rightfully expect that they will get the benefits when they retire. Clearly, we must assure the American people a solvent Medicare now.

What solvency test do you think the HI Trust Fund should meet in 10, 25, or 75 years, and what approach do you think we should take to insure solvency? Should taxes be raised or should spending growth be curbed?

Secretary SHALALA. Mr. Chairman, we have made it very clear that we believe that, number one, the problems of the Medicare Trust Fund cannot be solved by simply looking at the Medicare Trust Fund, because anything we do to the current Medicare Program has implications for the rest of the American health care system, because the public part is such an important part of that system.

Second, the President in his letter to the Speaker, has made it very clear that we believe that you ought to put a detailed budget on the table to tell us how you intend to keep your promise to balance the budget and to provide a large tax cut for the well-off and to explain to the American people that you are not slashing Medicare to pay for those tax cuts.

Obviously, we are prepared to sit down in a bipartisan manner, but only after we have seen the budget proposals of the current majority, and only in the context of larger health care reform because we do not believe that the Medicare problem can be solved by simply narrowly looking at Medicare.

Chairman ARCHER. You, in effect, are telling this Committee that you will have no proposal to solve the Medicare Trust Fund shortage, which will bankrupt the system by 2002 or earlier according

to your own actuary and your trustees' report, short of the Federal Government taking over the entire health care system of this country, which you know is not going to happen, and you are holding Medicare and the payment of Medicare bills hostage to a Federal takeover comprehensively of the entire health care system in this country.

That is what I hear you saying, Madam Secretary.

Secretary SHALALA. Mr. Chairman, I am saying exactly the opposite. I am saying that any sophisticated understanding of the American health care system recognizes that it is heavily a private system with a strong public participation, and that it is not possible to squeeze down on the public part of that system without spilling over into the private part, and therefore, we have to look at the entire system, not a takeover. The President made clear in his letter to the Congress in December, and he has said it repeatedly, that it is necessary for us to talk about a whole set of health care reforms, the first steps, incremental approaches, but that we cannot simply expect the Medicare beneficiaries and the providers to absorb radical cuts in the system without it having an effect on the private sector, and that must be part of the discussion.

Chairman ARCHER. Well, Madam Secretary, you and our colleague, Mr. Stark, continue to want to talk about the budget. We are here today to talk about saving the Medicare Part A Trust Fund and what it will take to do that. Now, that is what we are talking about. That is the focus of this Committee today, and you can obfuscate it with political sort of comments, but the reality is that we have got to do something about this. We are prepared to do it. We would like the President, as leader of this country, to give us a specific proposal that we can look at. We would like for Mr. Stark to give us a specific proposal that we can look at.

I am curious inasmuch as you think that the overall comprehensive dictated reform of the health care system by the Federal Government is the only way we can answer Medicare, whether or not you supported the Stark bill that was before this Committee and voted out by the Democrats last year.

Is it fair to say that the administration supported that bill?

Secretary SHALALA. The administration supported its own health care reform bill, and the point that I am making, if I might repeat it, is that it is not possible, as we learned last year and the year before, to squeeze down on the public system without it having enormous implications on the private system, and that independent recommendations to strengthen the Medicare Trust Fund can only have marginal impact.

This administration, since OBRA 1993, has actually extended the number of years to improve the solvency of the Medicare Trust Fund and our whole approach has been to protect and to improve the HI Trust Fund in a series of actions related to the deficit, investments in the trust fund, and our own strong innovative approaches to improve the quality of the Medicare Program. To reduce the baseline of the Medicare Program, and to see this independently of the private health care system would be wrong and dangerous in our judgment.

Chairman ARCHER. Yes, ma'am. You have repeated that now three times and I am sure we will hear it many, many more times

by members of the administration and by our Democrat colleagues up here, but the reality is that irrespective of what has happened in the past, we have a big problem today. Your trustees' report shows that.

It is probably bigger, based on the actuarial statement that I just read, than the trustees' report even admits. We have the responsibility to do something about that, not talk about what we did in the past or the budget, but to talk about Medicare, and I, for the life of me, do not understand how reducing payments to the medical profession in the area that is not under Medicare is going to help you save money under Medicare. If you reduce the income flow on this comprehensive program that you proposed last year, then you certainly are going to off-load more responsibilities if you are going to keep hospitals open and doctors functioning from the Medicare standpoint.

The reality is that the bill that was presented to our Committee and voted out of our Committee in the last Congress, which was primarily conceived by our colleague, Mr. Stark, was supported by your administration, people who sat right at that desk, and that bill took $490 billion in the next 5 years out of Medicare and Medicaid, $490 billion of cuts out of Medicare and Medicaid endorsed by your administration.

Clearly comprehensive reform, as you see it, is not going to remove the slashing of Medicare and Medicaid, as evidenced by the bill you endorsed.

We need to focus on the fact that the HI Part A Trust Fund is going to go broke by 2002 or earlier and do something about it to assure the senior citizens and working Americans that we have measured up to our responsibility.

I yield to the minority ranking member, Mr. Gibbons, for questions.

Mr. GIBBONS. Well, thank you, Mr. Chairman. First of all, let me say that if anybody can make any suggestions as to how to improve Medicare, its services and its cost, I am willing to listen. I do not get panicky about any trustees' report. I think I have heard every trustees' report brought before this Committee since 1965 and I was here on—in Congress in 1965 and I think I am the only Member here who voted for the program in 1965.

There has been a constant stream of people appearing on this Committee and before this Committee predicting that Medicare was going out of existence, never would work, and I just am not impressed by that. I know there is a profession of people that make a good living around Washington telling you that everything is going busted and going broke, but as I look at the Medicare Trust Fund, it is about as sound as it has ever been and I believe it will remain sound and I believe that any changes that must be made are minor changes. I just do not hit the panic button when we begin to talk about this.

I want to say that when I first came on the Committee, there were some changes we had to make in the Medicare Trust Fund. We simply did not change the overall rate of taxation for Medicare and Medicaid; we simply shifted some of the Medicare money into the Medicaid system and it made the system completely sound and it did not disrupt the Social Security system. All those options are

available today and I think if anybody has any proposals, I would be glad to listen to them and thoughtfully try to think them out.

Chairman Archer, as I recall, the health care reform program that we presented last year would have reduced Medicare expenditures over a 7-year period by the tune of $168 billion. That is a large amount of money, but not real large when you compare it to the overall size of the program.

I do not think we want to get Medicare and Medicaid mixed up in this discussion today. Medicaid, as everyone knows, is a low-income program, it is a charity program. Of course, if the health care proposal that we put forward last year had been enacted, we would have saved a lot of money in Medicaid because there would not have been any Medicaid Program left, just about. All of it would have been subsumed in the program we put forward last year. The figure that Democrats proposed to cut out of Medicare last year for the aged was the $168 billion, not $410 billion, as was said here.

Madam Secretary, I looked over your report and I notice you had a chart in the back of it tracing the solvency of the trust fund, and it seemed to me that the solvency of the trust fund and the length of the solvency of the trust fund to a certain extent tracked the U.S. economy. As unemployment goes up, the solvency of the trust fund tends to go down, and vice versa in this picture.

It also seems to me that the solvency of the trust fund tends to follow the projected line of what medical costs, particularly hospital costs, will be in the future. All of us know that the number of days of stay in a hospital paid by Medicaid—Medicare patients, and all patients today, is much less than it was just a few years ago. In fact, as I recall, the average daily residency in hospitals 15 years ago was about 1.3 million a day, and the average daily residency in hospitals today is down to about 750,000 people per day. There has been a substantial drop in the use of hospitals. There has not been the concomitant drop in hospital costs, unfortunately, despite the fact that residencies in hospitals are much shorter than they used to be, even for Medicare patients.

I say again, if anyone has got a proposal about how to improve this program and how to make it more secure, I am open, willing to listen. I do not think the program is in dire danger. I do not think the trustees' report is anything that I haven't heard on this Committee numerous times as trustees have come before us to testify about the condition of the Medicare Trust Fund. I am really mystified by all this scare talk, unless they are just trying to carve more money out of programs for old folks and give it away in tax breaks for people who I do not think particularly deserve it.

If anybody has got a suggestion, I am here to listen and thank you very much, Madam Secretary.

Chairman ARCHER. Mr. Crane.

Mr. CRANE. Thank you, Mr. Chairman.

Madam Secretary, last year you agreed that program expenditures should be slowed and you proposed to reduce the rate of growth by about $118 billion. Do you continue to support those proposals?

Secretary SHALALA. We do. I think the point I was making earlier is that the President believes, when we are talking about looking at the Medicare Program and our need to slow the growth of

the Medicare Program, that it ought to be part of an incremental health care reform discussion because of its implications on the private sector, and continuing the extenders was part of the current budget. We do think that there are things that we can do within the system, but we do not think that these big numbers that have been talked about and asking the Medicare recipients and the providers to take $300 billion in cuts is anything more than a very dangerous approach to this country's commitment to its elderly and disabled.

Mr. CRANE. Madam Secretary, you are talking about the President's proposal, and my question was about that $118 billion recommendation you made last year; Do you especially as a trustee, continue to support that proposition?

Secretary SHALALA. I'm sorry. You are referring to last year's health care reform budget. Let me simply say that we made those proposals within the context of health care reform. What the President has said is that any proposals to slow down the growth of Medicare, such as those that we recommended as part of his own health care reform proposal, ought to be discussed this year within the context of incremental health care reform, some steps that we can take to both slow down the growth, but simultaneously make sure that we have looked at issues like coverage and affordability and quality and choice. While I can't speak specifically to those recommendations, we certainly would consider them as part of a broader discussion of how to strengthen both the trust fund as well as make certain that we maintain a quality health care system, both in the private sector as well as the public sector in this country.

But again, the President this year has made very clear in his letter, we are talking about incremental reforms, taking steps toward what we hope will be a goal of every American having affordable health care available to them.

Mr. CRANE. Madam Secretary, since you as a trustee perhaps know better than anyone the compelling nature of the bankruptcy problem with the Medicare Trust Fund and the real effect of delayed action, can you, first of all, explain why you haven't sent us a plan to address this problem; and second, when might you be sending us a proposal to save the Medicare Program?

Secretary SHALALA. Mr. Crane, what we have said is—and what the chief of staff said very clearly in his letter, is that when your party puts a detailed budget on the table, when you tell us how you intend to keep your promise to balance the budget and to provide a large tax cut for the well-off, when you explain to all of us how you are not slashing Medicare to do that, we are anxious to sit down in a bipartisan way, as long as the context is real health care reform. the first steps toward health care reform, that we want to do it in that context because of the implications for the private sector health care system of making changes in the public health care system.

Mr. CRANE. Well, we have been waiting patiently for specific proposals to address the pending bankruptcy of that program, and we would hope and pray that you as one of the trustees might give us some guidelines since you have a specialized form of expertise. It hasn't been forthcoming to date and I think——

Secretary SHALALA. Congressman Crane, we have waited patiently, expecting on April 15, for the budget resolution to be passed. The President has committed himself to a bipartisan approach to health care reform in this country, to taking the first incremental steps. We expect the HI Trust Fund issue to be part of that discussion, and—but it has to be part of a broader discussion, because of our clear understanding, and this Congress', too, that if you do something on the public side of the system, it has implications for the health care infrastructure, for beneficiaries, for how much they actually get in their Social Security check, and it must be part of a larger discussion.

Mr. CRANE. Well, Madam Secretary, one final point, and this is a quote out of the Hospital Insurance Trustees' Report; "The fact that exhaustion would occur under a broad range of future economic conditions and is expected to occur in the relatively near future indicates the urgency of addressing the health insurance trust fund's financial imbalance." We are counting on input heavily from you and the other experts on the Hospital Insurance Trust Fund.

Thank you.

Secretary SHALALA. I appreciate that, Mr. Crane, and just let me repeat that when we inherited this government in 1990—the date of the trust fund bankruptcy was scheduled for 1991—1999, and everything we have done since then has added years on to protect the solvency of the trust fund. We are committed to that but it must be part of a larger discussion.

Chairman ARCHER. Mr. Thomas will inquire.

Mr. THOMAS. Thank you, Mr. Chairman. You have used the term incremental, Madam Secretary, twice now, in referring to health care reform, and that is real progress. The Ranking Member of the Health Subcommittee talked about our positions in the 103d Congress. The administration's position in the 103d Congress on their comprehensive health care plan basically had three problems with it; I think you will agree. A majority of Republicans were opposed to it. A majority of Democrats were opposed to it, and a majority of the American people were opposed to it.

We can now set aside the 103d Congress. I think we are all in agreement that the American people did not want a government takeover of their health care system and that we are committed to incremental reform.

When I look at the Board of Trustees of the Federal Hospital Insurance Trust Fund, I see six names. Four of them are members appointed by the President; in fact, three of them are secretaries of Cabinet positions. Four of the six trustees are Clinton's leadership team, similarly on the OASI, Old-Age and Survivors Insurance, same Board of Trustees.

In your initial statement, Madam Secretary, you indicated that there were demographic factors which were shaping the trust fund. Isn't it true that the same demographic factors are shaping the OASI Trust Fund, and if both are subject to the demographic factors, why is the insurance fund running out in 2002 and the Social Security Fund seems to be secure to 2030? Is there anything that was done in the Social Security Trust Fund structure that hasn't been done in the, HITF, Health Insurance Trust Fund, structure?

Secretary SHALALA. I am not sure that I shouldn't provide a more comprehensive answer for the record. When we are talking about——

Mr. THOMAS. If you will do that in writing. I have 5 minutes and I have several more questions, but I guess my question was pretty particular. Is there anything that was done in the OASI Trust Fund on demographic factors that hasn't been done in the HITF?

Secretary SHALALA. Let me simply say that the HITF and what we are paying for is the growth of health costs in this country. I made the point that private sector health costs per capita——

Mr. THOMAS. Madam Secretary, what age triggers the HI Trust Fund eligibility?

Secretary SHALALA. Oh, you mean you are talking about the difference between——

Mr. THOMAS. In the HI Trust Fund, when are you eligible to receive benefits from the trust fund?

Secretary SHALALA. At 65.

Mr. THOMAS. Sixty-five. In the OASI Trust Fund, through the year 2030, what is the eligibility?

Secretary SHALALA. We are—I believe, if I remember correctly, that it is a graduated age base, that Congress changed the dates.

Mr. THOMAS. What is the age by 2030 that people are eligible?

Secretary SHALALA. It is 67.

Mr. THOMAS. Sixty-seven. So, there is a different age eligibility in the Social Security Trust Fund as opposed to the Health Insurance Trust Fund. Would you, as a trustee of these trust funds, perhaps recommend that the Health Insurance Fund in the OASI fund be conformed in that regard?

Would that be a suggestion of the trustee?

Secretary SHALALA. It has not been a suggestion of the trustees and let me give you some concerns that we would have about that, and that is that——

Mr. THOMAS. So, that would not be something that you would support?

Secretary SHALALA [continuing]. What that may well do is add to the number of uninsured in this country. As you well know, the number of people, because of the reorganization of companies, that are being pushed out of the insurance market because of what is happening to their jobs is increasing among people 55 and older and we would have some concern that we would add to the number of people who are uninsured in this country.

Mr. THOMAS. Madam Secretary, on page four, you indicate that the trust fund actually increased at a slower rate than the private sector. Interestingly enough, the years you chose were 1984–91. Does this mean then that you have no figures available to you between the years 1992 and today, or was this merely an example of picking a timeframe in which you appeared pretty good? Do you have any 1992–94 figures?

Secretary SHALALA. I do not think we have—what has happened after that, if I remember the numbers correctly, what happens after that is the fundamental point that we are making that public health care per capita growth is not out of line with private health care per capita growth.

Mr. THOMAS. I think you will find if you had used, Madam Secretary, 1992–94 numbers, you would have found an accelerating reduction in the private sector and that, in fact, the public sector was significantly higher percentagewise. I believe you were trying to make your point. The problem is, you stopped in 1991.

Last question.

Secretary SHALALA. Let me, if I might respond to that, Mr. Thomas, let me point out that the longer the period of time, the more accurate the statistics are, and that no one that I know is projecting the down trend in private sector health costs as rapidly as it has been over the last couple of years. I think the general point of private and public sector per capita growth rates being about the same holds.

Mr. THOMAS. Just let me say, in conclusion, Mr. Chairman, that I would take your argument that you are not making partisan statements more seriously if you didn't carefully select years to make your points and have them, in fact, leave the 1992–95 period out. I think that weakens your argument that you are not making partisan statements frankly.

Chairman ARCHER. Mr. Rangel will inquire.

Mr. RANGEL. Thank you, Mr. Chairman.

Madam Secretary, I do not know whether you understand what my Republican friends are saying. They are here waiting for direction from the President of the United States to tell them what to do about repairing the solvency of the Medicare Trust Fund, and they are now frozen like deer in the headlights of cars. They can't move. They are immobilized. I do not know why you are just not getting that.

It is true that they have the votes to do anything they want to do, but they do not want to move now because—well, like the Chairman said, do not we have a plan to give them?

Now, as I recall, the President did have a plan in the last session, but they did not have the majority and I am not going to attribute statements to any of my Republican friends because I am flexible, too, depending on whether I am in the majority. I certainly recall that one of our major leaders on this Committee said, one thing you can depend on is that we are not going to use Medicare to fund any tax cuts. As a matter of fact, he said that "I would prefer to wait to do that in thinking about reform."

Now, I do not think that it is any big surprise that Medicare is just a part of a big health system. In my community, it is the Cadillac of reimbursement for the number of poor people we have. You take a car in and you tell them just to fix the water pump and they will tell you that the water pump is connected with this and connected with that and you know what mechanics do. That is the same thing the hospitals do.

If they want to reduce this massive $780 billion tax cut over 10 years, just reduce it so that our old folks can rely on the trust fund. Is that one vehicle that they might consider? I am not suggesting that the President will tell them how to do everything, but could they not do this on their own?

Secretary SHALALA. They obviously could.

Mr. RANGEL. Let's try another thing.

In the last Congress, when we were the majority, didn't we increase taxes on a lot of folks that were out there in the work market so that we could have this fund at least in better shape than it was before?

Secretary SHALALA. We did, sir, and it was repealed under the Contract With America, which added—which reduced the trust fund by at least 1 year in terms of its solvency.

Mr. RANGEL. Whatever we did in increasing taxes to make the fund more solvent, they decided that they would reduce the taxes and to put it in even more serious jeopardy.

Anything that we have done and they have complained about, it seems like they are doing it and making it worse. Now comes the question as to where do we go from here. If I understood the contract correctly, they told me, and I did believe them then, that they would not even suggest a tax cut to this Committee until they showed us where the savings were going to come from.

I know that a lot of savings came from the poor folks on welfare, because they targeted them even before the campaign. Poor folks have made more than their contribution toward balancing the budget.

They say they have $100 billion that they are going to cut but they won't say what they are going to cut. Could not some of these cuts be related to the same health delivery system that we have to look at the whole picture of when we are talking about health care?

Secretary SHALALA. Yes, sir.

Mr. RANGEL. How the devil can the President give them direction as to how they can repair this part of the health delivery system when they are hiding in the back rooms what they intend to do with the entire health system?

I hope the President has given them a lot of direction in other areas and I hope that they will respond with the enthusiasm that they are waiting now to see how we are going to do this. The way I looked at it is that they raked the increases we have had and deleted that with the contract and then all of a sudden, after 100 days when they cannot perform the contract because it is impossible to do with all the promises they make, now on the 101st day they come to the President of the United States and say, please get us out of this. Give us direction because, after all, you are the President.

I think this is a good beginning for the next hundred days and I hope that they come back to the President of the United States and ask exactly how they are going to pay for the tax cut, how they are going to pay for the nutrition programs, how they are going to cut all of these things that they are cutting and at the same time be able to say that it is a better America.

I really appreciate the humbleness of my colleagues on this Committee because I never thought that they thought the President had any ideas about this. They didn't like what the President presented before, and obviously they read the American people correct because they are hearing the numbers. You got a mandate on that side. I remember when we were talking about——

Chairman ARCHER. The gentleman's time is expired.

Mr. RANGEL. Oh, it has?

Chairman ARCHER. Long time. Long time expired.

Mr. RANGEL. Let me congratulate my majority for recognizing that there is a White House and we will give you something to work on.

Chairman ARCHER. Mr. Shaw.

Mr. SHAW. Thank you. Thank you, Mr. Chairman.

The gentleman from New York always tries to kill us with his levity, and I always enjoy listening to him. I think when you look at something as potentially disastrous as the collapse of Medicare, you have to at some time take a little bit of a break to try to find something that is amusing in what is said.

I would like to take his example of having a water pump broken on the car, and we have invited the administration in to give us their position, and their position is, unless you change the whole engine, we are not going to play. It seems to be that this hearing is rapidly becoming a total waste of time. If we did not ask the administration here to give us their direction, then we would have been severely and justifiably criticized because the President is the leader of this country and the President should definitely be a player.

What you have told us, Madam Secretary, is that unless we take some significant steps forward toward a comprehensive health care plan, you have nothing to tell us. Am I misinterpreting something here, or is that exactly what you have told us?

Secretary SHALALA. It is not what I have said at all, Mr. Shaw, and I have not used the word comprehensive. The point I have made about Medicare——

Mr. SHAW. Incremental. Let's define incremental steps toward health care reform. Would you, in about 30 seconds, just tick off a couple of incremental steps that you feel are necessary in order for you to be a player in this whole thing of trying to salvage Medicare?

Secretary SHALALA. The President has made very clear in his letter in December and in his subsequent comments, and most recently Mr. Panetta made clear in his letter to the Speaker, that we clearly believe that there continues to be a health care crisis in this country, that it is a crisis both of coverage, of affordability——

Mr. SHAW. Excuse me for interrupting. I only have 5 minutes. Would you tell us specifically what incremental steps? I took that out of your testimony on questioning by one of the Members here. You said incremental steps for health care reform. What is your minimum standard of incremental steps that are necessary in order for you to come in and be a player and join with us, as the Chairman has suggested, in a bipartisan way of trying to solve Medicaid?

Secretary SHALALA. We have talked about the necessity to look at insurance reforms, to look at coverage issues, particularly for children. As you well know, the difficulty of moving people from welfare into the work force without health care coverage, we have talked about our concerns about simply taking sharp cuts, the biggest Medicare cuts in American history out of the Medicare system to finance tax cuts is not an adequate way for dealing with the health care crisis in this country.

Mr. SHAW. Can I assume that you do not have an answer to my question? You know, in the last Congress, we had the Democrats controlling the House, the Democrats controlling the White House, the Democrats controlling the Senate. You did not get a vote on your health care plan. It never came up. It was changed in the Subcommittee. It was not even voted on, as I recall, in the Full Committee.

It was never brought to the House floor. In fact, nothing was ever brought to the House floor. When we tried to move welfare reform, we were told that we couldn't do that unless we had comprehensive health care. What in the world do you people do down there? Just waiting on health care? You have got to come forward and give this country some leadership.

I have got a great deal of respect for you, but you are getting some marching orders which are very inconsistent with the talent that you could bring to this Committee.

Secretary SHALALA. Congressman Shaw, we have provided extensive leadership, from OBRA 1993 when we made the major proposals to cut the deficit in this country, to the President's own health care debate when he made it very clear that we could not fix the problems in the public sector health care system without simultaneously talking about some of the needs in the private sector system, particularly those needs for coverage and affordability.

Mr. SHAW. Let me ask you a question. Do you still believe that welfare reform is dependent upon health care reform, that we cannot have welfare reform unless we have health care reform, as the President said last year?

Secretary SHALALA. We still believe that it is difficult to move young mothers from welfare to the workplace without child care and without addressing the health care needs of their children, whether it is through public sector changes or through the private sector reaching out and providing affordable health care to low income folks.

Mr. SHAW. Mr. Chairman, I am absolutely amazed that we are not getting any answers from this particular witness. I had looked forward, as you said in your very nonpartisan opening statement, in reaching out to the Democrats, and then you were answered in a very partisan manner by Mr. Stark, and then the statement of the Secretary in saying that the administration was not going to play ball unless they had comprehensive health care. I think that is an affront to the senior citizens of this country who are depending so vitally on Medicare.

Chairman ARCHER. The gentleman's time has expired.

Mr. Stark.

Mr. STARK. Well, Mr. Chairman, thank you. I guess in the few minutes it would be difficult to educate the Republicans, Madam Secretary, to the complexities of this system which obviously they have been ignoring for 40 years. They didn't need any help when it came to figuring out a tax system, which is arguably pretty complex. They figured out how to give hundreds of billions of dollars to rich people in the first 100 days. They didn't need any help figuring out how to destroy school lunches and lead to more abortions and destroy the welfare system. That they could do in 100 days.

They never asked the White House, I do not think they have asked you for any assistance, did they, Madam Secretary, when they reformed welfare? I do not know as they have needed any assistance, they haven't asked the White House for any help on a budget. All of a sudden they are stumped. They just can't figure Medicare out. That is the problem. I think maybe we ought to send them off to school and we could teach them a few things.

Medicare has been running right well I think for the last 30 years. I think they are in a box, and they won't face up to it. They do not know what to do. They have been lying to the American public about the idea that they can pay for these tax cuts to the rich without hurting anybody, and they want us to do the dirty work. I do not think you should, Madam Secretary. I think you should do just what you are doing and let them stew in their own juice and figure out how this contract will not balance, and will not work. It is going to do nothing but harm seniors the way they have already harmed children in this country. I can understand why the President doesn't want to have any part of it. I would like to yield the balance of my time to Mr. McDermott.

Mr. MCDERMOTT. Thank you, Mr. Stark.

Obviously, it has eluded the attention of the Republican leadership that tax measures start in the House of Representatives, according to the Constitution, and they start in the Ways and Means Committee, and they are supposed to, by law, pass a budget resolution by April 15. We have never come this far into the session without even a proposal laid on the table. All of this weeping and wailing here is a little bit hard to take.

I would like to ask Secretary Shalala, I think you rightly hit the point again and again about universal coverage, you can't control costs, the President made a proposal, but I would like to ask you a specific question.

If Medicare is cut by $250 billion over the next 7 years—let's just take that as an example because I read in the newspaper they are going to take $300 or $400 billion. I do not know. I do not know what they are going to do because they won't put out a resolution and commit themselves. They want the President to run out and throw himself in the street. They trashed him 2 years ago, and now they won't put anything on the table.

But let's say $250 billion are cut. What is the estimate by HCFA, the Health Care Financing Administration, as to the estimated increase in out-of-pocket costs to the American senior citizens by that kind of a cut?

Secretary SHALALA. Well, the best way to translate it would be probably in terms of its impact on people's Social Security check and what it would do is cut the COLA, cost-of-living adjustment, in half between now and 2002. That gives you some impact. For the senior citizens, the thousands that are coming to town this week, an increase in their part B payments, a cut in Medicare that is passed on to them, is, in fact, a cut in their Social Security check, and HCFA has estimated that if that was applied, we were basically talking about them getting half the COLA that they would normally get during that period of time. That is a tremendous impact for millions of Americans.

Mr. McDERMOTT. You are saying that my parents who are living on an $880 a month check, 89 years old and 85, when they get that 3-percent increase, this cut in Medicare is going to cut their COLA in half?

Secretary SHALALA. Yes.

Mr. McDERMOTT. That is basically what is going to happen to every senior citizen in this country?

Secretary SHALALA. Let me—if Medicare was cut by $250 billion over a 7-year period, we are talking about the estimated increase out-of-pocket expenses from about $3,000 to about $3,500.

Mr. McDERMOTT. My parents, who are living on $880 a month, around $10,000, they are going to have an extra $3,000 coming out of their pocket?

Secretary SHALALA. Over a 7-year period.

Mr. McDERMOTT. Oh, I see. It is about $300 a year. If they can't come up with it, where does it come from?

Secretary SHALALA. I do not know. For the senior citizen, it is one pot of money. If they have to pay more for their Medicare, it essentially comes out of their Social Security, and they understand that and that is why, when you talk to senior citizens and to the disabled in this country, they understand the very close relationship between the Medicare Program and the Social Security Program. That is, in fact for them—the part B premium, as you well know, is actually deducted from the Social Security check. So any effort to increase the part B premium as a way of financing the HI Trust Fund would, in fact, actually lower the check that people get.

Mr. McDERMOTT. If we take——

Chairman ARCHER. The gentleman's time has expired.

Mr. McDERMOTT. Thank you.

Chairman ARCHER. Mr. Bunning.

Mr. BUNNING. Ms. Shalala, the President's budget for 1996 that he has presented to the Congress, and your trustees' report, which was written first?

Secretary SHALALA. The President's budget.

Mr. BUNNING. The President's budget was written first and then the trustees' report. There is nothing in the President's budget that addresses this problem that you all reported relating to the shortfall in the Medicare Trust Fund. Is that correct?

Secretary SHALALA. There is nothing in his budget that directly addresses that, though, in OBRA 1993——

Mr. BUNNING. No. Just answer my question.

Secretary SHALALA. No. The President actually wrote a letter saying that, as we were in the process of preparing his budget, we were making it very clear that he expected to deal with the health care issues, including the issues of Medicare and Medicaid, as part of a larger bipartisan discussion with Congress this year.

Mr. BUNNING. He said that in his budget?

Secretary SHALALA. He said that in a letter to Congress.

Mr. BUNNING. Letter to Congress; right.

Secretary SHALALA. In December.

Mr. BUNNING. Did OBRA 1993 not increase taxes by $240-plus billion?

Secretary SHALALA. What OBRA 1993 did was combine cuts in existing programs and some taxes to reduce the deficit over time,

and that had an impact on the HI Trust Fund of increasing the solvency for three more years.

Mr. BUNNING. That is according to the trustees' account. What did the trustees' report say last year, relating to the expected termination or exhaustion of the trust fund?

Secretary SHALALA. We have added a year in the last year.

Mr. BUNNING. One year. That is what I thought, OK.

Do you recommend fixing the Part A Trust Fund solvency problem by increasing payroll taxes?

Secretary SHALALA. We do not.

Mr. BUNNING. You do not. Can you give us an indication of the extent of the cost growth reductions necessary to achieve a 10-year solvency, 15, 20, or just like we did in Social Security, a solvency for 75 years?

Secretary SHALALA. Let me, if you will give me one moment, see whether I have got it with me. I do not believe that I have it with me, but I would be happy to provide it for the record.

I think, Mr. Bunning, the point I want to make back to you is that we are not putting anything specific on the table at this point in time. What we have said very clearly is that we would like to see the detailed Republican budget, see the budget resolution, and that we are committed to dealing with Medicare in the context of a bipartisan discussion about health care reform.

Mr. BUNNING. I have heard that about four times now. We do not need to repeat that since we only have 5 minutes.

Since the Congress, under your control, rejected a comprehensive reform of health care, and since our side of the aisle always was for incremental change in the health care system, there ought to be some mutual ground that we can agree on to achieve that. I would suspect that the President and the administration would come forth with an incremental suggestion. They have not.

Secretary SHALALA. Congressman Bunning, what we have said is to put forward an incremental approach——

Mr. BUNNING. Well, we have attempted to address the problem, too, for 2 years, but we didn't get any cooperation from the administration. They said, you are going to take this or leave it. That is exactly what you said, Ms. Shalala.

Secretary SHALALA. In December, the President sent a letter to Congress, to the congressional leadership, and made it very clear——

Mr. BUNNING. This year. Only after the defeat of the one that was going to be stuffed down our throats.

Secretary SHALALA. Mr. Bunning, the President has committed himself, both in that letter and in his State of the Union Address and his subsequent statements, to sitting down——

Mr. BUNNING. We are not going to hold our seniors hostage to the fact that you failed in passing your health care plan when we have a Medicare problem and we have got to save it. If you do not want to suggest anything, then we are going to do it ourselves without your assistance, and I am not like some of my other colleagues. I think we are very capable of doing it without your assistance. We have asked you to participate. You are refusing to participate.

Secretary SHALALA. We are not refusing to participate, Mr. Bunning.

Mr. BUNNING. You absolutely have refused to participate in your answers to the previous five Members on our side of the aisle.

Secretary SHALALA. Congressman Bunning, we have not refused to participate. We have simply said, put your detailed budget on the table.

Mr. BUNNING. We will do that.

Secretary SHALALA. Get to dealing with the Medicare Trust Fund issue in the context of talking about incremental health care reform and we are prepared to sit down.

Mr. BUNNING. We have heard that four times. We do not need to hear it again.

Chairman ARCHER. The gentleman's time has expired.

Madam Secretary, where in your budget is there a provision to take care of this Medicare crisis?

Secretary SHALALA. Chairman Archer, as you well know, we did not deal with the HI Trust Fund issue in our budget. What the President did say in December in his State of the Union Message and what Chairman—what Chief of Staff Panetta has repeated is after the budget resolution is passed, we are committed to dealing with the HI Trust Fund issue in a bipartisan manner within the context of talking also about the——

Chairman ARCHER. I remember that, but you keep telling this Committee that we have to put a budget forward before you will do anything, but you——

Secretary SHALALA. Mr. Chairman, the law requires that you put a budget forward.

Chairman ARCHER. You put a budget forward yourself that has something to do with saving the HI Trust Fund. Your budget has zero attention to that.

Secretary SHALALA. Our budget was submitted before the trustees' report.

Chairman ARCHER. No. Madam Secretary, we all knew last year, because we had documentation, that the HI Trust Fund was going to go negative in 1996 and was going to go bankrupt in 2002 by the most optimistic actuarial projections. You knew that and we knew it. There was nothing in your budget. You sit here before this Committee today and say you are not going to do anything unless it is in our budget.

Secretary SHALALA. Mr. Chairman, I didn't say that at all. What we said was that we are prepared to sit down in a bipartisan manner after we see the Republican budget that was due, after all, on April 15. We are prepared to deal with the HI issue and to sit down in a bipartisan manner and work through these issues after the budget resolution has been passed.

Chairman ARCHER. Yes, ma'am. You are suggesting then that nothing in our budget resolution should have anything to do with the dire straits of the HI Trust Fund as yours did. Mr. Herger may inquire.

Secretary SHALALA. Mr. Chairman, I am not giving you any advice on your own budget resolution. I am simply saying that once the budget resolution has passed and we see it, we are prepared

to sit down in a bipartisan manner and to discuss the Medicare Trust Fund within the context of incremental health care reform.

Chairman ARCHER. Ms. Secretary, I agree with one of my colleagues. I have a great deal of respect for you, but your marching orders merely become a broken record in response to every question that is being asked.

Mr. Herger may inquire.

Mr. HERGER. Thank you very much, Mr. Chairman.

Madam Secretary, the trustees' report, this report which I have in my hand, the 1995 annual report of the Board of Trustees of the Federal Hospital Insurance Fund, is a Clinton administration document and as a matter of fact, three of the trustees who have signed it are Cabinet secretaries.

Secretary SHALALA. In the same way that in 1992, three of the trustees would have been Bush administration Cabinet secretaries. There is nothing different about trustee reports. They all have Cabinet secretaries as trustees of the system.

Mr. HERGER. That is correct. Let me just continue.

In this report, on which we are meeting here today, the trustees say that Medicare will be broke by 2002. As a matter of fact, by that date, there will be no more money for seniors to receive their health benefits.

Now, even if the budget was in surplus and if health care was perfect, Medicare would still go broke by this report, of which, again, you are a signatory. The issue cannot be ignored, and I guess I have to ask the question, does the administration feel a responsibility to be involved in this process, and if you do, can you come forward now and help us out with some of what your thoughts and what you feel the direction should be.

Secretary SHALALA. Congressman, I have said very clearly that we are prepared to sit down in a bipartisan manner after we see the budget resolution, but let me remind you of what the trustees said about the context in which the HI Trust Fund ought to be reviewed.

They said, "With the magnitude of the projected actuarial deficit in the HI Program and the high probability that the HI Trust Fund will be exhausted in less than 11 years, the trustees urge the Congress to take additional actions designed to control the HI Program costs and to address the projected financial imbalance in both the short range and the long range through specific program legislation as part of broad-based health care reform. The trustees believe that prompt, effective and decisive action is necessary."

Those are both the public, as well as the administration trustees saying that. That is what we are committed to, and all the administration has said is put your detailed budget on the table, commit to dealing with Medicare in the context of health care reform as the trustees recommend, and that we will sit down in a bipartisan manner and work through these issues.

Mr. HERGER. OK. In essence, you are saying to me, as you have said to many of the questioners before, that we are not going to see anything prior to that time. Now, we will have our plan out. I guess what I am asking, is that we would like to also see some leadership, some involvement at this time on an issue which is clearly and certainly, I would say you accept as being the case, one

of the most crucial challenges that we have before the American public today.

Let me now go to your testimony——

Secretary SHALALA. Mr. Herger, this is leadership. This is making it very clear to Congress and to the administration from administrative members as well as public members that the HI Trust Fund must be dealt with both in a short run strategy as well as a long run strategy and pointing out——

Mr. HERGER. But no specifics. No specifics. We are talking in generalities.

Secretary SHALALA. A bipartisan approach to the specifics, and we would like to sit down and do that. We fully expected the budget resolution to be passed by now, as is required by law. As soon as that is done, we are prepared to deal and to discuss the questions of the Medicare Trust Fund within the context of the kind of incremental health care reform that the President has talked about.

Mr. HERGER. Well, again, we will have specifics. As Republicans, we will. It would be nice if during this process, that the President, who is the chief administrator of our Nation, could be involved more so than just generalities, and if we could get some—at least some direction, some specific direction from him.

Thank you, Mr. Chairman.

Mr. THOMAS [presiding]. Mr. Matsui will inquire.

Mr. MATSUI. Thank you very much, Mr. Chairman.

I want to thank you, Madam Secretary, for your testimony today, and I think you are absolutely correct in not suggesting a specific proposal on how to deal with this Medicare problem until the Republicans come up with a budget. Actually, who we should have here today really is Speaker Newt Gingrich, the Republican Leader, mainly because on Friday, he made the observation that any savings from Medicare should be plowed back into the system. I thought, well, then that makes some sense, if you want to plow it back in, you can keep it separate from the budget.

Today I read in Congress Daily A.M. that a Gingrich aide says the Medicare savings won't be put in a lockbox, in other words, kept separate, but it will be made to reduce the deficit. Essentially they are saying that whatever savings we have in the Medicare system will then be used to reduce the deficit, which in turn will pay for the tax cut that goes to basically the very wealthy in America, and other unidentified spending cuts.

Essentially, we need to make sure we see their budget and a budget resolution passed before we fool around with the Medicare system, because we have got a lot of seniors out there who are dependent upon Medicare, and to use their money, their savings, the money they put into the HI Trust over the years to pay for tax cuts for the wealthy would be criminal for the Congress to pursue. Your approach is the right approach.

Second, what you have said in terms of the comprehensive approach—I talk to hospital administrators and my physicians in California all the time and they have said over the last decade, when we made 10 billion dollars' worth of cuts 1 year out of the Medicare system with tinkering—and I understand Mr. Stark had no choice, because that is what the budget resolution always re-

quired, we then put the situation on the private sector through cost shifts. Anybody elementary can figure that out if they understood the health care system.

All we will be doing is cost shifting $50 billion a year onto the private sector, thereby increasing premiums. You need a comprehensive approach. You can't do this piecemeal. We are not talking about little tubes that go into engines. We are talking about the engine itself.

Let me just make another observation. I think it is very important. I noticed panic on the other side of the aisle. I have never seen quite the panic the first hundred days. We are seeing it now.

I do not think the panic is because of the Medicare Trust Fund. I think it is because all of a sudden, with those individual bills they passed over the last hundred days, they can't balance the budget. They got a $640 billion tax cut. They, at the same time, won't make cuts in domestic programs, even though the Budget Committee chair almost every week comes up with another illustration of where he is going to cut $100 billion out of discretionary programs, but we know he is not going to be able to do it because they won't do it.

They won't do it on agriculture subsidies, they won't do it on anything that they want to protect in their own program. They are going to have to use Medicare in order to balance the Federal budget, and we are not going to let them do that without the American public knowing it.

Let me make this observation in terms of all this. If, in fact, we make these cuts and we do this, whatever amount of money they are looking at here, you indicated that we are basically going to be cutting back on the overall lifestyle of the average senior citizen. Now, what did you say that was, $3,500 over 10 years or do you have the actual statistics?

Secretary SHALALA. No. The actual numbers, $250 billion over 7 years would increase out-of-pocket costs 30—about $3,000 to $3,500 over 7 years.

Mr. MATSUI. OK. Now, let me also make one final comment because my time is running out here. Under this report, and I do not think this has been brought up yet, under this report, you are basically saying that the Medicare Trust Fund has an extra year, right? An extra year before it goes insolvent. Instead of 2001, it is 2002?

Secretary SHALALA. Right.

Mr. MATSUI. Now, I do not understand why the Members on the other side of the aisle, when it was 2001, didn't panic out then. Why didn't you panic out last year when we were trying to do comprehensive health care reform? That is what I can't understand. You are sure of that? In other words, we have gained an extra year on solvency through this report and through what we have done over the last year; is that correct?

Secretary SHALALA. Yes, but that would be lost if the tax cuts that the Republicans have proposed takes effect.

Mr. MATSUI. Exactly. But the panic should have been last year, because we gained some time; is that correct?

Secretary SHALALA. Well, that is correct, and as I pointed out, the year was 1999 when we came into the administration, which

means the previous administration, the previous trustees had some serious problems with the trust fund then.

Mr. MATSUI. I think we are seeing panic now because they can't balance the Federal budget with these tax cuts and they want to take it out on the backs of seniors.

Thank you.

Mr. THOMAS. The gentleman's time has expired.

Mr. Hancock.

Mr. HANCOCK. Thank you, Mr. Chairman.

You know, I do not know that what we are asking for is impossible from the President and from our Democrat colleagues. For 40 years, their solution to every problem was to raise taxes. Now, they are in a situation where they can't raise taxes and they do not know what to do. They cannot come up with any ideas about how we can live within the existing budgets.

I just wonder, they talk about us being in a panic. We are not in a panic. We are trying to do what the American people said they wanted done. They said we want to get government under control and we do not want any tax increases.

Now, the mentality of the Democratic party cuts them completely out of the circle because the only way they know how to solve any problem is to raise taxes, and I think we are asking the Democrats, including the President, for an impossible task. It is totally foreign to their thinking to try to solve any problem without spending more government money and raising taxes on the American people.

Now, would it be improper for me to suggest that the administration put itself in the frame of mind that we need to come up with suggestions to live within the present income as ways to solve the problem? It would appear to me that you are positioning yourself to ask for another tax increase, and the only thing you know to suggest is another tax increase.

Now, surely, surely there is enough brain power in this country that we can address this problem without going back to the Democrats' old tried and true method, we have got to have more money, we have got to start and create class warfare. We are going to give money to the rich and take it away from the poor. I mean, let's try to do like everybody in their own budget—that every businessman has to do when you have got a limited income, then you start trying to address the solutions other than saying, well, I am just going to go out and borrow more money and I am going to raise taxes. Is that impossible to ask you all to think in that vein a little bit?

Secretary SHALALA. Congressman Hancock, as far as I know, none of us have recommended additional tax cuts.

Mr. HANCOCK. I am aware of that. But, your refusal to try to solve it within the present tax structure is sure putting us on the road to saying, we have got to raise taxes. That is what you did in 1993.

Secretary SHALALA. All we have suggested is a tax cut for the well-off on the backs of the elderly and the disabled. This is not what is acceptable to this administration. The biggest Medicare cut in American history as a way to finance a huge tax cut for the well-off is not a way of keeping our contract with the elderly in this country.

Mr. HANCOCK. Would you recommend some tax increases on the well-off then?

Secretary SHALALA. I have not suggested that. I have simply said, let's see your detailed budget. Tell us how you intend to keep your promise to balance the budget, and to pay for tax cuts for the wealthy.

Mr. HANCOCK. We are going to balance the budget and we will do it without the administration, if necessary. We would like to ask them to cooperate. We would like to ask them to get this idea out of their head that you have got to have more money.

That is the only thing they can think about. In fact, let's go back to Harry Truman of the State of Missouri. He talked about the "do nothing" Congress. Well, I think we ought to be talking about the "do nothing" presidency. The only thing that Bill Clinton can do is attempt to put us in a position where we are going to have to raise taxes, and that is exactly opposite of what the American public, including the senior citizens of this country, want done. They know that those methods have gotten us into this position in the first place and it is time we address it based on the existing tax that we have got set up now and we can do it if, in fact, we get some cooperation.

Mr. THOMAS. Gentleman's time has expired.

Madam Secretary, a number has been repeated a couple of times and I just want to make sure, as we go through this, that we try to at least remain as accurate as possible in terms of numbers. The repeal of the phase-in on taking Social Security taxes and funding HI unprecedentedly, according to Joint Tax, was $15.6 billion over 5 years. Is that a figure that the administration agrees with?

Secretary SHALALA. I simply will have to provide that for the record, which I will, sir.

[The information was not available at the time of printing.]

Mr. THOMAS. Well, it is in relation to the statement the Secretary has made several times, that removing this unprecedented tax shift would reduce the solvency of the fund by 1 year, and Joint Tax has indicated that the cost of this will be a $15.6 billion cost over 5 years. When in 2000, the shortfall in the HI Fund alone, in just that 1 year, will be more than $35 billion.

The funding of this over 5 years is less than one-half of the cost of the shortfall in even just 1 year. I am concerned that the Secretary, in continuing to repeat the statement that it shortfalls for 1 year, perhaps is not accurate according to the numbers.

Secretary SHALALA. We are probably—I have to determine whether you are using CBO numbers versus Joint Tax.

Mr. THOMAS. Using the Joint Tax number.

Secretary SHALALA. Which we will review, sir, and provide for the record.

Mr. THOMAS. Although it seems a little ludicrous to the American people, I am sure our arguing over several months shifting into another fiscal year as to whether or not any change saved is 1 year or not, they are looking at ultimate solvency, but I do want us to be accurate.

Secretary SHALALA. The CBO numbers that we were using is 26 over 5 and 87 over 10.

Mr. THOMAS. Over five, that still is equal to less than the shortfall in 1 year of that 5-year period. Once again, it is a little incredulous that the dollar amount would extend it 1 year when, in fact, in 1 year the shortfall is $35 billion.

Gentlewoman from Connecticut's time is available.

Mrs. KENNELLY. Thank you, Mr. Chairman.

Thank you, Madam Secretary, for being with us this morning and I understand this is tedious, this testimony, because we are talking about a very difficult subject. I have been hearing all morning that this task is impossible, that the administration finds it impossible to go forward with addressing this program. That is not true. It is also not true that this Committee has found it impossible.

You, in your testimony, highlight very definitely what happened in OBRA 1993, the Budget Act, where in fact a very difficult vote was taken by this Committee to, in fact, help us get an additional 3 years in the HI Medicare Fund. That did happen. That is a fact. It was voted on in this Committee and a number of these Members, myself included, made that tough vote. It is not impossible, but it will be difficult.

I would like to go on to the next year, 1994, which again illustrates why this is not going to be easy. All of us know it is not going to be easy because we have been there.

In 1994, this very Committee voted on comprehensive health care reform. Once again, a very difficult vote, and in that vote, for those that voted for those changes and those improvements, everyone didn't agree on everything, there was a lot of angst to try to get there, but the majority of the Committee felt the status quo in the health care world is unacceptable.

In that comprehensive health care legislation that we addressed in this Committee, which is history, $168 billion in Medicare cuts were voted on. I just want to say to this Committee, we have always had a history of being able to take the hard choices and do something about it, and I certainly would hope at the end of the day, that this Committee can once again address the needs of the elderly citizens and future elderly in this country, that the Medicare Program has worked and it is up to us to do something about protecting it for the future. Let the facts stand that difficult decisions have been made in the past and only difficult decisions that are very unpopular will have to be made in the future.

What we are trying to do this morning is try to make sure that the difficult decisions we make do not go for tax cuts; that they go to help the Medicare Program. That is what all this talk is about. We are going to have to put up with each other until that is made very clear. Where the changes will come from and where they will go, to pay for what. That is what we are talking about.

Let's talk about a couple of those changes that were in fact made, Madam Secretary. In 1993, you came here and presented the idea that we do change the tax on Social Security for some people who had an income of a certain amount, and that change would go in the trust fund.

History was made again, just recently, when we passed a tax bill on the floor of the House that changed that back to 1993 and those dollars will not go into the trust fund and therefore we won't have

that money to bankruptcy that year off. Madam Secretary, as you just mentioned yourself, this passed the House. It is now before the Senate.

Is it the intention of the administration to try to convince the Senators that in their wisdom they should not have this tax cut—or excuse me, that they should not renege on this change and that they should leave it the way it is now so at least we will have a little more breathing room before we get to that horrible year of bankruptcy?

Secretary SHALALA. It is, Congresswoman. It is our intention.

Mrs. KENNELLY. I hope you are successful because I think the people I have talked to at home would much prefer that the program remain solvent rather than some get a better deal, though they found it hard, and every one of us heard from our constituents about that change.

Let me ask you about another possible change so we are not just at each other. In the report, your group, the trustees, recommended that the quadrennial advisory council be reinstated. Now, we have been hearing talk about the possibility of a commission, as happened in 1983 for the reform of Social Security. Would this commission—would this quadrennial advisory council be like a commission, or would you—any possibility you would want a commission to look at this as they did in 1983 for Social Security?

Secretary SHALALA. The trustees recognize that in the creation of the new independent Social Security Agency, we did not put in language to keep a quadrennial advisory Committee for the Medicare Trust Fund. In fact, it moved over to Social Security and became the advisory Committee to Social Security. We were simply asking for the reinstatement as another vehicle.

We believe that that advisory Committee, within the context of what the trustees have recommended, and that is we look at some health care reform as we discuss the HI Trust Fund issues, that that certainly would be important. It is a reinstatement, though, is the point that I should make, as opposed to something new that has not been there before.

Mrs. KENNELLY. Thank you——

Mr. THOMAS. The gentlewoman's time has expired.

Mrs. KENNELLY. Thank you. You will be back here and we will be here, and when the initial dancing is over, we are all going to have to come together to figure out how to save this program and I look forward to working with you.

Secretary SHALALA. Thank you.

Mr. THOMAS. In using terms like the biggest cut in history to balance it on the backs of seniors and disabled, isn't it true, Madam Secretary, that the 1993 budget made the largest program cut in the history of the trust fund? Is that true?

Secretary SHALALA. I am certain that there is no comparison between those steps and the kinds of steps that are being talked about in terms of the Medicare Program.

Mr. THOMAS. The largest program cut in the history of Medicare was made in the 1993 Budget Act. President Clinton attempted to balance the budget on the backs of seniors and the disabled, if we use your phraseology, Madam Secretary.

The gentleman from Wisconsin, Mr. Ramstad.

Mr. RAMSTAD. Thank you, Mr. Chairman.

Mr. Chairman, I think your point is well taken. I wish we could get away from this hyperbolic rhetoric and roll up our sleeves and work together in a bipartisan, pragmatic way to deal with this Medicare crisis, and it is a crisis, as your own trustees have pointed out to us.

Madam Secretary, in that spirit, I would like to ask you a series of questions for which I believe there is a yes or no answer. I am just trying to get at what, if anything, the administration has considered in terms of solving this crisis.

My first question, has the administration considered means testing higher income seniors as a way to reduce Medicare costs?

Secretary SHALALA. Congressman, I am not prepared to discuss what would be part of a broader discussion in terms of how we would reinforce the HI Trust Fund, make changes that would improve affordability and coverage and quality and choice as part of our discussions of insurance reforms, and I am not prepared to answer yes or no questions about very specific narrow changes that some may well want to consider as an indication of what we would put on the table.

Mr. RAMSTAD. Madam Secretary, what point in time will you be willing to discuss the administration's proposal?

Secretary SHALALA. Put your detailed budget on the table, sit down with us in a bipartisan manner, and right after that——

Mr. RAMSTAD. I think I am asking a very legitimate, straightforward question. Has the administration considered, as a way to solve this Medicare crisis, means testing?

Secretary SHALALA. The administration is not going to answer specific questions, and we have repeated that 75 percent of all of the Medicare recipients in this country have incomes under $25,000 a year. Eighty-three percent of our expenditures for Medicare recipients are for those with incomes under $25,000 a year. I do not know what we are talking about.

Mr. RAMSTAD. Madam Secretary, if I may, I only——

Secretary SHALALA. We are not talking about means testing because we are talking about a poverty population. To be old in America is not to have very much money, and I think that to have a reasonable discussion in a bipartisan manner, put your budget on the table and we are prepared to sit down and to talk about the Medicare Program, insurance reforms, what kinds of implications that has for the private sector. We obviously want to reduce the amount of cost shifting that goes to individuals who pay for private health insurance, but I will not answer detailed questions about what will be part of that discussion.

Mr. RAMSTAD. Madam Secretary, I thought that was the purpose of this hearing, to air not only the problem—we all know the problem. We know Medicare is going to be bankrupt by 2002. You, as the trustee, told us that previously. We want to try to deal with some solutions. Again, in a bipartisan, pragmatic spirit, may I ask the question, has the administration considered giving Medicare recipients incentives to participate in managed care plans? That is a very straightforward question. Have they considered that?

Secretary SHALALA. This administration has expanded access to managed care more than any previous administration, and both in

Medicaid and in Medicare, people are moving rapidly to managed care. In Medicare alone, at a rate of 1.5 percent a month. Individual plans are offering incentives for people to move in. In some cases, they are being taken. In other cases, they are not.

We are preserving choice. We are committed to choice, but simultaneously, we believe that the choices that Medicare recipients have ought to be expanded. We have already announced that we are discussing, in addition to the HMO range that are available—and 75 percent of all Medicare recipients now have access to HMOs, point of service options, PPOs.

Mr. RAMSTAD. Madam Secretary, is it your plan to deal with this problem with increased incentives?

Secretary SHALALA. There is—let me simply say this. It could be——

Mr. RAMSTAD. My time is almost up. I have two more important questions.

Does the administration support vouchers for seniors to purchase private health care insurance, again, as a way to move more seniors into private health care plans to avert the Medicare bankruptcy?

Secretary SHALALA. Mr. Ramstad, I am not sure I can answer that question as quickly as you would like. We have deep concerns about proposals that we have seen for vouchers.

Essentially what you are saying is that 37 million people, most of whom have preexisting conditions by the nature of their age, be tossed into the individual insurance market in this country to sink or swim, and I think that most of us, including the market itself, would have some deep concerns about whether they could be absorbed as such. We have made a commitment to a benefit package, to a series of benefits.

Mr. RAMSTAD. Madam Secretary, we have heard that, please. I'm sorry. I do not mean to be rude at all, but the time is obviously waning.

Mr. THOMAS. The gentleman's time has expired.

Mr. Zimmer.

Mr. RAMSTAD. I would have asked about medical savings accounts, but we will save that for another day.

Thank you.

Secretary SHALALA. I think I am on the record about that one, too, Mr. Ramstad.

Mr. ZIMMER. Thank you, Mr. Chairman.

Whether we like it or not, for the next—for the better part of the next 2 years, this country is going to be governed by a Republican Congress and a Democratic President, and we really have to try to figure out how we can try to work together. This relationship is beginning to remind me of a bad marriage. As with a lot of bad marriages, the problem is one of communication.

Secretary SHALALA. Where do I get a divorce?

Go ahead, Congressman Zimmer. I apologize.

Mr. ZIMMER. The administration says it is asking for a bipartisan dialog, but it won't start the dialog, and you are saying that you will talk to us when we do certain things first, and I just do not understand why we can't talk about the trust fund before you see the final Republican budget, and I do not understand why we can't

talk about the trust fund without a discussion of some unspecified health care reform, that you won't get into. The administration has punted on the issue of the budget. It has not fulfilled its own promise to half the deficit, let alone eliminating the deficit and in the budget, it doesn't deal at all with the HI problem, and the administration has punted at least in this session on the issue of health care reform, incremental or comprehensive, by not proposing specific ideas.

If, as somebody said on the other side of the aisle, the intent is to have Republicans stew in our own juices, that may be a politically desirable objective from your point of view, but it certainly doesn't help deal with what is a major and pressing problem.

I just want to express my dismay at this situation and I won't try to ask the same questions that have been asked over and over again because I would anticipate getting the same canned response, but let me just ask you, Madam Secretary, whether you agree with a couple of the statements that were made by some of the Democratic Members of this Committee.

The Ranking Democrat, Mr. Gibbons, said that the cuts that were proposed as part of the administration's health care reform program last year, $168 billion, "were not real large in the context of the entire program." Do you agree that 168 billion dollars' worth of cuts aren't real large?

Secretary SHALALA. Only if you continue the sentence in the context of the program.

Mr. ZIMMER. I did.

Secretary SHALALA. That was a comprehensive health care reform proposal which balanced off some of the cuts, or slowing down the growth of the Medicare Program with slowing down the growth in the private sector at the same time. All we have said is that the context for dealing with the HI Trust Fund, with Medicare and Medicaid, must be the broader context of the entire health care system, because what we do not want to do is to create terrible problems for the private health care system because of what we do with the public health system.

Mr. ZIMMER. Then that leads me to something that Mr. McDermott said. He said, without universal coverage, you can't control costs. Do you agree with that statement?

Secretary SHALALA. Yes. The point that Dr. McDermott was making is that large numbers of people without insurance are both putting off health care, which means that when they do finally go to the doctor, they are sicker, or using the most expensive parts of the health care system, the emergency rooms. Until we can get everybody into some kind of insurance, it will be very difficult for us to control overall spending in this country.

It means that we cost shift to cover some of that, as we—and one of the difficulties that rural hospitals have in America is they are very dependent upon Medicare because they are the payer and that Medicare money helps them to pay for the uninsured at the same time. The large public hospitals have the same kind of problem. That coverage is important as part of the equation.

The President has made it very clear that he fully understands that we are not going to again take on a comprehensive approach, but incremental discussions that include coverage as one of the

things on the table is absolutely critical to trying to control health care costs in this country.

Mr. ZIMMER. You do not think we can control costs even within Medicare without making major—without starting on the way to universal coverage with the anticipated objective of getting to universal coverage.

Secretary SHALALA. What we have said is that taking large cuts in the Medicare Program will simply cost shift and put at risk both the rural health infrastructure in this country——

Mr. ZIMMER. Could you answer my question yes or no? Can you make Medicare cuts without starting off on the way to universal coverage?

Secretary SHALALA. The point that we have made is that because we believe that coverage is critical to cost, that making Medicare costs—Medicare cuts or slowing down the growth of Medicare without understanding the implications for the rest of the health care system, the last thing you want to do is increase the number of people without health insurance or adequate health care coverage, and therefore we have argued that there is a—as most health economists have, that there is a relationship between coverage and the large number of uninsured and what happens in the public system.

Mr. THOMAS. Gentleman's time has expired.

Madam Secretary, despite the rhetoric, some of us are trying to look at solutions and I would like to ask of the resources that you have if it is possible, within a reasonable timeframe, next week or whenever it is reasonable, if you could give us what your department actuaries believe would be a growth rate that would ensure solvency for a 10- 15- 25- and 75-year period.

Secretary SHALALA. I will—whatever requests that you have, we have in a bipartisan manner tried to fill those requests. Anything specific the Committee wants to ask us, we will see whether the actuaries are able to do it, but we would be happy to respond.

That would be the request, because clearly it is an actuarial problem and not a political one.

[The information was not available at time of printing.]

Mr. THOMAS. Mr. Levin will inquire.

Mr. LEVIN. Thank you, Mr. Chairman.

Mr. Zimmer, I think you asked some good questions and I think the Secretary gave you good answers and I would like to just briefly respond to them. Who goes first?

You can simplify this issue. There is a political dimension. I think there is also a public policy dimension. People who make promises should tell the public what they mean. You made promises. You should tell the public what you mean, period. Do it.

The budget resolution in previous years had already been passed by the time we convened here this morning by many days. The broken record here is the broken record of your promises when you were going to come forth with a budget. Now it is said you will separate that. I mean, you go back and forth. One day it is part of the budget; the next day the Speaker says it will be taken separately. This morning, a senior member of the panel, Mr. Walker, said you have to include Medicare savings in the budget. We will provide a number and an overall level of confidence.

Say what you mean. That is good public policy, and it is bad public policy for you to say the other party will say what you mean when you run into some promise you may not be able to keep. That is why we are waiting. There is a political dimension, but there is also a public policy dimension.

People in the district I represent are disillusioned by people in public life who have made promises and then do not say how they will keep them. Say it. Tell us specifically, what you plan to do. Then, just do it. do not wait for anybody else. I think that is what the Secretary is saying. That is what the President is saying, and then you try to change the subject. You talked about $158 billion in Medicare cuts last time. I voted for those, and it wasn't an easy vote, but the vote for Medicare cuts were for cuts that plowed money back into the health system. That was what it was, and we took some money out of the Medicare system, for example, indirect medical education, or direct medical education, and we put it back so that hospitals would be compensated for uncompensated care.

Just do it. Do not look to the other person or blame the other person or look to the White House when you want to be bipartisan only when it suits your needs. You were not the first hundred days. Some of us tried, for example, on welfare reform.

Let me ask the Secretary a question about the testimony of June O'Neill about one possible response to this problem, and I think there is a problem with the Medicare Fund. There is no use disguising it. At least there is potential.

She says on page 15 about major restructuring, "major restructuring, however, would take time to develop and could not therefore address the short-term financing issues." You want to comment on this statement? Because, there is a lot of discussion about managed care, I think we are going to have to take a look at it. Some people look there and see a magic bullet. You have less than a minute. I am sorry, but if you would.

Secretary SHALALA. OK, thank you. I have great respect for Dr. O'Neill. The point she is making is that one of the alternatives that is being looked at, certainly by the administration as well, is a competitive system, and the point she makes is that the competitive redesign of Medicare is a major restructuring. It is not something that could be done quickly. It would have to be phased in, perhaps as demonstrations, and it is not something that someone could count on for potential savings in the short run, but it is something that ought to be looked at.

We have said publicly that we would like to look at it. It has to do, for those of you who have not followed this detailed discussion, with the pricing of HMOs in parts of the country, to go to a more competitive design as opposed to what we have been doing, and that is using fee for service as the base. It requires a great deal of conceptualization. We have done a lot of it already in the Department, but it is not a short run solution.

Mr. THOMAS. The gentleman's time has expired. Ms. Dunn.

Ms. DUNN. Thank you, Mr. Chairman. Madam Secretary, I am very troubled by the hearing that we are participating in today. I hoped, as a newcomer to this Committee, we could gather together and discuss really solid ideas on how we could solve this major problem. I see a huge crisis in leadership by the executive branch,

and I should think that you personally would feel very, very concerned coming to this Committee without a proposal for how to solve this crisis. I would think you would find that your plan to wait until we propose our budget-balancing plan is very reactive. I think it brings in the question of relevancy of the Presidency.

We are dealing with real reasons and good reasons, and I would simply like to know the real reason the President and the administration have not come forth with a plan to solve this crisis. For example, you and Secretary Rubin have been here with some ideas that were considered during our debate, proposals and our passage of that bill on the House side. This dearth of leadership is very sad. It is certainly not what the people I represent want to see out of the executive branch, and I would like to know the real reason you are not coming forth with some ideas.

Secretary SHALALA. Congresswoman Dunn, I think your comments are unfair. All I have said here is that we fully expect to see a detailed budget. The credibility issue, given what the law says, is not on our side. We fully expected a detailed budget because we were told that within that budget you would keep your promise to balance the budget, to provide a tax cut for the well off, and that——

Ms. DUNN. Madam Secretary, if you will excuse me, the budget is not the question. Your proposed ideas for reform of the health care system and reform of this system that we are talking about, Medicare, is the topic of today's debate. Where are the answers? Where are you going to provide some solution that we can put together in a bipartisan way and solve this crisis?

We know what your trustees have said. I know what I am hearing in the communities around my district where I just spent 2 weeks holding 13 townhalls in 13 different communities. They want us working together to solve this problem. They do not want this sort of rhetoric that we have heard during this debate and—excuse me, Madam Secretary, I would like to know when you are going to come up with this proposal. I would like to have it disconnected from the budget because we have got to work on this now. It was the number one priority in all my townhall meetings. They want us to solve this problem. They do not want you or anybody from the executive branch giving an excuse that we will wait until you propose the plan. Leadership should rest with the President. Where is it?

Secretary SHALALA. Congresswoman Dunn, the leadership of Congress is now in the hands of your party and we are waiting to see your budget. We have said——

Ms. DUNN. Have you completely given up, then, on the fact that the executive branch should be offering leadership in this and every other major debate we are going through in the House of Representatives?

Secretary SHALALA. Absolutely not, but it is fully acceptable for us to wait to see the detailed budget in which you have promised to deal with these issues, and we have said as soon as we see that detailed budget, we are prepared to sit down and to deal in a bipartisan manner with the health care portion of that budget, specifically——

Ms. DUNN. I think at this point excuses are not good enough, Madam Secretary. I would expect more than that from the administration. Thank you, Mr. Chairman.

Mr. THOMAS. Mr. Collins will inquire.

Mr. COLLINS. Thank you, Mr. Chairman.

Ms. Shalala, thank you. Let's talk a minute about the budget and how the budget actually pertains to the benefits that are paid for by those who are covered under Medicare. The budget itself is actually a foundation whereby the appropriated funds are used to pay benefits, are debited against the Hospital Insurance Trust Fund; is that not true?

Secretary SHALALA. The budget affects both parts of the Medicare Program, but specifically part B of the Medicare Program. Any cuts in the budget would affect other parts of the budget.

Mr. COLLINS. Ms. Shalala, please, we are talking about part A, true? This is a report on part A. The appropriated funds that are based on the budget for benefits are debited against the Hospital Insurance Trust Fund; is that not true?

Secretary SHALALA. It is true and——

Mr. COLLINS. OK, that is enough.

Under the current law, there is no authorization to use any other funds for health insurance benefits other than trust funds, is that not true?

Secretary SHALALA. Under current law, that would require a change by Congress.

Mr. COLLINS. Is that not true, my statement, under current law that it is no authorization——

Secretary SHALALA. That is exactly what we are waiting to hear, your budget.

Mr. COLLINS [continuing]. To use any other funds than trust funds for benefits for Medicare, true?

Secretary SHALALA. That is precisely why we are waiting to see your budget, to see what you are doing.

Mr. COLLINS. Is that not true, Ms. Shalala? Please. I do not want to go into all that other rhetoric.

Secretary SHALALA. I think I answered the question. I think I said it would require a Congressional change.

Mr. COLLINS. You did. You said it was true. No funds in the trust fund can be used for anything other than Medicare benefit payments or the administration of Medicare; is that not true?

Secretary SHALALA. That is true.

Mr. COLLINS. OK. That really makes the budget kind of a moot issue; is that not true?

Secretary SHALALA. No, it doesn't.

Mr. COLLINS. If you are not authorized to use those funds for anything else other than Medicare and you can't use public or general funds for Medicare, then that makes the budget a moot issue; is that not true?

Secretary SHALALA. I think that the difficulty here is understanding the——

Mr. COLLINS. No. There is no difficulty. There is, but we won't get into the difficulty.

But based on that, the budget issue is a moot issue because any adjustments that are made in Medicare in any shape, form, or

fashion remain within the guidelines in the trust fund called Hospital Insurance; is that not true?

Secretary SHALALA. You are misunderstanding the unified budget concept which——

Mr. COLLINS. I think I am very well in tune with how this program works. Taxes are collected from every employee and employer and from those who actually opt to be covered under Medicare. They pay a premium, $261 a month. I believe that is the figure, based on your report.

Those funds, they go into the general fund, but they are credited to the Hospital Insurance Trust Funds. Any benefits that are paid out and the cost of administration of those benefits are debited against the trust fund.

Those trust funds, the surplus in those trust funds, can only be used to purchase government securities. Therefore, any changes in the Medicare Program in any shape, form, or fashion will remain within the realms of the Medicare Program itself or the Hospital Insurance Trust Fund; is that not true?

Secretary SHALALA. I think that——

Mr. COLLINS. Yes or no. Yes or no.

Secretary SHALALA [continuing]. We have a difference of opinion over the unified budget.

Mr. COLLINS. Yes or no. Yes or no. Yes or no. The circle you have been running in is just like when I used to rabbit hunt. You cannot delay a rabbit. He will run way out and come back. That's what you keep doing. You keep running in circles, but the truth of the matter is, any adjustments made within the Medicare Program or the Medicare Trust Fund, those funds will stay in that Medicare Trust Fund, Mr. Chairman, therefore, the budget itself is a moot issue. You are not even talking about the budget when you talk about the trust fund and the Medicare benefits.

Secretary SHALALA. It is not a moot issue.

Mr. COLLINS. I wish you would stop this debate of trying to divide people and to threaten our seniors. I just do not like it that you want to hold our seniors hostage to your rhetoric and your programs. It is just not fair to them. You are not being honest with the American people and I regret that, Ms. Shalala.

Thank you for your appearance here today.

Mr. THOMAS. Mr. Payne will inquire.

Mr. PAYNE. Thank you very much, Mr. Chairman, and thank you, Madam Secretary, for being here today.

I wanted to first, since we are discussing Medicare, an issue that is so important to all of our senior citizens in this country, to commend you and the administration for the work you have done in setting up the Conference on Aging, will be held this week. It was a conference on aging that really laid the foundation that gave us our Medicare system, perhaps the first conference back in the sixties, and so these are very important conferences.

As I have talked to many people back home in my district, they were very interested in this. Of course we all have someone who is representing us at this conference, and this is an opportunity to get a lot of input from our senior citizens from all over the country, and I think this is an important part of any reform of the Medicare system, certainly as we move forward, and I did want to comment

on that and commend you for your work and the administration for that.

Secretary SHALALA. Thank you very much, Congressman Payne.

Mr. PAYNE. I understand from your testimony and from what I am seeing here in terms of the tables that were presented to us that the reduction in income from the taxation of benefits to the trust fund, in other words, the tax cuts that were passed as part of the Contract With America, have not been considered in the report of the trustees, so that if, in fact, that was considered, that it would not be a 7-year period of time, but rather something less than seven, maybe as short as six or fewer years that we now have to act as a result of that action that was taken. Is that correct?

Secretary SHALALA. Yes. Something—six plus I think it is. I think it is closer to about 8 months that that would knock it out.

Mr. PAYNE. So that the one action that this Congress has taken generally regarding this issue has actually exacerbated that problem to the extent that there is some $31 billion less that will be flowing into the trust fund.

Secretary SHALALA. That is exactly right, Congressman Payne. The point we were making is that it is going exactly in the opposite direction, all the steps that the administration and the Democratic leadership took previous to that was to extend the number of years to protect the HI fund and the contract actually reversed that for a number of months.

Mr. PAYNE. Now, in trying to understand this and putting aside partisan politics, just to understand where this is and what needs to be done, as I understand it, there are two different trust funds associated with Medicare, one the Part A and the other, the Part B Trust Fund. Why do we have two different trust funds? What was the purpose of setting that up that way and has any consideration been given to or has there been talk about making that a single trust fund?

Secretary SHALALA. There have been some conversations about making it a single trust fund over the years. One was set up obviously with payroll financing and the other, which has some cost sharing and some premiums paid by individuals, and I think that there have been some very thoughtful people who believe very strongly they ought to be combined, particularly as we begin to go to other kinds of vehicles, HMOs and other kinds of choices for people, and I would think that a thoughtful discussion on that subject would be worthwhile.

Mr. PAYNE. But, there is not yet——

Secretary SHALALA. There is not a proposal any place, and one obviously has payroll taxes deposited directly and the other has out of pocket and discretionary money allocated for it.

Mr. PAYNE. I understand there has also, in the past, been some discussion about the need for a trust fund at all. Is that something that the trustees have discussed at all?

Secretary SHALALA. Not during my term as a trustee; we have not had a discussion about that.

Mr. PAYNE. So, that there is no recommendation that it be——

Secretary SHALALA. There is no discussion on that.

Mr. PAYNE [continuing]. That it be examined relative to the necessity of doing that. Thank you very much and I will yield back the balance of my time.

Mr. THOMAS. The gentleman's time has expired, and the Committee will stand in recess for not more than 10 minutes. We have a vote on the floor. The Chair will return as soon as possible for additional inquiries.

[Brief Recess.]

Chairman THOMAS [presiding]. The Committee will reconvene. Mr. Christensen will inquire.

Mr. CHRISTENSEN. Thank you, Mr. Chairman.

Madam Secretary, I have listened and I have waited patiently for a long time. During, the last 2 1/2 hours you have been giving very difficult answers. It has been a very difficult situation for you, I am sure, because I know that you are very capable and a very smart lady and I think that you have been given some marching orders that are probably contrary to what you would normally be able to do in answering the questioning.

As a new guy on this Committee, I come from a business background, and the best thing that I could probably do is—in terms of comparing what I have heard today and what I have seen from the Medicare Board of Trustees, would be to try to compare it to a board of directors. If you were the board of directors and I was the stockholder, I would probably sue and win on dereliction of duties, because from what I have seen, the stock of Medicare has gone down drastically during your watch, and what I would like to do, and rather than just throw barbs back and forth, I would like to talk about a couple of ideas that—and I know you gave Congressman Ramstad, you wouldn't answer specifics, but if you would, just for the moment, talk about some constructive ideas that might work.

For example, in the Medicaid situation, you have allowed a lot of waivers to various States. I know that our State, Nebraska, was allowed to receive, a medical waiver.

Do you think the administration would be open to allowing a couple of States to look at this situation of Medicare, whether they could handle the problem better, more efficiently, get better use of dollars on their own as a trial basis to see if we could do the same with Medicare like we have tried with Medicaid? Would the administration—and maybe if you can't speak for the administration, speak specifically as the Secretary of HHS.

Secretary SHALALA. I am afraid they are one in the same. I am not even an individual.

Mr. CHRISTENSEN. Personally.

Secretary SHALALA. I can't even speak personally. Let me make a couple of comments here and try to be helpful to you.

First, I think that you would probably keep me as the chief executive officer because our stock has gone up. As I pointed out at the beginning, we inherited a system that was supposed to be bankrupt by 1999. At least we have added some years to the solvency of the system.

Second, the trustees of the system, while they are called the Medicare trustees, are in fact advisors to Congress and to the administration.

The Congress and the executive are the trustees of the system, and we have, in fact, done our job as advisors to all of you. We have come and said that the HI Trust Fund has only a few more years and we need to make some thoughtful proposals together. With the split between who are the new majority in the Congress and the executive, we have said that we should do it together, not that I should independently truck out some ideas.

As to your proposal about Medicare and whether we should try some things that we tried on Medicaid, I think that the programs have two different histories. Medicaid has always been a State-Federal partnership. Medicare has not. The general point, and that is, should we try some things, competitive bidding, for instance, is one, on a regional basis, should we try different kinds of demonstrations for delivering care?

I have not been in Nebraska recently but I have been in South Carolina recently where we are trying, with the State, some different ways of delivering adult day care, for example; that we are using the Medicare system and the Medicaid system, sometimes in combination to try different approaches to health care.

That is precisely what we ought to be doing in an innovative way, trying to fit these programs together with Governors, within regions sometimes, so that they work better and so that we get more bang for the buck in the business sense.

Mr. CHRISTENSEN. I guess, Ms. Shalala, that we are talking about here, the advisors, and I am not so much in disagreement that we are going to go ahead and put together a plan.

Now, we would like to have your input. We would like to have a dialog so that we can work on together in a bipartisan fashion, but thus far, from what I have heard from your answers, it has been quite a one-sided discussion. We pretty much know your pat answers. What we would like to do is work together as much as we can and that is why I threw out the idea of what ideas would you have to come to the table with, and I guess this is a start. Thank you for your testimony here today.

Mr. THOMAS. The gentleman's time has expired. Mr. Portman will inquire.

Mr. PORTMAN. I thank the Chairman. Isn't this nice? We are at the lower rung, everybody is gone, the cameras are turned off. Now we can roll up our sleeves and really get into it.

Mr. THOMAS. Have her whisper her answer.

Mr. PORTMAN. I won't tell anybody.

During your budget presentation, you and I had a dialog about Medicare. At the time, you indicated you were looking forward to working with those of us on this panel who thought that not addressing Medicare in the budget was irresponsible, that based on the magnitude of the program, its cost increases, it couldn't be ignored, and is probably the single largest budget buster. I am disappointed, as are many of my colleagues, that we do not have a more forthcoming dialog yet. I hope we will get to that point.

Just very briefly, one of my colleagues, I wish he were here, Mr. Stark, said that, he wants us to stew in our juices for awhile, that he thought the program, and I quote him, "has been running right well." You know the statistics very well, but I think we have a need to back up maybe for purposes of the bigger picture for a minute.

In 1975, Medicare was at $12 billion. Now, it is at about $178, $180 billion. This past month, CBO told us that the figure is going to be $345 billion in 7 short years, by 2002, which is a $167 billion increase. That is a huge budget issue.

In addition to that, of course, we have the HI Trust Fund solvency issue in 7 years, and no more money to pay the beneficiaries. Whether you deal with it as a budget issue—broad-based budget issue or as a trust fund issue, we have a crisis and we need to resolve it. I would hope that with the administration, we can at least set some targets.

You told us when you came forward on the budget, you thought Medicare was going to be increasing at 10, maybe up to 11 percent per year over the next 5 years. As we all know, that is unacceptable. Perhaps we should start with saying, let's get our Medicare funding within a reasonable range over that 5-year period or 7-year period, maybe it is 7 percent, maybe it is 6 percent, maybe it is 8 percent, but I would hope we could agree on some targets and then work together in a constructive way to address it.

I am at a loss on the logic of not sitting down with us until we do a budget. I do not know if that means you want us to do Medicare in the budget or you do not want us to do Medicare in the budget. We can go back and forth on that, but I am disappointed and I hope we can work on together.

Let me ask you a couple specific questions, if I could.

We started to get into some specifics. It is my view that you pretty much shot down the means testing idea, the HMO issue. As you indicated, there is sort of full HMO coverage now and there is fee for service now. Many of us have talked about something in between, a PPO, preferred provider organization, or some other kind of provider.

Secretary SHALALA. Come forward with one.

Mr. PORTMAN. If, you are continuing to be interested in that, this may be an area we can work together.

How would this notion of continued employer coverage, where you would have the employer providing managed care now and under some arrangement through the government would be able to continue that same managed care under Medicare? How do you feel about that idea?

Secretary SHALALA. I think, Congressman, all of the issues that you are talking about, the additional HMO ideas, PPOs, point-of-service options, are things that we have been working on for quite awhile and have introduced some new—have tried to get some better coverage. We are clearly interested in the competition idea. It is difficult to do. It has required a major conceptual effort within the Department. All of the above ought to be part of our discussions as we sit down on a bipartisan manner so we can fill you in on all of the things we are already doing.

What I wanted to do was send a clear message that we are not locked into the old Medicare fee-for-service plan. The President said from the moment we walked in that this program has to get some discipline, we have got to provide some other options, we have to preserve choice, we have got to look at more efficiencies. We have collapsed our computer system. We have done all sorts of things, so——

Mr. PORTMAN. Specifically, then, you are not discounting the notion of an employer link, sort of a continuous service from the employer in some way?

Secretary SHALALA. I am not discounting anything, and as we see what is happening to people moving into Medicare—into HMOs, for example, clearly those who are currently in HMOs are interested in staying in their HMOs and working out these transitions ought to be part of the discussions that we are having.

Mr. PORTMAN. One other question, if I could. I do not want to lose my time here. Again, I think you are right. The continuing on makes sense. More and more Americans are used to managed care now and I think it would be easier to have them adjust to that at the Medicare level.

Medical savings accounts, Congressman Ramstad wanted to ask you about that. How do you feel about that? How much impact is it going to have on the Medicare population? An idea, as an example, would be for people to save tax free over time, during their working life, and then have that available upon retirement to draw from. They would be required to have some sort of catastrophic plan as well. What is your reaction?

Secretary SHALALA. When I testified earlier on medical savings accounts, I raised questions about whether we were not, in fact, taking the healthier and wealthier folks out of the health care system and setting them up separately. There is some evidence that we may be paying too much in terms of what our contributions are, and I think that we have had some very deep concerns about medical savings accounts. Creaming off part of the population is not the way to solve the health care crisis in America, and that is why it has to be part of a broader discussion.

Mr. PORTMAN. I thank you.

Mr. THOMAS. The gentleman's time has expired.

Mr. PORTMAN. I wish we had another hour or so. I thank the Chairman.

Mr. THOMAS. The gentleman from Nevada will be the last inquirer, I would tell the Secretary.

Mr. ENSIGN. Thank you, Mr. Chairman. Just a couple of quick questions. What does the administration see as the fundamental underlying problem with the growth of Medicare spending?

Secretary SHALALA. Well, the problem with the growth of Medicare spending——

Mr. ENSIGN. Or the cost. The cost.

Secretary SHALALA [continuing]. Is similar to what is happening in the private sector. It is the introduction of new technology. It is——

Mr. ENSIGN. The volume of services?

Secretary SHALALA [continuing]. For the Medicare population in particular, it is health inflation. I mean, it is the growth of health care costs.

The point I was making is that the growth in health care costs in the private sector is similar to what is happening in the public sector for very vulnerable populations. It is also, as we get better treatment, it costs us more in health care. Unlike other parts of the economy, if you have a technological breakthrough, it doesn't necessarily save you money.

Mr. ENSIGN. You are talking volume of services basically; that is the fundamental underlying problem?

Secretary SHALALA. The increase in population, too, and we have talked about the demographics.

Mr. ENSIGN. That is going to get much worse obviously with the baby boomers.

Earlier you and Mr. Matsui were in an exchange about cost shifting to the private sector. I guess one of the things that I want to get straight here, and then we need to get past this rhetoric, is that the private sector, the last couple of years, has done better than the public sector.

You are asserting that the public sector over the last 10 to 15 years has done as well, if not better, than the private sector as far as controlling its costs or how fast they are increasing their services. The cost shifting that Mr. Matsui was talking about, has that contributed to the private sector's increase in cost in your statistics?

Secretary SHALALA. It has, to the extent—Medicaid, in particular, where we clearly do not pay as much as we should.

Mr. ENSIGN. Medicare is the cost shifting I am talking about.

Secretary SHALALA. In Medicare, there is some cost shifting that is going on. What we do not want to do is produce more cost shifting by slashing the budget.

Mr. ENSIGN. No. I agree with that. My point is that in your statistics, when you were trying to defend the public health care system, Medicare basically, you were saying that it did as well or not better than the private sector, but yet we have been shifting costs to the private sector because of some of the reforms that have been done in this Congress; is that not true? That contributes to those statistics. OK, I just wanted to establish that. You agree?

Secretary SHALALA. No, I can't agree with that.

Mr. ENSIGN. We have not shifted costs to the private sector from Medicare?

Secretary SHALALA. It is not clear at this moment that the—that—it is clear that the private sector has been squeezing down, there is no question about it.

Mr. ENSIGN. Wait a second. We are talking about shifts of costs to the private sector from Medicare.

Secretary SHALALA. Yes.

Mr. ENSIGN. You have said, you were exchanging with Mr. Matsui, that we had shifted the cost to the private sector from the public sector in terms of Medicare.

Secretary SHALALA. I think that——

Mr. ENSIGN. You disagree with that now?

Secretary SHALALA. My point was to Mr.—I thought Mr. Matsui was asking me about cuts in the—dramatic cuts in the Medicare system.

Mr. ENSIGN. Correct, which shifted costs to the private sector. I am saying, were those taken into account in your statistics the total spending in the private sector? Do you understand what I am saying?

Secretary SHALALA. Yes, I understand what you are saying.

Mr. ENSIGN. It skews the statistics is all I am trying to say.

Secretary SHALALA. Well, it could be going both ways, though, Mr. Ensign. There is some evidence now, and some of the hospitals have indicated this, that Medicare has become the better payer, so that there may be some cost shifting going back the other way. To give you a precise answer at this point in time is very difficult.

Mr. ENSIGN. OK. Let me get to this, to a further definition, and that is, if a company saves dollars in a particular program, they have efficiencies through management techniques, technologies, and the next year they actually spend less money on one particular program than they did on that previously, do you define that as a cut or savings?

Secretary SHALALA. True efficiency, I would count it as savings, not——

Mr. ENSIGN. OK. So in Medicare, if we are able through efficiencies, through management techniques, through whatever we are able to do, to save money, is that going to be defined by the administration as a cut or savings?

Secretary SHALALA. It depends on the impact it has on quality, whether we are cutting out benefits in the process.

Mr. ENSIGN. That is what I am saying. I am saying delivering the same quality, through more efficient means. That would be considered a savings?

Secretary SHALALA. That would be counted a savings, if we could maintain quality and benefit coverage.

Mr. ENSIGN. If that savings is applied to the deficit or whatever it is, is that calling a cut in Medicare to apply to the deficit? Is that the way the administration will define it?

Secretary SHALALA. I would hope that we would be very precise in what changes we thought we could make in whatever the public system was, and the difference between changes that will save us money and maintain quality and changes that actually will reduce benefits, reduce coverage and increase costs to other parts of the health care system.

Mr. ENSIGN. I agree with that. I just want to make sure that we are precise in our definition and credit goes to savings and not called a cut. We have to distinguish between cuts and savings, because in the past, there have actually been cuts in Medicare, where in the future, hopefully, some of the things we are going to be doing will be savings, like American business. American business has transformed itself so that it can save money in some of its programs.

Thank you, Mr. Chairman. Thank you for your testimony.

Mr. HOUGHTON [presiding]. Mr. Neal will inquire.

Mr. NEAL. Thank you very much, Mr. Chairman.

As always, I want to welcome you here, thank you today, Madam Chairperson. I thought one of the purposes of these hearings in the form of this setting was to allow the panelists to answer the questions. I know you haven't been given that opportunity this morning. Generally, as you have asserted yourself, somebody has interrupted you to state another opinion, but we do thank you and welcome you here in the true spirit of what these hearings are supposed to be about.

Secretary SHALALA. Thank you.

Mr. NEAL. I would like to offer you an opportunity for a constructive opinion as well. The panacea that is being suggested in the halls of the Congress today, is we simply herd everybody into HMOs or managed care, that at the end of the day, we will recognize and witness considerable cost savings in Medicare.

Is that your understanding of the program if it were to be initiated on that basis? Would you care to, at least from a conceptual view, offer a suggestion at this time?

Secretary SHALALA. We believe that choice is absolutely critical to the Medicare system that—and that we ought to continue choice and that people ought not to be shoved into HMOs. There is no evidence thus far that there would be huge savings from putting large numbers of people into HMOs.

While there have been some initial savings which have been identified, most people believe it is because of the first group that went into HMOs from Medicare actually were a healthier group. We have to be extremely careful as we add—as more people choose HMOs not to assume that there will be substantial cost savings in the short—in the short run, or even in the long run, and I think both the administration and the CBO and other health care experts are being very careful in their language not to promise something that we are not sure initially that we can deliver.

That does not mean in any way we do not think people ought to have choices of HMOs or that we shouldn't make reforms in the system to make it more efficient, to bring down unnecessary utilization, and to be very hard-nosed about our administration of the program. We simply do not wish to overstate the effect of moving millions of people into HMOs in this country.

Mr. NEAL. Just a quick followup to that. Would you suggest that if we were to proceed down that road, that it ought to be done on an experimental basis?

Secretary SHALALA. Well, we have, as you know, increased the number of options available to senior citizens. Seventy-five percent of the Medicare population now has access to HMOs. The ones that do not actually live in rural areas where there are no HMOs. We think in addition to what we already have, we ought to have point-of-service options and some PPOs, but there ought to be more choices out there, and that those choices ought to, if possible, improve the efficiency of the system.

Mr. NEAL. Thank you. I have a quick anecdote to share. Yesterday morning, I went along to get a cup of coffee and there were some booths, and in three successive booths three different couples said to me, do not let them touch Medicare, do not let them destroy our Medicare system; and, indeed, at the end of the day we are counting on folks like you if we have to make changes, make changes, but certainly we intend not to let them destroy the system. Thank you.

Secretary SHALALA. Thank you very much, Congressman.

Mr. HOUGHTON. Madam Secretary, you have been through a real wringer this morning. Do you have time for one more inquiry from Mr. McDermott?

Secretary SHALALA. I do indeed.

Mr. HOUGHTON. OK. Mr. McDermott.

Mr. MCDERMOTT. Thank you, Mr. Chairman. I just want to set the record straight, I think, for—the Secretary has talked about the need for the budget resolution and why it is there. The President produces a budget, and he has done that. He has presented it to us. Then the Congress, by law, is required by the April 15 to produce a budget.

Now, last year the House passed the budget resolution on March 11. The year before it was on March 18. On the year before, when Mr. Bush was President, he presented his budget, and then the House Democrats produced their budget resolution by March 5. That is almost a month-and-a-half, and then the year before that, it was April 17.

Now, it is clear that when we go to make major cuts, we have had the budget resolution before us so that we know what we are doing, and when one reads the Speaker's comments from yesterday where he was asked about the use of Medicare savings, he says, "I know nothing, go ask Tony Blankley."

Now, that simply suggests that you are in an impossible position to react to this, but I want to ask a question that really troubles me, and that is this: Senior citizens, 63 percent of them, live on—substantially on Social Security. That is the major source of their income.

Now, this seems like really a hidden tax on them, and I wonder, where do the additional costs get picked up if you have already cut Medicaid? It seems to me that it is going to come out of the pockets of their children or there is going to be an increased debt in the system. Is that a fair analysis of what is going to happen if we do not pay at the Medicare level?

Secretary SHALALA. Well, I think that in real life for so many of our senior citizens who lived on fixed incomes it means less money available for food, to pay for housing and to pay for other things. Already they spend 21 percent of their income on average for health care, and passing on to them additional health care costs puts them clearly in a very difficult situation. We do not want to do that.

Recognizing who the program serves is very important as we think through what can we do to make it better, to make it more efficient, to keep our promises at the same time, but simultaneously to understand the impact that these large public expenditures have on the budget.

Mr. MCDERMOTT. In the present situation, if they have additional out-of-pocket costs and they are of low income, it is picked up by the Medicaid Program.

Secretary SHALALA. It is picked up by Medicaid from there.

Mr. MCDERMOTT. Are you guaranteeing the Medicaid Program will still have the capacity to pick up this increased out-of-pocket costs?

Secretary SHALALA. I cannot do that because of the conversations that are going on about the Medicaid Program in this country and the discussions going on in terms of capping it or block granting it, so the States would struggle with more limited resources and would have great difficulty handling the shift of costs that would come from Medicare recipients.

Mr. McDERMOTT. The States could choose in that block grant not to cover the out-of-pocket costs for senior citizens in their Medicaid; is that correct?

Secretary SHALALA. As I understand the kinds of recommendations, talking about it would be up to the State unless Congress mandated they pick up those costs.

Mr. McDERMOTT. For my mother and father, my mother 85, my father 89, living on Social Security, if they have additional out-of-pocket costs, it either comes out of their Social Security check or they turn to my brothers and my sister and I to pay for it; is that the alternative?

Secretary SHALALA. That is essentially what happens in real life in the United States.

Mr. McDERMOTT. This will accelerate that process, in your view?

Secretary SHALALA. It will accelerate that process.

Mr. McDERMOTT. Thank you very much.

We appreciate your testimony today. You have done a very fine job.

Mr. THOMAS. Madam Secretary, we appreciate your testimony. Although we engage in debate, what may or may not happen in the interaction between Medicaid and Medicare is precisely what we were trying not to do, but rather deal with realities.

Thank you very much for your generous time.

Next, we will have June O'Neill, Director of the Congressional Budget Office.

Director O'Neill, any written testimony you have will be made a part of the record, and you may proceed as you see fit to inform this Committee about this question from the Congressional Budget Office perspective.

STATEMENT OF JUNE E. O'NEILL, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Ms. O'NEILL. Mr. Chairman and Members of the Committee, it is my pleasure to be here today to testify on the financial status of the Medicare Program. Unfortunately, the financial liability of Medicare is currently eroding, primarily because of continuing growth in the cost of providing coverage to each beneficiary.

If left unchecked, this trend will create a problem of major proportions when the baby-boom generation begins to reach retirement age in 2010.

The 1995 Annual Report of the Board of Trustees of the Federal Hospital Insurance Trust Fund, released last month, indicates that under intermediate assumptions, the Hospital Insurance Trust Fund, that is, the HI Program, will be depleted in 2002 unless changes in policy are made.

Even under the trustees' most optimistic assumption, the HI Trust Fund will be exhausted by 2006, which is just 11 years from now.

CBO finds ample reason to agree with the broad conclusions of the trustees regarding the short-range adequacy of HI funding. These projections of HI insolvency address only part of Medicare's overall financial outlook. It is well to keep in mind that the, SMI, supplemental medical insurance, which pays for physician and out-

patient services for Medicare beneficiaries, is also experiencing rapid growth in costs.

The Medicare Program is absorbing a growing share of the Nation's resources, and is expected to constitute 3.5 percent of the gross domestic product by 2005. Moreover, as the baby-boom generation reaches retirement age, the number of workers available to support each HI enrollee is projected to drop.

Currently, about four covered workers support each HI enrollee, but this ratio will decline rapidly after the turn of the century. Only two covered workers will be available to support each enrollee by midcentury. That demographic change will cause a continuing deterioration in the financial situation confronting Medicare and the Social Security program.

The evidence strongly supports the conclusion of the trustees that prompt effective and decisive action is necessary by the Congress to avert a financial crisis in the Medicare Program.

CBO projects that under current law, Medicare expenditures in HI and SMI combined will increase from $181 billion in 1995 to $463 billion in 2005. That reflects an average rate of growth of 9.8 percent a year.

Consequently, under current law, outlays for Medicare's share of Federal outlays will increase from 11 percent in 1995 to 16 percent in 2005.

Most of the projected increase in Medicare spending over the next 10 years can be attributed to rising medical prices and increases in the use of services. Beneficiary growth, however, will be slow as the baby-bust generation retires. The elderly population is growing slowly now, much more slowly than that which will come later.

The financial instability of the HI Trust Fund has been evident since 1992 when HI outlays first began to exceed income from the payroll tax.

HI outlays will begin to exceed all sources of income to the program in 1996. As a result of a continuing annual deficit in the HI account, the balance of the HI Trust Fund will erode each year, and by 2002 it will be depleted. In that fiscal year, according to CBO's assumptions, total HI income would be $153 billion, and the total amount in the trust fund at the beginning of that year would be about $16 billion. But projected outlays for the full year equal $199 billion; that would leave a shortfall of $30 billion.

Thus, without congressional action to provide additional financial resources the HI Program would be unable to pay for all the services that Medicare beneficiaries are expected to receive in 2002.

The rate of growth in Medicare's costs has caused concern almost from the program's inception. The Congress has made repeated attempts to slow that growth, including developing a prospective payment system for hospitals, changing the physician payment system, and allowing beneficiaries to enroll in HMOs. Those efforts have met with limited success.

A key question is whether Medicare can take advantage of managed care savings. Since 1985, Medicare enrollment in risk-based HMOs has grown steadily, although at 7 percent it is still very low compared with the privately insured population.

In 1992, almost 20 percent of people with private insurance were in HMOs. Currently, Medicare beneficiaries pay no more to enroll in fee-for-service Medicare than they do to enroll in a HMO. They often receive supplementary benefits, such as reduction in cost-sharing or prescription drug coverage if they enroll in a HMO.

They would have to pay a substantial premium for Medigap coverage to receive these benefits in the fee-for-service sector. For some Medicare beneficiaries, the financial incentives appear to be outweighed by the desire to choose physicians outside the HMO network. Others may not enroll in managed care programs simply because they are unaware of all the options available to them.

In the future, however, both stronger financial incentives to beneficiaries and better information will be necessary to encourage more Medicare enrollees to sign on for managed care programs.

Despite apparent evidence that the overall cost of services used by Medicare beneficiaries falls when they move from the fee-for-service sector to a HMO, higher HMO enrollment does not reduce Medicare's costs, and it may even increase them under Medicare's current payment system.

This effect occurs—and it is complicated partly because HMOs are paid 95 percent of Medicare's fee-for-service cost to provide care to a beneficiary, regardless of the actual resource cost of the services provided to the HMO.

Many analysts attribute the recent slow down in the rate of growth of private health insurance spending to more aggressive price competition among health programs. Between 1990 and 1993, private health insurance spending grew at an average annual rate of 7.7 percent, compared with 11.2 percent for Medicare.

As it is currently structured, the Medicare Program cannot take advantage of the recent competitive developments in the private health care market. If nothing is done and Medicare continues to grow at its current rate, the program will consume an increasing share of the Nation's resources. In part, that outcome reflects improvements in health services for the elderly, but it also raises concern about efficient resource allocation.

If Medicare absorbed less of the Nation's output, more could be spent on investment to improve the productivity of current and future workers. Moreover, a growing economy could be more dependably counted on to pay for the benefits of current and future retirees.

Fixing Medicare's financing problems will not be easy. As the reports of the trustees make clear, the problems begin in the short term and will only escalate in the long term as the baby boomers start to retire.

Either taxes must be increased or expenditures reduced or both, and the orders of magnitude involved are large. The tax alternative taken in isolation would require an increase in the HI payroll tax of 1.3 percentage points. That is a more than 40-percent increase over the next 25 years to ensure that HI financing covers program costs.

However, while an increase in the HI payroll tax would secure the HI portion of Medicare outlays, it would do nothing to secure the funding of SMI or to improve the overall efficiency of the Medicare Program.

There are two broad approaches for achieving slower growth of Medicare outlays, budgetary reductions and program restructuring. The two approaches are not mutually exclusive. With or without a tax increase, a combination would probably be needed to achieve immediate savings and longer term goals.

Examples of budgetary reduction options are included in CBO's 1995 report, "Reducing the Deficit: Spending and Revenue Options." They represent a traditional approach to containing Medicare costs. Such options which typically reduce payments for providers or raise the amounts that beneficiaries must pay, can offer immediate short-term savings in the Medicare Program. They are not necessarily designed to improve the efficiency of the program or to address the underlying long-term structural problems of spending growth.

Slowing the long-term rate of growth of Medicare spending and ensuring the solvency of the HI Trust Fund will probably require a major restructuring of Medicare. Three basic tenets underlie most redesigned proposals. One is that Medicare beneficiaries would have meaningful choices among a range of health plans, including fee-for-service options.

Two, beneficiaries would also have financial incentives to select efficient health plans.

Three, health plans would have strong incentives to compete for Medicare beneficiaries.

Several possible models for structuring the Medicare Program along those lines have been proposed. Frequently, competitive market approaches offer participants more choices and clearer financial incentives to choose less costly options.

A key feature of these approaches is the notion of Medicare making a defined contribution on behalf of each beneficiary. Participants could then put those contributions toward the cost of a health plan of their choice.

Beneficiary choice and limits on the government's contribution, for example, are important elements of the design of the existing health insurance program for Federal employees.

A competitive redesign of Medicare is a possible strategy for addressing the fiscal problems of the program. Establishing a competitive system could be a major undertaking requiring time to develop. Moreover, full implementation all at one time could be difficult, a phased-in approach starting with younger Medicare beneficiaries might be more feasible.

For these reasons, a structural change could not be counted on to deliver substantial immediate savings, although considerable savings might well accrue as time goes on.

One thing is certain, postponing decisions on Medicare's financing will only make the necessary policy actions in the future more severe. Without a tax increase, ensuring that the HI Trust Fund remains solid will require immediate spending cuts as well as reductions in the underlying rate of growth of spending.

Any delay will require more dramatic cuts and program changes in the future.

Thank you.

I would be happy to take any questions you may have.

[The prepared statement follows:]

STATEMENT OF JUNE E. O'NEILL, DIRECTOR
CONGRESSIONAL BUDGET OFFICE

Mr. Chairman and Members of the Committee, it is my pleasure to be here today to discuss the financial status of the Medicare program. Continuing growth in the cost of providing Medicare coverage to each beneficiary, coupled with a steady increase in the number of beneficiaries, is eroding the financial viability of the program. If left unchecked, those trends will create a problem of major proportions when the baby-boom generation begins to reach retirement age in the year 2010. Addressing the short-term and long-term financing problems of the Medicare program presents a serious challenge for the nation.

The *1995 Annual Report of the Board of Trustees of the Federal Hospital Insurance Trust Fund*, released last month, indicates that under intermediate assumptions, the Hospital Insurance (HI) Trust Fund will be depleted in 2002. In other words, unless changes in policy are made, the HI program will only be able to pay fully for services provided to beneficiaries for about the next seven years. Indeed, even under the trustees' most optimistic assumptions, the HI trust fund will be exhausted by 2006--11 years from now.

Based on the Congressional Budget Office's (CBO's) analysis of the trustees' projections and our independent analysis of the Medicare program, we find ample reason to agree with the broad conclusions of the trustees regarding the short-range adequacy of HI funding. But those projections of HI insolvency address only part of Medicare's overall financial outlook. The Supplementary Medical Insurance (SMI) program, which pays for physician and outpatient services for Medicare beneficiaries, is also experiencing rapid growth in costs.

Moreover, the Medicare program is absorbing a growing share of the nation's resources. Combined spending for HI and SMI has increased from 0.8 percent of gross domestic product (GDP) in 1974 to 2.4 percent of GDP in 1994. It is expected to increase to about 3.5 percent of GDP by 2002. Program revenues, however, are not increasing nearly as rapidly. The evidence strongly supports the conclusion of the trustees that "prompt, effective, and decisive action is necessary" by the Congress to avert a financial crisis in the Medicare program.

My statement today covers four topics:

- An overview of the Medicare program,
- Trends in program spending and in the trust fund balance,
- Medicare's cost containment measures to date, and
- Options for responding to the fiscal crisis in the Medicare program.

OVERVIEW OF THE MEDICARE PROGRAM

Medicare is the nation's major program providing medical services to the elderly and disabled populations. It offers two different types of insurance coverage, which are financed and administered separately.

The Hospital Insurance program pays for inpatient hospital care and related care for people 65 and older and for the long-term disabled. Payroll taxes primarily finance the program, with the taxes being paid by current workers and their employers. Those tax receipts are mainly used to pay for benefits to current beneficiaries. Income not currently needed to pay for benefits and related expenses is credited to the HI trust fund. In 1994, the HI program covered about 32 million aged and about 4 million disabled enrollees at a cost of $103 billion.

The Supplementary Medical Insurance program pays for physician and outpatient services. Although it is optional, most individuals eligible for Medicare enroll in SMI. Currently, premiums paid by enrollees finance about 31 percent of SMI program costs. But that share is projected to decline significantly under current law--to 25 percent in 1996 and lower after 1998. General revenues finance the remaining costs. The SMI program is not intended to accumulate funds for the payment of future benefits. In 1994, the SMI program covered about 31 million aged and about 4 million disabled enrollees at a total cost of $60 billion.

Payroll tax rates for the HI program are set at 1.45 percent of taxable earnings each for workers and their employers. However, the consensus among economists is that most of the tax charged to employers is indirectly paid by workers, whose earnings are ultimately reduced by the amount of the employer's contribution. Self-employed workers pay 2.9 percent of taxable earnings. No cap is placed on taxable earnings subject to the HI payroll tax. In 1994, approximately 141 million workers (and their employers) paid $92 billion to the HI trust fund.

As the baby-boom generation reaches retirement age, the number of workers available to support each HI enrollee is projected to drop. Currently about four covered workers support each HI enrollee. The trustees project that this ratio will decline rapidly early in the next century. They expect that only two covered workers will be available to support each enrollee by mid-century.

TRENDS IN SPENDING AND THE TRUST FUND BALANCE

In 1994, the Medicare program spent $162 billion, including both HI and SMI. Between 1985 and 1994, Medicare expenditures increased at an average annual rate of 9.6 percent. Under current law, CBO projects that Medicare spending will continue to grow at a similar rate, rising from $181 billion in 1995 to $463 billion in 2005. That increase represents an average annual rate of growth of 9.8 percent. By contrast, cash benefits for Social Security recipients will increase at only about half that rate.

Inflation in medical prices and increases in use of services account for most of the projected rapid increase in Medicare spending. Medicare enrollment of the elderly and disabled combined is projected to increase at an average annual rate of only slightly more than 1 percent over the 1995-2005 period.

CBO projects that Medicare will absorb a growing share of the federal budget over the next 10 years. In fact, under current law, outlays for Medicare (net of SMI premiums) will increase from 11 percent of federal outlays in 1995 to 16 percent of outlays in 2005.[1] Medicare and Medicaid are the fastest growing of the major entitlement programs, and as such, they are major contributors to the escalating budget deficits that face the country.

The Medicare trustees report 75-year projections of the financial status of the HI trust fund. Projections made by the trustees of the adequacy of HI funding to support program costs in the future are based on three alternative sets of assumptions about future economic and demographic trends: low-, intermediate-, and high-cost. Under their intermediate-cost assumptions, the HI trust fund will be exhausted in 2002.

According to the trustees, HI outlays began to exceed income from the payroll tax in 1992. They project that HI outlays will begin to exceed all sources of

1. Those estimates assume that discretionary spending rises with inflation after 1998.

income to the program (including interest on the trust fund balance) in 1996. As a result of that annual deficit in the HI account, the balance in the HI trust fund will begin to erode, and by 2002 it will be depleted.

CBO's projections of the HI trust fund balance only cover the 1995-2005 period. Those projections support the trustees' estimates concerning the depletion of the HI trust fund in 2002. Moreover, CBO's analysis provides ample reason to agree with the broad conclusions of the trustees regarding the short-range adequacy of HI funding.

It is useful to consider what trust fund depletion in 2002 means for the operation of the HI program. Under current-law assumptions, HI payroll taxes would continue to be collected from all covered workers (and their employers) throughout the year. According to CBO's assumptions, total HI income in fiscal year 2002 would be $153 billion. The total amount in the trust fund at the beginning of that fiscal year would be about $16 billion. Projected disbursements for the full year equal $199 billion. Consequently, the HI program would have a shortfall of $30 billion in fiscal year 2002. Thus, without some Congressional action to provide it with additional financial resources, the HI program would be unable to pay for all of the services Medicare beneficiaries are expected to receive in that year.

MEDICARE'S COST CONTAINMENT MEASURES TO DATE

The rate of growth in Medicare's costs has caused concern almost from the program's inception. The Congress has made repeated attempts to slow that growth, but with limited success.

Early efforts, in the 1970s, relied on price controls and relatively weak utilization review programs. It became apparent, however, that much of the potential savings to Medicare from price controls was lost, offset by an increase in the volume or intensity of services provided despite utilization review. Subsequent cost control efforts sought to introduce mechanisms that focused not just on price but on spending--the product of service price and volume.

The prospective payment system (PPS) for hospital services was established in 1984 to replace retrospective cost-based reimbursement. Under the PPS, hospitals are paid a fixed amount for each inpatient case, based on the patient's diagnosis. Under that payment system, hospitals are given strong incentives to avoid unnecessary services during a patient's stay and to discharge patients as soon as possible, since extra services or days in the hospital would increase hospitals' costs but not their reimbursement from Medicare. By contrast, under the previous payment system, Medicare paid hospitals for the costs of whatever services they provided.

Changes in the physician payment system were implemented in 1992 to replace charge-based reimbursement for physicians' services. The new system includes an explicit fee schedule along with an updating mechanism intended to generate lower fee increases when growth in the volume of physicians' services is large. Unlike the earlier changes in the hospital payment system, these changes did little to alter incentives for physicians. The method of setting fees was changed, but it remains a fee-for-service system that rewards physicians for providing more services.

One can see some indication of the effects of those changes for hospital and physician payment in the fee-for-service sector by comparing the rates of growth in Medicare's spending by service category for different time periods. Between 1985 and 1990, the rate of growth in Medicare's total costs was nearly half the rate for the preceding decade--annual growth of 9.0 percent, down from 17.1 percent. That

slowdown was mostly the result of sharply lower growth for hospital inpatient costs over the five-year period immediately following implementation of the prospective payment system. The growth rate for hospital inpatient spending rose somewhat after 1990.

By contrast, the freezes on and cuts in physicians' fees that took place during the latter part of the 1980s had little effect on the growth rate in spending for physicians' services because those measures were largely offset by an increase in the volume of services. Although the rate of growth in physicians' costs was lower between 1990 and 1995 than it had been before the fee schedule and its volume-based update system were introduced, the slowdown may reflect the low level at which the initial rates under the fee schedule were set. Projections for the 1995-2000 period assume a return to pre-1990 rates of growth.

Another significant change to Medicare during the 1980s was development of a mechanism whereby health maintenance organizations (HMOs) could enroll Medicare beneficiaries on a risk basis--receiving a capitation payment from Medicare for each enrollee. Until then, HMOs were able to serve Medicare enrollees only on a cost basis--a payment system not consistent with the way HMOs operate. Since 1985, Medicare enrollment in risk-based HMOs has grown steadily, increasing more rapidly than private-sector HMO enrollment has since 1989. Nevertheless, Medicare's risk-based HMO enrollment rate is still low--at 7 percent--compared with the privately insured population. In 1992, almost 20 percent of people with private insurance were in HMOs.

Currently, Medicare beneficiaries pay no more to enroll in fee-for-service Medicare than to enroll in an HMO. They often, however, receive supplementary benefits--such as prescription drug coverage and waiver of cost-sharing requirements--for little or no extra premium if they enroll in an HMO, whereas they pay a substantial premium for medigap coverage to receive those benefits in the fee-for-service sector. For some Medicare beneficiaries, those financial incentives appear to be outweighed by the desire to be able to choose physicians outside the HMO's network. Others may not enroll in managed care plans simply because they are unaware of all the options that are available to them. In the future, both stronger financial incentives and better information would be necessary to encourage more Medicare beneficiaries to enroll in managed care plans.

The most effective HMOs share the insurance risk for enrollees with their providers, thereby reversing or counteracting the incentive providers have to provide unnecessary services that is characteristic of the fee-for-service sector. As a result, an HMO's cost of caring for a given patient is generally lower than the costs incurred by an indemnity plan in the fee-for-service sector.

Despite apparent evidence that the overall resource cost of services used by Medicare beneficiaries falls when they move from the fee-for-service sector to an effective HMO, higher HMO enrollment may have the perverse effect of increasing Medicare's costs--not lowering them--under Medicare's current payment system. That effect occurs for two reasons. First, risk-based HMOs are paid 95 percent of Medicare's fee-for-service cost to provide care to a beneficiary, as measured by the average adjusted per capita cost (AAPCC). That link to fee-for-service costs means that Medicare pays a fixed capitation amount for each Medicare beneficiary enrolled in an HMO, regardless of the actual resource cost of the services provided. Second, Medicare's capitation rates do not fully adjust for the generally healthier group of people who are likely to choose the HMO option compared with those who remain in fee-for-service, nor do they account for the greater efficiency of managed care. If the service costs are lower than the capitation amount, Medicare does not recover any of the savings. The fee-for-service link also means that Medicare payments to HMOs

would increase if per capita costs in the fee-for-service sector rose, even if HMO per capita costs fell.

Medicare's HMO enrollment could generate savings, however, if the method of setting capitation rates was changed. A number of possible alternatives exist. But significant savings would not be generated unless the payment link between fee-for-service and managed care was broken. One way to break the link would be to allow the capitation rates to be set by competitive bidding in areas with enough HMOs to make that approach viable. That market-based approach could encourage stronger price competition among Medicare risk-based HMOs in a market area. However, generating more savings for the Medicare program could reduce the additional benefits that HMOs currently offer to beneficiaries, blunting incentives to enroll in HMOs.

Many analysts attribute the recent slowdown in the rate of growth of private health insurance spending to more aggressive price competition among health plans. Between 1990 and 1993, private health insurance spending grew at an average annual rate of 7.7 percent compared with 11.2 percent for Medicare. As it is currently structured, the Medicare program cannot take advantage of the recent competitive developments in the private health care market.

OPTIONS FOR RESPONDING TO THE FISCAL CRISIS IN MEDICARE

If nothing is done and Medicare continues to grow at its current rate, the program will consume an increasing share of the nation's resources. It will also continue to be a major cause of the rising federal budget deficit and the increasingly burdensome federal debt. Those outcomes raise concern about the efficient allocation of the nation's scarce resources and about the long-run prosperity of the nation. If Medicare absorbed less of the nation's output, more could be spent on investment to improve the productivity of current and future workers. Moreover, a growing economy could be more dependably counted on to pay for the benefits of current and future retirees.

Fixing Medicare's financing problems will not be easy. As the reports of the trustees make clear, those problems are of both a short-term and a long-term nature. Either taxes must be increased, expenditures reduced, or both, and the orders of magnitude involved are large. (A third approach that is sometimes suggested to address shortfalls in the HI trust fund would be to transfer funds to it from the Old-Age and Survivors Insurance (OASI) trust fund. That strategy, however, would merely postpone rather than address the funding shortfall and would hasten the depletion of the OASI trust fund.)

The tax alternative, in isolation, would require an increase in the HI payroll tax of 1.3 percentage points--more than 40 percent--over the next 25 years to ensure that HI financing covered program costs. Although such an increase in the HI payroll tax would secure the HI portion of Medicare outlays, it would do nothing to improve the overall efficiency of the Medicare program.

Two broad approaches would achieve slower growth in Medicare outlays: budgetary reductions and program restructuring. Those approaches are not mutually exclusive. With or without a tax increase, a combination of them would probably be needed to address Medicare's immediate and longer-term financing problems.

Budgetary reductions--exemplified by the options included in CBO's 1995 report *Reducing the Deficit: Spending and Revenue Options*--represent the traditional approach to containing Medicare's costs. Such options, which typically lower payments for providers or raise the amounts that beneficiaries must pay, offer immediate short-term savings in the Medicare program. Although both types of

policies are likely to be part of a more thorough reform of Medicare, they are not necessarily designed to improve the efficiency of the program or to address the underlying long-term structural problems of spending growth.

Slowing the long-term rate of growth of overall Medicare spending and ensuring the solvency of the HI trust fund would probably require major restructuring of the Medicare program. Three basic tenets underlie most redesign proposals: Medicare beneficiaries would have meaningful choices among a range of health plans, including a fee-for-service option; beneficiaries would also have financial incentives to select efficient health plans; and health plans would have strong incentives to compete for Medicare beneficiaries.

Several possible models for restructuring the Medicare program along those lines have been proposed. Frequently, such competitive market approaches offer beneficiaries more choices and clear financial incentives to choose less costly options. A key feature of those approaches is the notion of Medicare making a defined contribution on behalf of each beneficiary. Beneficiaries could then put those contributions toward the cost of the health plan of their choice. Beneficiary choice and limits on the government's contribution are important elements of the design of the health insurance program for federal employees.

A competitive redesign of Medicare is a possible strategy for addressing the long-term fiscal problems of the program. Major restructuring, however, would take time to develop and could not therefore address the short-term financing issues. Establishing a competitive system could be a major undertaking. Moreover, full implementation all at one time would be difficult; a phased-in approach, starting with younger Medicare beneficiaries, might be more feasible. But potential savings would accrue more slowly under that approach.

One thing is certain: postponing decisions about Medicare's financing will only make the necessary policy actions in the future more severe. Without a tax increase, ensuring that the HI trust fund remains solvent will almost certainly require immediate spending cuts as well as reductions in the underlying rate of growth of spending. Any delay will require more dramatic cuts and program changes in the future.

Mr. THOMAS. Thank you very much, Director.

Ms. O'Neill, we have heard testimony from people who have said we have been there before and do not worry about it, things will somehow work themselves out.

In fact, in your testimony you indicated that at one time the outlays exceeded income, in 1992, and once again will reach the tip point in 1996.

I do not think anyone has really directly addressed the problem if we do nothing.

If, in fact, the Congress and the President do not agree on what you have described as what I would call relatively far reaching and fundamental changes to Medicare, what would happen in 2002 and into 2003, if we do nothing and we play out this funding scenario, what would actually occur?

Ms. O'NEILL. If no legislative action was taken at all, in that year—according to our projections, and we agree substantially with the trustees—the trust fund would be depleted, which means that there would not be enough financing to cover what expenditures are likely to be in that year.

Mr. THOMAS. But what would happen?

Ms. O'NEILL. What would happen? I guess either some emergency infusions would have to be made at that point or spending would be cut off. Some type of rationing would have to occur at that point.

Mr. THOMAS. Since we have a relatively short lead time, and I guess in these areas actuaries would tell us a 6- or 7-year lead time is a relatively short lead time, decisions postponed really do have a significant impact on our options, isn't that true?

Ms. O'NEILL. That is true. You know, as I mentioned, the longer we wait, the spending proceeds will increase at a much higher rate than one might wish, making the problem harder to deal with. The longer you wait, the deeper the cuts you all have to make when you get there.

Mr. THOMAS. All of us are aware that the baby boomers are coming into a retirement period. That is going to affect the Social Security, OASI, Old-Age and Survivors Insurance, Fund. It is going to clearly affect the Medicare Fund. My understanding is that the wave, that demographic structure really will not hit the HIF, Hospital Insurance Fund, in the timeframe that we have been discussing. Is that accurate?

Ms. O'NEILL. We are talking about the easy years. The deficit in the trust fund account is growing and will, therefore, be depleting the trust fund. This is occurring during a slow period when the Depression babies and World War II babies are coming to retirement age. The baby-bust cohort was a very small one.

Mr. THOMAS. We have several problems in front of us, not just a short-term funding problem but the long term problem of the demographic shift that we would have to deal with. Is it possible in terms of the models that you have been looking at to make adjustments in this short-term period that will also help us in that demographic longer term problem period?

Ms. O'NEILL. The kinds of budgetary changes that would lead to expenditure reductions in the programs outlined in our options book are things that could be done right away. Significant savings

could be obtained in the short run. One could think of that as something that you might use in a transition period.

If the Congress and the Nation were to move toward a restructuring, many of those provisions would not be needed. They would be eclipsed by more systemic changes that would result in more efficient behavior on the part of providers, as well as, individuals making choices about their own medical care.

Mr. THOMAS. A fundamental restructuring of Medicare, getting it more into what seems to be a model that is occurring in the private sector, will not only help us in the short run, but will help get us ready for that more significant funding problem in later years?

Ms. O'NEILL. I meant, that the fundamental restructuring would probably take time, but in the transition one could use some of these short-range changes and presumably the particular bundle of immediate cost savings that were selected would be ones that would be helpful in leading to a major restructuring.

Mr. THOMAS. In the past, most often adjustments have been in adjusting formulas for providers. If we continue to do that, would that offer us a solution to our current funding program problem?

Ms. O'NEILL. It really hasn't worked very well in the past. Usually past history gives you some idea of what you can expect in the future.

In the past, Medicare problems seemed to be able to be resolved fairly easily. That was done in the context of a period when the retirement of the baby-boom population was not looming on the horizon, and it was started when the initial HI tax rates seemed very low. One could raise that and increase the tax base. We have gone those routes so that now there is no cap on the taxable earnings for HI program.

Mr. THOMAS. In fact, we have gone further than the Social Security Trust Fund payroll tax which has a cap on it.

Ms. O'NEILL. That is right.

Mr. THOMAS. You are saying we have gone to that well so frequently that we have removed all caps on income and it is simply then a factor of increasing the percentage of payroll tax. Do you have any estimates of what increase might be required of the payroll tax?

Ms. O'NEILL. The increase would be about 40 percent, somewhat more than a 40-percent increase in the HI tax rate. That is a 1.3 percentage point increase.

Mr. THOMAS. Forty-percent increase would cover us for the foreseeable future?

Ms. O'NEILL. No. I believe that is for the coming 25 years.

Mr. THOMAS. Thank you very much.

Mr. English will inquire.

Mr. ENGLISH. Thank you, Ms. O'Neill.

Following up on the last question, reviewing the report of the trustees, is it not true that without fundamental reform, payroll tax rates would have to triple to sustain the current Medicare Program long term.

Ms. O'NEILL. Through what period of time?

Mr. ENGLISH. This would be going out to the middle of the next century.

Ms. O'NEILL. That could well be because the problem is explosive. I could supply that for the record, but more than a 40-percent increase is needed for the first 25-year period. It would be significantly greater later on when the rate of increase in the elderly population is extraordinarily large.

Mr. ENGLISH. Thank you, Ms. O'Neill.

Can the Medicare Program as it is currently structured take advantage of managed care savings, and if not, why?

Ms. O'NEILL. The problem here stems from a number of factors that are quite complicated.

From the beneficiary's side, the incentive to go into a HMO is not exactly the same as it would be for private persons who face an array of costs and choose among the plans on the basis of the real costs of providing those resources.

In Medicare, the cost to the beneficiary is the same. The main difference would come from provision of services that might be offered by a HMO. Presumably it costs the HMOs less to provide the care because the managed care system allows them to take advantage of factors that a fee-for-service plan cannot. Those cost savings can't really be passed on.

A big factor there is that HMOs are paid 95 percent of the cost of a fee-for-service plan. It is not based on the actual costs. Even if it were, that would not be revealed to the beneficiaries.

You really do have an odd system. You can offer HMOs. More of the elderly have been moving into HMOs, possibly because many retirees have been in a HMO before and are used to the concept. Also, because HMOs do not compete in price, and their lower costs makes it possible to provide supplementary benefits, such as prescription drugs, no copayments, no deductibles, things of that sort.

Mr. ENGLISH. Ms. O'Neill, if we do not restructure the Medicare Program and we reduce spending growth through traditional budgetary approaches, in your view, what will be the likely result?

Ms. O'NEILL. I am sorry, I didn't——

Mr. ENGLISH. If we do not restructure the program as it is now and we reduce spending growth through the traditional budgetary approaches like we did during the eighties, in your view, what will be the likely result?

Ms. O'NEILL. There are a couple of changes that may have produced some reductions in the rate of growth, for example, the prospective payment system that is now used for the payment of inpatient services in hospitals. Of course, some of those may be shifted every time you try to control provider charges in some way. That is probably a better way because it doesn't allow for inpatient services. If it were just charges—the daily charge that was controlled—there would always be the option of increasing services. That controls the whole bundle in a prospective way, and it does appear to be a slow down in patient services, but it led to more outpatient services which are not controlled, and increasing use of home health care and other services that may be covered.

That is the reason we do not get very big savings; because most of the kinds of things that you can think of within the current system are forms of price controls.

Mr. ENGLISH. Thank you, Ms. O'Neill. I find your testimony to be substantive and nonpartisan, and as such, an edifying contrast with our last witness.

Mr. THOMAS. Mr. Portman will inquire.

Mr. PORTMAN. Thank you, Mr. Chairman.

Thank you Ms. O'Neill for your being here.

Is this your first appearance before the Committee?

Ms. O'NEILL. Yes, and I am happy to be here.

Mr. PORTMAN. Welcome before the Committee. We are very pleased to have you at CBO, and be so knowledgeable about this program, which I said earlier is the budget buster because of the magnitude of it and escalating costs that you outlined so well in your statement.

I have just a couple of questions, can you give us a sense as to the relationship between taxes paid and benefits received?

Often in the debate on Social Security we get into this discussion with our constituents, at least I do, and I would like to get a sense of what current Medicare recipients have paid in, versus what they are projected to get out on an average basis, and if you could look down the road some period of time, if you have that information, 10 years, 20 years.

Ms. O'NEILL. Well, in the HI Program——

Mr. PORTMAN. I am talking about HI.

Ms. O'NEILL [continuing]. Essentially, taxes paid by current workers provide most of the funding for the program.

Mr. PORTMAN. Which is true with Social Security as well, but the beneficiaries have also paid in a certain amount over their working life and——

Ms. O'NEILL. Yes.

Mr. PORTMAN [continuing]. Benefits, can you give us a sense of that?

Ms. O'NEILL. Payroll taxes right now bring in about $100 billion. There is also income from the taxation of benefits. Income from the trust fund accounts for less than one-third of the total that is needed to pay outlays. Outlays in 1995 run about $114 billion. So, it is mostly coming from payroll taxes of current workers.

Mr. PORTMAN. If you could provide, in writing, to the Committee, information as to current beneficiaries, that would be most helpful. In other words, the average beneficiary today given that person's life expectancy, whether that person indeed will draw more in benefits, and if so, how much more as compared to how much that person would have paid in payroll taxes under the HI Program over that person's working life. That would be very interesting for me and I think for other Committee Members.

If you could do a comparison with Social Security, I think we have it from the Social Security Subcommittee, but that would be very interesting to see just to contrast those programs.

[The following was subsequently received:]

On average, people turning 65 this year will contribute about $32,000 (in present value terms) over their lifetime to the costs of their Medicare coverage through payroll taxes during their working years and supplementary medical insurance premiums. They will use about $95,00 in Medicare benefits.

My second question would be what do you view as the larger problem, the impending bankruptcy of the HI Trust Fund? I know

you address this in your statement, of sort of the baby boomer crossing of the demographic lines, which does not occur before 2002, but in fact would occur at some later point. Which of these two problems do you see as the most pressing? I ask that question because our approaches might be guided by that.

Ms. O'NEILL. I think the next 10 years is a pretty big problem, and if you do not resolve the problem now, one thing leads to another.

I think the longer one waits, the harder it is to do anything about it. It is a problem now, but will be a worse problem in the future.

Mr. PORTMAN. Given the kinds of solutions that we have been talking about, even here today, some of which are longer term solutions, it seems to me we should get started now to address that demographic shift, where instead of four workers per retiree, where you indicated possibly two within 40 or 50 years.

Ms. O'NEILL. That is right, there is that.

Mr. PORTMAN. Again, thank you very much for your statement again. We look forward to working with you on this and other issues.

Mr. THOMAS. Mr. Cardin will inquire.

Mr. CARDIN. Thank you, Mr. Chairman.

Ms. O'Neill, let me also welcome you. CBO has had a rich bipartisan tradition with this Committee, and we look forward to you building on that tradition with CBO.

If I might clarify a couple points that have been previously raised; if I understand your testimony based upon your projections, the HI Trust Fund would run into a shortfall in fiscal year 2002 of $30 billion?

Ms. O'NEILL. That is right.

Mr. CARDIN. That is based upon no changes in the current funding system relating to the revenues or expenditures.

Ms. O'NEILL. These estimates are made on the basis of current law, so that doesn't assume any legislative change.

Mr. CARDIN. You have not put into these calculations the impact of the Contract With America on repealing the tax that went into the HI Fund on the part of the Social Security income?

Ms. O'NEILL. Only legislation that has passed, so it includes the current tax on Social Security recipients' benefits.

Mr. CARDIN. Chairman Thomas asked Secretary Shalala when the trust fund would run into trouble if that particular change would have come into law. The information that we have, I believe from you—it could have been from Joint Tax—it was a $26 billion loss of revenue over 5 years.

Ms. O'NEILL. It accelerates the depletion of the trust fund by 1 year.

Mr. CARDIN. One year. The statement is correct that there would be a 1 year difference in which the fund would go into depletion, 2001 rather than 2002?

Ms. O'NEILL. That is correct.

Mr. CARDIN. Thank you for that clarification.

Let me also clarify the point Mr. Collins raised earlier, because I think it should be clarified in the record. It is true the HI is a trust fund. The funds can only be expended for Medicare purposes.

If, in fact, we were to change the law so that HI produced surpluses and did not go into deficits, what impact would that have on the budget of the country as far as the deficit of the overall budget?

Ms. O'NEILL. It depends on how that was done.

Mr. CARDIN. If we were to just increase the revenues, or reduce the spending in Medicare so that the HI Fund ran surpluses, what impact would that have on the overall budget?

Ms. O'NEILL. Literally anything that you do to reduce expenditures in any program would contribute toward deficit reduction.

Mr. CARDIN. Even though the moneys can only be spent in Medicare, the fact we reduce Medicare spending reduces the overall deficit of the country?

Ms. O'NEILL. The way we figure the budget deficit is that, we figure the net deficit, we do not count the surplus.

Mr. CARDIN. Unless there is an understanding that the Medicare savings will not be used for deficit reduction, the way the current bookkeeping of the Federal Treasury is managed, a Medicare savings would be used for overall deficit reduction.

Ms. O'NEILL. To the extent that they are blended. The way it is currently figured, that would be true; what is called the net budget.

Mr. CARDIN. I say that for Mr. Collins' benefit, because you can't separate under our current way that we budget, the Medicare HI Trust Fund from the overall budget considerations unless there is some understanding as to how the Medicare cuts are being handled.

I just wanted to underscore the point that on April 15, we were supposed to have the budget. Without having the budget before us, it is impossible to know how Medicare is being calculated within the overall budget situation by the Republican leadership. I just wanted to clarify this point for Mr. Collins, and maybe others. If we run surpluses in the trust fund, it impacts the deficit and could be used to help finance the tax cut.

That is what concerns many of us on this side of the aisle.

Thank you, Ms. O'Neill.

Mr. THOMAS. Thank you very much.

Apparently, this is a debating point that obviously is going to go back and forth.

When you said, "extend it by a year," does that mean 12 months, since all of us know 12 months is 1 year. Frankly, if you look at the total dollar amounts we are dealing with, it couldn't possibly extend it for 1 full year. It might tip it from one fiscal year into the next by several months, but my understanding, and the understanding of most people watching, is that 1 year is 12 months.

Are we prepared to say that the extension of this particular program, which you have estimated at $26 billion, which Joint Tax has estimated at $15.6 billion over a 5-year period, is really 1 year as was stated?

Ms. O'NEILL. No, it is not. It is probably not a full year. The tax, as you say, is small per year. It is raising something like three, four, maybe up to——

Mr. CARDIN. Would the Chairman yield to clarify?

Mr. THOMAS. I would say that near the end of the Secretary's testimony, the Secretary indicated it would shorten it by some

months. I believe the Secretary was accurate in her last statement in regard to this issue, that it would shorten it for some months.

Mr. CARDIN. Would the Chairman yield?

Mr. THOMAS. Certainly.

Mr. CARDIN. I appreciate that.

The 5 years under CBO's projections cost the HI Fund $26 billion. If after 7 years we are going to be insolvent at $30 billion, it seems to me we could easily project that by the seventh year the loss in the HI Trust Fund revenues would exceed a full year's deficit or at least fiscal year 2002's deficit. Therefore, the $30 billion that you had projected in 2002, in fact, would not be there.

Ms. O'NEILL. I haven't followed everything that you have said but——

Mr. THOMAS. The point is that there is quite possibly some projected capability to cross once again a fiscal year structure. It seems to me that this is exactly the thing that we shouldn't be arguing, whether it is 6 months, whether it is 9 months, whether it is a year. That is no solution.

The gentleman from Nevada.

Mr. ENSIGN. No questions.

Mr. THOMAS. Does the gentlewoman from Connecticut wish to inquire?

Mrs. JOHNSON. I am sorry I had to miss your testimony. I wanted to welcome you here, and I appreciate your comments, which I did skim.

I did want to inquire in a general sense, one of the things that has been a difficulty in the past has been that the reorganization of the delivery system in health care has been moving so rapidly that it is hard to get good numbers on which one can predict any reduction in costs; in other words, by the time you have numbers they are outdated in terms of the pace of change in today's world.

Are you going to be able to work with us on those issues, look at the pace of change and the pace of cost savings when a company has gone from nonmanaged care to managed care, where an area of the country has gone from nonmanaged care to managed care, to help us understand the impact of seniors moving into integrated care systems on Medicare costs?

Ms. O'NEILL. We certainly would be. What you say is quite true, that it is very difficult to get data, partly because the changes have really been happening very fast. For example, I do not think that we know for sure what proportion of people in private health plans are in HMOs. This year, 1995, we do not know that.

We have some idea based on particular insurers who have provided some information, but that is only partial, it doesn't cover the whole United States. It takes a number of years. Our firmest data are actually for 1992.

Mrs. JOHNSON. For instance, in California where now managed care is a larger proportion of the care structure than any other State, we are beginning to see evidence that the slowing of growth in the health care costs in the private sector has also affected health care cost growth in the public sector.

While those figures are in a sense theoretical, nonetheless, they may indicate a trend.

We are going to have to look at some of those kinds of things. The fact that some of the most efficient providers in the State of California, like Kaiser, are seventh or eighth on the efficiency list, have to be looked at, and we have to look at what the implications will be for the future if we achieve that kind of thing.

In other words, we may have to project out on the basis of a different level of experience or different kind of experience rather than the data we have collected that are always 2 years old.

Ms. O'NEILL. There is considerable uncertainty because of these changes, in constructing our projections. We have worried about these issues and we feel that for both Medicare and Medicaid there probably is a larger degree of uncertainty about what will actually happen, in part because changes have been rapid.

In the Medicare Program, the managed care situation is not really the same as that which exists in the private sector. In the private sector you could safely assume that the reason that people are moving rapidly into managed care plans is that the plans cost less and people believe they are getting more for their money.

How much that would translate into for an elderly population is truly not known. There is a presumption that that could be true, and there is some evidence that that is true, but we do not know for sure.

One of the benefits of a private situation is that you do not have to guess what will be provided and what people will do, because you know that the situation really establishes itself. People do what is to their best advantage. That is not the way the Medicare system is currently structured. That can't really happen.

Mrs. JOHNSON. It might be necessary to have a number of projections, if that percentage moved, that would be the outcome, if this percentage moved, this would be the outcome, and if this percentage made that choice, this would be the outcome. So that we at least understand a fiscal implication of various choices within the senior community in terms of choosing a more even integrated system of care.

Ms. O'NEILL. That is true.

Mrs. JOHNSON. Thank you.

Mr. THOMAS. Mr. McCrery will inquire.

Mr. MCCRERY. Thank you, Mr. Chairman.

Mrs. O'Neill, I have some questions about the budget and how Medicare fits into the budget, kind of following up on Mr. Cardin's questioning.

Let's skip to part B Medicare for a minute. As I understand it, part B Medicare is subsidized, if you will, by general revenues, to the tune of about 70 percent, 70 to 75 percent.

Ms. O'NEILL. Yes.

Mr. MCCRERY. What is the mechanism by which we divert general revenues to make up the difference in part B, is that not an annual appropriation?

Ms. O'NEILL. The program is an entitlement so that there is a kind of trust fund—not exactly in the same sense as HI, since it is not a trust fund that accumulates. There is a trust fund and it also is a mandatory program so that spending is not appropriated.

Mr. MCCRERY. Not appropriated annually, we just by law say we will spend whatever it takes to make good the Medicare Part B Trust Fund.

Ms. O'NEILL. Premiums cover about 30 percent and the rest comes from general revenues.

Mr. MCCRERY. What about part A? If we were to reach 2002 with no changes and suddenly the trust fund is insufficient to pay the dependents of part A, is there some automatic mechanism that would fall into place to mandate that general revenues be used to supplement the trust fund money to make good on part A?

Ms. O'NEILL. I do not believe there is. It would require legislation. Of course, legislation could also put in an infusion from general revenues. That would require a change in the law.

Mr. MCCRERY. Even though Medicare Part A is also an entitlement, there is nothing——

Ms. O'NEILL. It has the complicated structure of an accumulating trust fund. I could check that further. Maybe I shouldn't be so quick to speak.

Mr. MCCRERY. I do not know either——

Ms. O'NEILL. I do not believe there is any automatic authority to use general revenues to pay for the HI expenditures.

Mr. MCCRERY. If that were the case, then at such time as we reached a negative balance in the trust fund and do not have to pay obligations under part A, that providers would go without payment if no further action were taken by the Congress?

Ms. O'NEILL. Or services would be rationed in some fashion. It is hard to say.

Mr. MCCRERY. OK. Right now, we have a positive balance in the trust fund; is that correct?

Ms. O'NEILL. Yes, that is true.

Mr. MCCRERY. Isn't that trust fund balance covered in the unified budget calculation?

Ms. O'NEILL. The trust fund balance is counted in the sense that it offsets. Not the trust fund accumulation. It is the incoming tax dollars that are earmarked for the trust fund that is in fact merged with other revenues when we calculate the net budget deficit. Not the funds in the trust fund. Those are really parenthetical to the budget calculation.

Mr. MCCRERY. Any interest that the trust fund earns would be counted as income?

Ms. O'NEILL. It is counted as income.

Mr. MCCRERY. OK.

When you get right down to it, Mr. Cardin and the Majority last year, or 2 years ago, chose to shore up the, if you will, the Medicare Part A Trust Fund by increasing taxes on Social Security recipients; is that correct?

Ms. O'NEILL. That is correct.

Mr. MCCRERY. We are saying there ought to be a better way to shore up that trust fund and make Medicare Part A pay for itself and that we choose not to raise taxes on Social Security recipients to do that. We choose some other way—which might be cutting spending in some other program or making programmatic changes in Medicare, but certainly, in our view, it was not a wise thing to do to raise taxes on Social Security recipients. Really, when you get

down to it, we are all searching for ways to make this trust fund viable past 2002. We just may disagree on which particular method to use to do that.

Mr. THOMAS. The gentleman's time has expired.

Mr. Levin will inquire.

Mr. LEVIN. I hear you, and the challenge is to spell out a better way.

Remember that you are digging the hole deeper if you repeal the tax on benefits—there have been savings from proposals spelled out by Ms. O'Neill that were initiatives from Republican administrations, regulating both hospital and physician reimbursement.

Anyway, Ms. O'Neill, welcome. I thought your testimony was really candid.

As mentioned, you have a great tradition in which you follow. We have had your predecessors come here and they have rather successfully walked the line and not let partisanship twist their testimony. That is true of this testimony. I congratulate you on it.

Could I ask in that regard a couple of questions about your comments on managed care?

Before I do that, do you know offhand, if not, maybe you could supply us, what percentage of the projected increase in Medicare expenditures in the next years would come from increased numbers of beneficiaries, and which would come from projected increases in hospital/physician costs?

Ms. O'NEILL. About 80 percent of the increase comes from increases in expenditures per beneficiary, and about 20 percent from increases in the number of beneficiaries. It is approximately of those orders of magnitude.

Mr. LEVIN. If you want to just—as you do recheck figures, and if there is any basic change in that, let us know?

[The following was subsequently received:]

CBO estimates that increases in caseload—that is, the number of beneficiaries—will increase Medicare spending by about 10 percent between 1995 and 2002. That estimate does not take into account possible changes in the demographic composition or health status of the beneficiary population.

Mr. LEVIN. Let me ask you about your testimony on managed care, because clearly there is increased discussion about there being more managed care in Medicare, and I think it is worthy of discussion as long as nobody thinks we are just finding an easy answer there.

You talk about it in your prepared statement. You say in the future both stronger financial incentives and better information would be necessary to encourage more Medicare beneficiaries to enroll in managed care plans. You go on to say that higher HMO enrollment may have a perverse effect of increasing Medicare costs not lowering them under Medicare's current payment system.

Then you take that issue right on, and there you say, but significant savings would not be generated unless the payment link between fee-for-service and managed care was broken.

Give us a clue how we would break that? I know mechanically how we would do that, but how would we implement a breakage in that linkage?

Ms. O'NEILL. It is very difficult under the current system because it is not a market system. It is essentially a fee-for-service system. In terms of the beneficiaries the cost is the same.

On the other hand, there must be some mechanism whereby the Federal Government could benefit from cost savings that HMOs actually incur.

Mr. LEVIN. But how would we——

Ms. O'NEILL. It has been suggested that one thing we could do would be to have competitive bidding on the part of HMOs. That is a change that could be implemented, instead of pegging it to 95 percent of the cost of the fee-for-service plan. Operating regionally, HMOs could bid and presumably the ones that could provide the same quality service for less would be the ones that would be awarded the HMO contracts.

Mr. LEVIN. I think you point out on page 12, there is a potential catch-22 in that. Because you say, however, generating more savings, theoretically, the program could reduce the additional benefits that HMOs currently offer to beneficiaries, blunting incentives to enroll in HMOs.

Ms. O'NEILL. That is right. On one side, you have generated a way that the Federal Government Medicare Program could actually receive some of the savings. But you have not done anything on the other side, because there is no way for the beneficiary to benefit by going into the HMO.

Now, although the dollar amount is the same, there are fewer costs attached to a HMO because it has room to add such features as not charging deductibles or providing free drugs.

Mr. LEVIN. Thank you.

Mrs. JOHNSON [presiding]. Thank you, Mr. Levin.

Mr. Houghton, it is your opportunity.

Mr. HOUGHTON. Just a very quick question.

Mrs. JOHNSON. I think we will be able to finish this very quickly.

Mr. HOUGHTON. Ms. O'Neill, good to see you, thanks very much.

One specific thing the Secretary stressed over and over again this morning was that you cannot take Medicare in isolation from the other health plans of both the public and private sector. I want to sort of ask you how you feel about that, because if I remember correctly, during the seventies and eighties when there were all sorts of health care programs, DRGs and things like that, the government really through Medicare moved way ahead of the private sector. The private sector really floundered. Then in the late eighties and early nineties, it sort of flipped.

As I look at the figures here that came out of the Annual Report of the Federal Hospital Insurance Trust Fund, that—and comparing those to the private sector, really, the government expenditures after the growth rate is about two times what the private sector is. The whole thing changes. Since we are running out of money, this thing has happened. It is different from what happened to the last generation.

I just wonder whether this isn't something we have to fix now rather than worrying about the totality of the private and public health programs?

Ms. O'NEILL. I do not think there is any question that Medicare is posing a problem right now. It seems to us, technically, it really

does have to be fixed because something negative will happen if it is not.

In the past few years it is true that private-sector spending has grown more slowly than Federal programs.

Mr. HOUGHTON. In effect, in terms of prioritizing this, you would fix Medicare and then at a later time go on to some of the other programs?

Ms. O'NEILL. I can't really comment on that, you know.

Mr. HOUGHTON. All right, thanks very much.

Mrs. JOHNSON. However, I would ask you to clarify your response. What I hear my colleague from New York saying is that in the early eighties, we made big changes in Medicare with hopes that it would affect the private sector, which to some extent it did. I mean, the DRGs came to cover reimbursements in the private sector as well as the public sector and initially that system did cut costs.

That indicates that it is perfectly possible to reform Medicare without reforming all of health care and the private sector as well and have some good effect on the Medicare problem. Is it not so?

Ms. O'NEILL. I believe that is true. I haven't fully followed or seen an argument that spelled out what that linkage is perceived to be, so it is hard for me to comment on it.

Mrs. JOHNSON. I think it is relevant to this hearing that the linkage has never been clearly defined, and in fact, past practice has recognized that while there is a linkage, it still is possible to reform one section of the economy without reforming the whole economy, or one section of a sector without reforming every section of that sector. I think that the implications of my colleague's comment was really in harmony with history, and I hear you not contradicting—not dissenting from that.

Ms. O'NEILL. As best I can tell, it looks as if it should be possible to do something to improve Medicare.

Mrs. JOHNSON. We only have 5 minutes. We do have to adjourn to vote and the next panel will convene. I would just ask you all, so if you would get back to me in writing any work that CBO has done on analyzing the Medicare premium from the perspective of what portion of it pays for seniors' health care costs, what portion of it pays for medical education in terms of percentage, and what portion goes to uncompensated care.

The other piece is any analysis you have done on all the different components that support medical education in America, because I want to get a better handle on those things.

Ms. O'NEILL. We do have those numbers. I would be happy to provide them.

[The following was subsequently received:]

The SMI, supplementary medical insurance, premium pays for about 31 percent of average SMI costs for an elderly beneficiary in 1995. Those costs include only medical benefits (97 percent of SMI outlays) and administration (3 percent of SMI outlays). All of Medicare's payments for medical education an uncompensated care are part of hospital insurance outlays. Direct and indirect medical education payments together account for about 5 percent of HI outlays, and disproportionate share payments account for about 3 percent of HI outlays.

Mrs. JOHNSON. Thank you very much and thank you for your testimony.

Ms. O'NEILL. Nice to be here.

[Recess.]

Mrs. JOHNSON [presiding]. If the panel will be seated, some Members have returned and others will be along shortly and we will proceed.

Mr. Ross, senior partner, Arnold & Porter, and public trustee of the Federal Hospital Insurance Trust Fund, you are welcomed to be with us. We appreciate you being here and you will open. After you, David Walker, partner, worldwide managing director of compensation and benefits, Arthur Andersen, another public trustee of the Federal Hospital Insurance Trust Fund; and then Guy King, consulting actuary, Ernst & Young, chief actuary of the Health Care Financing Administration.

We appreciate the opportunity to share your thoughts about a problem that really affects people of all ages, not just the seniors, but all of their families as well.

Mr. Ross.

STATEMENT OF STANFORD G. ROSS, SENIOR PARTNER, ARNOLD & PORTER, WASHINGTON, DC; AND PUBLIC TRUSTEE, FEDERAL HOSPITAL INSURANCE TRUST FUND

Mr. ROSS. Thank you, Madam Chairman, and Members of the Committee. We appreciate the opportunity to appear before you to testify on the 1995 trust fund reports. Mr. Walker and I have provided you a statement as public trustees and in order to maximize the value of our limited time before the Committee, I would ask that you enter our statement into the record and then Mr. Walker and I would like to each make some remarks on our own behalf.

Mrs. JOHNSON. Without objection.

Mr. ROSS. The public trustees are a part-time position and we act to represent the public interest in the preparation of these reports; and although I was appointed to the Democratic seat and Mr. Walker to the Republican seat by President Bush, we have operated through both a Republican and Democratic administration on what we believe is a nonpartisan basis.

We have made all of our statements jointly and we have had total accord in what we have reported over the 5 years, and my desire today is to emphasize some historical aspects of the long-term effort to adapt the Social Security and Medicare Programs to changing economic and social conditions, drawing particularly on my experience as Commissioner of Social Security in the late seventies and as a public trustee the last 5 years.

When viewed in historical perspective, the long-term financing problems of these programs that are before us today are not recent occurrences and the solutions are likely to be complicated to conceive and difficult to enact.

The Social Security Program was first enacted by the Congress in 1935 in a limited form. The program expanded slowly over the next 37 years and, in fact, did not reach full maturation until the amendments of 1972.

The Medicare Program was enacted in 1965. Although a Federal health care program was considered in 1935, only after some 30 years did such a program get enacted and then only for the elderly and disabled as a logical expansion of the Social Security system.

The extraordinary prosperity of the postwar period from 1945 to, roughly, 1972 allowed benefits to be expanded and the elderly to share in the economic success of the immediate post war period. The result of the matured Social Security Program and the Medicare Program was to remove many elderly from poverty and generally to enhance the security and well-being of workers who were disabled or retired.

However, beginning shortly after 1972 with the oil shock, stagflations and the more unsettled circumstances of the seventies, the Social Security system reflected the economic and social stresses of the time. It became clear that changes were necessary to adapt the program to these changed circumstances and those projected for the future. Thus major retrenchments in the program came in the form of amendments in 1977 and 1983. On each occasion, the Congress on a bipartisan basis, in a complex package of structural changes, both raised payroll taxes and reduced benefits in the interest of providing long-term financial stability to the program.

The Medicare Program was subject to a series of cost containment enactments in the eighties and has repeatedly been the subject of congressional concerns over the past decade. Many changes were enacted with the cooperation of Democratic Congresses and the Republican administrations of Presidents Reagan and Bush.

I believe it is clear from even this briefly capsulized history that it is entirely possible, indeed absolutely necessary, to successfully adapt the Social Security and Medicare systems to changing circumstances, and in particular, to the social and economic conditions that are anticipated to prevail in the next century.

However, the key to accomplishing needed changes is to make programmatic changes, that is, changes in which the programs are reformed on their own terms to provide long-term financial stability for them. History shows that changes proposed essentially to achieve deficit reduction or as part of any kind of a legislative program that is not perceived to preserve and maintain these programs for the benefit of not just current beneficiaries, but workers who will become beneficiaries in the years ahead, do not fare well.

In my judgment, deficit reduction and Social Security and Medicare reforms, which are both vital priorities for the nation, can best be achieved when pursued independently of each other. Bipartisanship and developing a broad consensus for change is essential to successfully adapting the Social Security and Medicare systems. I firmly believe that the problems these programs presently face are serious and need to be addressed promptly.

Perhaps the most important step we can take right now is to find ways for people of all persuasions to work together to bring these programs into long-term financial stability, for looking at history almost assuredly tells us that a complex package of structural changes will be needed that involves both benefit reductions and revenue increases, and construction of this package will require a great deal of goodwill and trust on the part of many people in our country.

Finally, I would submit that despite the difficulties in the last 20 years in achieving needed adaptations, our present Social Security and Medicare Programs have continued to serve the country well.

It is my strong belief that the Social Security and Medicare Programs are fundamentally sound and it is vital to the welfare of the nation in the 21st century that they be adapted now in ways to keep them sound in changing circumstances. By making relatively small changes soon and gradually, more radical disruptive changes can be avoided.

I will be happy to answer any questions you may have about either our statement submitted for the record or my personal testimony today. I thank you once again for the opportunity to appear before you and commend you for your sincere commitment in holding these hearings and trying to provide leadership vital to achieving needed reforms.

Mrs. JOHNSON. Mr. Walker, do you have a separate statement?

Mr. WALKER. That is correct.

Mrs. JOHNSON. Thank you.

STATEMENT OF DAVID M. WALKER, PARTNER, WORLDWIDE MANAGING DIRECTOR OF COMPENSATION AND BENEFITS, ARTHUR ANDERSEN LLP, ATLANTA, GEORGIA; AND PUBLIC TRUSTEE, FEDERAL HOSPITAL INSURANCE TRUST FUND

Mr. WALKER. Madam Chairwoman, Members of the Committee, I understand that each of the Committee Members have been provided with a copy of our latest joint public trustees' statement, therefore, I will focus my remarks on certain matters which, for the most part, go beyond our joint statement and present and represent my personal views.

These remarks are my personal views as an informed and concerned private citizen who also happens to be a former public trustee of the Social Security and Medicare Trust Funds, a former Assistant Secretary of Labor of Pension, Health and Welfare Programs, and head of the Pension Benefit Guaranty Corporation

In my opinion, when viewed on a combined basis, our current Medicare and Social Security Programs promise significantly more than this Nation can reasonably be expected to deliver in the next century, given known demographic trends, projected health care costs, the current national debt, projected fiscal budget deficits, the projected financial imbalances in the Social Security and Medicare Programs and other factors.

At the same time, the nature, timing, and magnitude of the projected financial imbalances facing the Social Security—namely the OASI and DI—and the Medicare, the HI and SMI Programs, are distinctly different. Clearly the projected financial balance in the HI Program is our most serious and immediate concern, since the projected cost rate for this program far exceeds the projected income rate, and the HI Trust Fund is projected to become exhausted in 2002.

Furthermore, the HI Trust Fund will start to experience a negative cash flow in 1996 and, in fact, already passed its peak of financial ratios. In other words, the highest trust fund balance was achieved in 1992 and we have been going downhill since then.

In addition, the projected escalation in health care costs for both the HI and SMI Programs is both alarming and unsustainable. These escalating costs were caused by a variety of factors, includ-

ing certain uncontrollable factors, such as the increasing dependency ratio and longer lifespans.

As Mr. Ross and I have stated in our last several public trustee statements, in fact the last three, the Medicare Programs, in their present form, are clearly unsustainable. In my opinion, these programs are in need of fundamental and dramatic reform. This includes reviewing who is covered, what benefits are provided, how they are provided, and how the programs are financed.

There is little question in my mind that the incremental and cost shifting approaches of the past have about been played out. In addition, while additional long-term savings can and should be achieved by more aggressive use of managed care approaches and tougher enforcement, these initiatives may result in more cost than savings in the short term. In addition, these actions alone will not come close to solving the long-term financing problems of the current Medicare Programs.

In my opinion, while the current Medicare Programs may have been appropriate and affordable in 1965, they clearly will not be in the next century. This opinion is based upon a variety of factors, such as known demographic trends, escalating health care costs, existing health care coverage gaps, the current tax treatment of health care benefits, the projected financial condition of Medicare Programs, the relative financial well-being of the elderly as compared to other cohort groups, the current national debt and fiscal budget deficits.

As a result, the time has come to reengineer our Medicare Programs in a manner that is fair, fiscally responsible, and economically rational. We must also assure that the reengineered programs are financially sound and sustainable over the longer term. Even fundamental reexamination of the Medicare Programs should preferably—I underline the word "preferably"—be pursued within the context of more comprehensive health care reform.

Practically, given the significance of the reforms that will be needed, we will have to pursue incremental reforms, conducting a major education public campaign and then pursue more comprehensive and dramatic health care reform on a bipartisan basis. Any broader health care reform initiative should include reviewing and reconsidering appropriate roles of government, employers and individuals in the provision and financing of health care, including reconsidering all current health care tax preferences.

This broader reform initiative should also focus on what individuals need and what our Nation can afford, rather than on what benefits are currently being provided and what additional benefits individuals want. After all, there is no free lunch, and to the extent that these programs are not self-sustaining or otherwise affordable, they will only serve to further mortgage our children's future and increase existing expectation gaps.

Importantly, a failure to effectively address escalating health care costs and the financial imbalance in the Medicare Programs in a timely, effective manner will have serious long-term economic and intergenerational consequences. We must have the courage, the vision, and the commitment to deal with the fundamental imbalance in the Medicare Programs and our other health care related challenges in a timely, comprehensive, and most importantly,

nonpartisan manner. Delay will only serve to increase the difficulty and the severity of any related changes.

In addition, failure to effectively address the financial imbalance in the Medicare Programs will likely have long-term adverse implications for the Social Security Program as well since Congress has had a history of redirecting funds from the better financed programs in the short term to the less well financed programs.

The most recent example is the transferring of the tax revenues achieved from increasing the amount of Social Security benefits subject to income inclusion from 50 percent to 85 percent from the OASI Trust Fund to the HI Trust Fund. This served to help the HI Trust Fund and hurt the OASI Trust Fund. In my opinion, that type of action is inappropriate.

In summary, as an informed and concerned private citizen and a father of two, I am extremely concerned that this Nation faces a number of looming crises, including a retirement and intergenerational crisis. We must have the courage, the vision and the commitment to deal with these looming crises in a timely, effective, and nonpartisan manner. Doing so is critical to the long-term competitive posture and economic security of this Nation, the economic security of our children and grandchildren, and the retirement security of American workers and retirees. As such, I stand ready to assist the Congress and any other interested parties to address this important challenge in a reasoned, responsible, and nonpartisan manner.

Madam Chairwoman, that concludes my statement. I would be happy to answer any questions you might have.

Mrs. JOHNSON. Thank you very much.

[The prepared statement follows:]

STATEMENTS OF STANFORD G. ROSS AND DAVID M. WALKER, PUBLIC TRUSTEES, SOCIAL SECURITY AND MEDICARE BOARDS OF TRUSTEES

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

It is our privilege to testify regarding the financial status of the Medicare Hospital Insurance Trust Fund as shown in the 1995 Annual Report of the Board of Trustees of that fund. As you know, the Public Trustees are part-time officials appointed by the President and confirmed by the Senate to represent the public interest in this important process of public accountability. In our normal activities, Mr. Ross is a lawyer and consultant and Mr. Walker is a CPA and consultant, both with extensive public and private experience in tax, financial and retirement security matters. Pursuant to law, our terms as Public Trustees ended with issuance of the 1995 Trustees Reports on April 3, 1995. Our joint statement reflects the positions we took in those reports.

Role of the Public Trustees

As Public Trustees, our primary activities were directed at assuring that the Annual Trust Fund Reports fully and fairly present the current and projected financial condition of the trust funds. During preparation of the Annual Reports over the last 5 years, we participated in the review of the proposed short-range and long-range economic and demographic assumptions and in the decisions made on those assumptions. We attempted to test assumptions, question methodologies and work with the Offices of the Actuary of the Social Security Administration and the Health Care Financing Administration and others in and out of government to seek improvements in the projections. Specifically, we sponsored roundtable discussions with expert panels on key assumptions, including the rate of change in fertility, mortality and real wages. We also sponsored a symposium and publication of papers on how methods and assumptions might be improved to better estimate the future income and health care needs of the elderly and disabled. The goal of these efforts was to assure the American public of the integrity of the process and credibility of the information in these reports.

In addition to our efforts to ensure the integrity of the projections in the trust fund reports, we also worked to improve communications with the Congress and the public regarding these important programs. We are particularly pleased to have provided leadership in returning to one set of intermediate projections, or "best estimates," in the reports, and in conceiving and instituting the increasingly popular *Summary of the Annual Reports*, including an annual "Message From the Public Trustees," as an important part of the reporting process. We also testified before congressional committees and other governmental commissions, and gave speeches and briefings to congressional staffs and other interested parties. Our goal in these activities has been to enhance understanding of the current and projected financial condition of the Social Security and Medicare programs.

A key point we have stressed is that projections ultimately are only estimates and must necessarily reflect the uncertainties of the future. Nevertheless, the projections in the Trustees Reports are useful if understood as a guide to a plausible range of future results and if acted on in a timely and responsible manner. With this purpose in mind, we now turn to the projections in the 1995 report on the Hospital Insurance (HI) Trust Fund but will also mention the status of the Supplementary Medical Insurance (SMI) Trust Fund.

Medicare Program

The 1995 reports on both the HI Trust Fund and the SMI Trust Fund show alarming financial results. While the financial status of the HI program improved somewhat in 1994, the HI Trust Fund continues to be severely out of financial balance and is projected to be exhausted in about 7 years. The SMI Trust Fund, while in balance on an annual basis, shows a rate of growth of costs which is clearly unsustainable. Moreover, this fund is projected to be 75 percent or more financed by general revenues, so that given the general budget deficit problem, it is a major contributor to the larger fiscal problems of the nation.

Currently about four covered workers support each HI enrollee. This ratio will begin to decline rapidly early in the next century. By the middle of the next century, only about two covered workers will support each enrollee. Not only are the anticipated reserves and financing of the HI program inadequate to offset this demographic change, but under all the sets of assumptions, the trust fund is projected to become exhausted even before the major demographic shift begins to occur.

The Trustees note that some steps have been taken to reduce the rate of growth in payments to hospitals, including the implementation of the prospective payment system for most hospitals. Experience to date suggests that this reimbursement mechanism, together with payment limitation provisions enacted by the Congress, has helped to constrain the growth in hospital payments and has improved the efficiency of the hospital industry.

Extension of this payment system to other providers of HI services and further legislation to limit payment increases to all HI providers could postpone depletion of the HI trust fund for about another 5 to 10 years. Much more substantial steps would be required, however, to prevent trust fund depletion beyond 2010 as the baby boom generation begins to reach age 65.

We continue to believe, as we also emphasized in our 1993 and 1994 Public Trustees Messages, that the Medicare program is clearly unsustainable in its present form. We had hoped for several years that comprehensive health care reform would include meaningful Medicare reforms and that comprehensive health reform would eventually reduce the rate of growth of health care costs and thus the financing shortfall facing Medicare. However, with the results of the last Congress, it is now clear that Medicare reform needs to be addressed urgently as a distinct legislative initiative. We also believe strongly that Medicare reform should be included as an integral part of any broader health care reform initiative which may be considered in the future.

There are basic questions with the scale, structure and administration of the Medicare program that need to be addressed. For example, is it appropriate to have a Part A (Hospital Insurance) and Part B (Supplementary Medical Insurance) today, or should this legacy of the political process that enacted Medicare in the mid-1960s be revised to create a unified program? Is it appropriate to combine participants' social insurance tax contributions for Part A and premium payments for approximately one-quarter of Part B with general revenues? If so, what should be the proper combination of beneficiary premiums, taxpayer social insurance contributions, and general revenues? How are each of these kinds of revenue sources to be justified and what rights to benefits and responsibilities to pay benefits are thereby established? How can the program become more cost-effective? How can fraud, abuse and waste be better controlled?

We believe that comprehensive Medicare reforms should be undertaken to make this program financially sound now and over the long term. The idea that reductions in Medicare expenditures should be available for other purposes, including even other health care purposes, is mistaken. The focus should be on making Medicare itself sustainable, making it compatible with Social Security, and making both Social Security and Medicare financially sound in the long term. While Social Security is in far better financial health than Medicare and the changes that will be required in Social Security can be relatively small and gradual if they are begun in the near future, the magnitude of those changes grows each year that action is delayed. Thus, urgent attention to Medicare's financing is critical, but it is important to keep in mind the financing needs of both Social Security and Medicare when making any changes because the resources that are devoted to one area will not be available to the other.

We strongly recommend that the crisis presented by the financial condition of the Medicare Trust Funds be addressed on a comprehensive basis, including a review of the program's financing methods, benefit provisions, and delivery mechanisms. Various groups should be consulted and reform plans developed that will not be disruptive to beneficiaries, will be fair to current taxpayers who will in the future become beneficiaries, and will be compatible with government finances overall.

We have attached to our statement the four-page "Message From the Public Trustees" that is included in the *Summary of the 1995 Annual Reports*, as well as our biographical information. We thank you for the opportunity to present our views and will be pleased to answer any questions you may have.

The Public Trustees

Six people serve on the Social Security and Medicare Boards of Trustees: the Secretary of the Treasury, the Secretary of Labor, the Secretary of Health and Human Services, the Commissioner of Social Security and two members (of different political parties) appointed by the President and confirmed by the Senate to represent the public. The Boards are required by law to report to the Congress each year on the operation of the four Social Security and Medicare trust funds and the projected financial status of these funds for future years. The Public Trustee positions were created by the Social Security Amendments of 1983. Stanford G. Ross and David M. Walker began four-year terms as Public Trustees on October 2, 1990, and completed their terms with issuance of the 1995 reports on April 3, 1995. In addition to their duties overseeing the trust funds, they have worked to increase public understanding and public confidence regarding Social Security and Medicare.

STANFORD G. ROSS

Stanford G. Ross is a Senior Partner in the law firm of Arnold & Porter in Washington, D.C. Mr. Ross dealt extensively with public policy issues while serving in the U.S. Treasury Department, on the White House domestic policy staff, and as Commissioner of Social Security. He also served as Chair of an Advisory Council on Social Security.

Mr. Ross has taught law at the Georgetown, Harvard, New York University and Virginia Law Schools, and has been a Visiting Fellow at the Hoover Institution, Stanford University. Mr. Ross has served as Chairman of the American Bar Association Tax Section Committee on Social Security and Payroll Tax Problems. He has provided technical assistance to various foreign countries on Social Security and tax issues under the auspices of the International Monetary Fund, the World Bank, and the U.S. Treasury Department. Mr. Ross served as President of the National Academy of Social Insurance from January 1990-April 1992, and is a founding member and a member of its Board of Directors. He received a J.D. degree from Harvard Law School and a B.A. degree from Washington University (St. Louis). He is the author of many papers on federal taxation and income security and is a frequent participant in conferences on these subjects.

DAVID M. WALKER

David M. Walker is a partner and worldwide managing director of the compensation and benefits practice of Arthur Andersen LLP based in Atlanta, Georgia. Mr. Walker has held a variety of executive and policymaking positions in the Federal government, including serving as head of two of the three Federal agencies that administer the Employee Retirement Income Security Act of 1974 (ERISA). His most recent full-time government position was Assistant Secretary of Labor for Pension and Welfare Benefit Programs at the U.S. Department of Labor. Mr. Walker served at the Pension Benefit Guaranty Corporation (PBGC) before joining the Department of Labor.

Mr. Walker is a Certified Public Accountant and received his B.S. in accounting from Jacksonville University. He holds a number of leadership positions, including serving as a director of the Association of Private Pension and Welfare Plans (APPWP), chairman of the American Institute of Certified Public Accountants' (AICPAs) Employee Benefit Plans Committee, and vice-chairman of the Legislative Committee for the Southern Employee Benefits Conference. He is a member of a number of other organizations, including the National Academy of Social Insurance and the Editorial Advisory Board of *Journal of Accountancy* and *Journal of Taxation of Employee Benefits*. He is a frequent speaker, author and expert witness on a variety of compensation, benefits, investment, retirement and related issues.

A MESSAGE FROM THE PUBLIC TRUSTEES:

This is the fifth set of Trust Fund Reports on which we have reported as Public Trustees. It is also, under the terms of our appointment, our last report, and we use this occasion to summarize our views on some major aspects of the Social Security and Medicare programs. As representatives of the public, our efforts have been to assure the American public of the integrity of the process and the credibility of the information in these reports. We feel privileged and honored to have been able to take part in this important exercise in public accountability, and want to provide our best advice on directions for change of these important programs in the years ahead.

The Need For Action

During the past 5 years there has been a trend of deterioration in the long-range financial condition of the Social Security and Medicare programs and an acceleration in the projected dates of exhaustion in the related trust funds. To some extent, this has been predictable because when doing annual 75-year projections, an additional deficit year in the 2060s is being added with each new projection. But to some extent, the increasingly adverse projections have come from unforeseen events and from the absence of prompt action in response to clear warnings that changes are necessary. These adverse trends can be expected to continue and indicate the possibility of a future retirement crisis as the U.S. population begins to age rapidly. We urge that concerted action be taken promptly to address the critical public policy issues raised by the financing projections for these programs.

Projections As A Guide To Action

We believe it is important for the public and the Congress to understand more about what the projections in the Trust Fund Reports really mean and how they are intended to be used. These projections represent the best estimates the Trustees can make based on the best available information and methodologies. We have, during our period of service, attempted to test assumptions, question methodologies and work with the Offices of the Actuary of SSA and HCFA and others in and out of government to seek improvements in the projections. We have also stimulated thought through a symposium and publication of papers on how methods and assumptions might be improved to better estimate the future income and health care needs of the elderly and disabled. Action should be taken to continue and extend survey and other data development efforts and to improve modeling capability regarding the income and health circumstances of future retirees. Such information is critical to the legislative and regulatory activity that will be required for both public and private income security and health care programs in future years.

However, with even the best data and models, projections ultimately are only estimates and must necessarily reflect the uncertainties of the future. They are useful if understood as a guide to a plausible range of future results and if acted on in a timely and responsible manner. They are not helpful if ignored, or if used improperly, or if distorted. We hope that more policymakers will come to grips with the strengths and limitations of projections such as those in the Trust Fund Reports and how those projections can be used most productively.

Social Security Program

The Old-Age and Survivors Insurance Trust Fund shows a deficit of 1.87 percent of payroll in the long run. It is by far the best financed of the trust funds, and we believe strongly that the OASI program can and should be maintained over the long term. Yet even here reforms should be undertaken sooner rather than later to ease the transition to providing financial stability in the next century. We note the recent work of the Bipartisan Entitlement Commission and the current work of the Advisory Council on Social Security regarding the long-term financing of the OASI program. We hope that this kind of work will continue and that this problem will be addressed in a timely fashion.

The condition of the Disability Insurance Trust Fund is more troublesome. While the Congress acted this past year to restore its short-term financial balance, this necessary action should be viewed as only providing time and opportunity to design and implement substantive reforms that can lead to long-term financial stability. The research undertaken at the request of the Board of Trustees, and particularly of the Public Trustees, shows that there are serious design and administrative problems with the DI program. Changes in our society, the workforce and our economy suggest that adjustments in the program are needed to control long-range program costs. Also, incentives should be changed and the disability decision process improved in the interests of beneficiaries and taxpayers. We hope that this research will be completed promptly, fully presented to Congress and the public, and that the Congress will take action over the next few years to make this program financially stable over the long term.

Medicare Program

The most critical issues, however, relate to the Medicare program. Both the Hospital Insurance Trust Fund and the Supplementary Medical Insurance Trust Fund show alarming financial results. While the financial status of the HI program improved somewhat in 1994, the HI Trust Fund continues to be severely out of financial balance and is projected to be exhausted in about 7 years. The SMI Trust Fund, while in balance on an annual basis, shows a rate of growth of costs which is clearly unsustainable. Moreover, this fund is projected to be 75 percent or more financed by general revenues, so that given the general budget deficit problem, it is a major contributor to the larger fiscal problems of the nation.

The Medicare program is clearly unsustainable in its present form. We had hoped for several years that comprehensive health care reform would include meaningful Medicare reforms. However, with the results of the last Congress, it is now clear that Medicare reform needs to be addressed urgently as a distinct legislative initiative. We also believe strongly that Medicare reform should be included as an integral part of any broader health care reform initiative which may be considered in the future.

There are basic questions with the scale, structure and administration of the Medicare program that need to be addressed. For example, is it appropriate to have a Part A and Part B today, or should this legacy of the political process that enacted Medicare in the mid-1960s be revised to create a unified program? Is it appropriate to combine participants' social insurance tax contributions for Part A and premium payments for approximately one-quarter of Part B with general revenues? If so, what should be the proper combination of beneficiary premiums, taxpayer social insurance contributions, and general revenues? How are each of these kinds of revenue sources to be justified and what rights to benefits and responsibilities to pay benefits are thereby established? How can the program become more cost-effective? How can fraud, abuse and waste be better controlled?

We feel strongly that comprehensive Medicare reforms should be undertaken to make this program financially sound now and over the long term. The idea that reductions in Medicare expenditures should be available for other purposes, including even other health care purposes, is mistaken. The focus should be on making Medicare itself sustainable, making it compatible with OASDI, and making both Social Security and Medicare financially sound in the long term.

We strongly recommend that the crisis presented by the financial condition of the Medicare Trust Funds be urgently addressed on a comprehensive basis, including a review of the program's financing methods, benefit provisions, and delivery mechanisms. Various groups should be consulted and reform plans developed that will not be disruptive to beneficiaries, will be fair to current taxpayers who will in the future become beneficiaries, and will be compatible with government finances overall.

Institutional Considerations

We have as Public Trustees tried over the past 5 years to provide continuity and improve the institutional framework surrounding the Social Security and Medicare programs. We have bridged two Administrations (one Republican and one Democratic), two Advisory Councils (one appointed by a Republican Administration and one by a Democratic Administration), and many changes in the ex officio Trustees. We have consulted with each of the Advisory Councils, as well as the working group of the prior Public Trustees, the Bipartisan Entitlement Commission, the Notch Commission and many other government entities. We have testified before both the House Ways and Means Committee and the Senate Finance Committee and held regular briefings for Congressional staff on the Trust Fund Reports. We know that with the advent of the new Social Security Administration as an independent agency, many of the institutional relationships in these areas will change. We hope that the Public Trustees in the future will continue to make a contribution towards a coherent institutional structure that serves the interests of the public.

Finally, we note that although the statute provides that one of the Public Trustees must be from each of the major political parties, we have operated as independent professionals on a nonpartisan basis. Every statement we have made over 5 years has been joint and consensual, and without partisan content or political dissonance. We believe these programs are too important to be politicized and urge that a highly professional, nonpartisan approach continue to be followed in future reports to the Congress and the public.

Stanford G. Ross
Trustee

David M. Walker
Trustee

Mrs. JOHNSON. We will hear from Mr. King.

STATEMENT OF ROLAND E. "GUY" KING, CONSULTING ACTUARY, ERNST & YOUNG, WASHINGTON, DC, FORMER CHIEF ACTUARY, HEALTH CARE FINANCE ADMINISTRATION

Mr. KING. Thank you, Madam Chairman. I have a statement for the record and I would like to make a brief statement summarizing that testimony with your permission.

We have heard today, there seems to be general agreement that the Hospital Insurance Trust Fund is going to be depleted or bankrupt in 2002, and there seems to be general agreement that the rate of growth after that period of time is going to be very high, high enough so that by 2025, the tax rate is going to double if nothing is done to control costs, and that by 2065, the tax rate will have had to have tripled in order to pay for the cost of the program.

But of course, these tax rate increases are not the result of some extremely pessimistic assumptions about the rate of increase in health care costs because we have heard testimony regarding the impact of the baby boomers on the future costs, so the problem is very real, very predictable. The baby boomers are alive today and we have a very good idea what their mortality rates are and how long it is going to be before they retire.

One of the things I would like to talk about is that the HI Program isn't just a budget problem. Solving the HI problem is a problem of solving the problem in a way that is fair to both current and future generations of beneficiaries. We can define generational equity by calculating and comparing each generation's contributions to the program with the benefits that they receive from the program. When we do that and then look at the cohort of beneficiaries retiring in 1994, 2014, and 2034, and then look at the timing and the way in which we solve the problem, we are led to two conclusions.

First of all, it is more fair to take action earlier rather than later in order to solve the problem because the current generation of retirees is going to receive back over $5 in benefits for each dollar they pay into the program. Second, it is more fair to solve the problem by reducing the rate of growth in the outlays of the HI Program than in taxing future generations to pay for current benefits today.

While we are talking about the financial problems of the HI Program, let's not forget about the SMI Program. It is not in immediate danger of becoming insolvent because of the way it is financed, but the rate of growth here is also unsustainable. The SMI Program as a percent of GDP in 1994 is 0.93 percent and that will triple as a percent of GDP by 2020, and then it will have quadrupled by the middle of the next century. We can't solve the problems in the HI Program merely by shifting costs to the SMI Program.

The outlays of both the HI and SMI programs are growing at excessive rates today because of two primary factors. The first factor is third-party payments and the second factor is fee-for-service medicine. Removing either one of these factors which interact with each other in order to produce the rate of growth we are seeing today is a way of dealing with the problem.

Removing—dealing with the first factor, third-party payments, is addressed by increasing coinsurance and deductibles, and a way for dealing with the fee-for-service medicine factor is the managed care approach, so I would characterize those two approaches as being complementary and what I would define as true reform in the Medicare Program as opposed to just reducing the payment rates to providers.

If some adjustments had just been made in the Medicare Program many years ago, we wouldn't be seeing the high rate of increase that we see today. For example, in the SMI Program, if the SMI deductible had just been indexed to inflation, then the SMI premium today could be only $4 a month, and yet the contributions of the government to the program could be $5 billion lower than they are today, and instead of—instead of the SMI premium being set at the rate of $46.10 per month that it is today, it could be reduced to the level of $4.

I can see that my time is up, so I will be glad to answer any questions.

[The prepared statement follows:]

TESTIMONY BY
Guy King
Former Chief Actuary for HCFA
before the
House Committee on Ways and Means
May 2, 1995

Mr. Chairman, my name is Guy King. I am a Consulting Actuary with the firm of Ernst & Young. I was the Chief Actuary for the Health Care Financing Administration from 1978 to 1994. During my time as Chief Actuary, the expenditures for both the HI and SMI programs grew at rates that are unsustainable in the long run, and they continue to grow at those unsustainable rates today and into the foreseeable future.

Hospital Insurance (HI) Trust Fund

The expenditures of the Hospital Insurance Trust Fund (Part A of Medicare) increased from $17.7 billion in 1978 to $107.2 billion in 1994. This is an average rate of increase of about 12 percent per year. In 1978, the Annual Report of the Board of Trustees projected that the HI trust fund would be bankrupt by 1990. Because of some minor price reduction changes in the program which have been legislated over the years, the date of bankruptcy has been pushed back by a few years, so that the 1995 Trustees Report projects that the HI fund will be bankrupt by 2002. Thus, during my 15 years as Chief Actuary, virtually nothing was done as the problem grew and the HI program moved closer to the bankruptcy. The impending bankruptcy of the fund is just the tip of the iceberg, though. The hole is just going to continue to continue to get deeper for many years, and the pace of decline is going to accelerate. The tax rate necessary to support the current program will have tripled by the year 2065. Even by the year 2025 the tax rate necessary to support the cost of the program will have more than doubled.

I know that some people view these projections as a red herring. I have often heard it suggested that we should just wait awhile to see if these problems really begin to materialize. That is apparently what lawmakers were thinking when they heard the same projections back in the mid-1970's. The financial problems of the HI program aren't just the result of some extremely pessimistic assumptions about the growth of health care costs. The assumptions regarding the rate of growth in health care costs and the growth in income to support the program are really very optimistic. These projections are being driven now by the coming demographic shift. The Baby Boomers who will retire and begin drawing benefits starting in 2010 are all alive today. As the Post World War II Baby Boom begins to reach age 65, the growth in the number of workers paying taxes is going to decline, and at the same time the growth in the number of people eligible for Medicare benefits is going to increase. Currently, about four taxpayers support each HI beneficiary. By the middle of the next century, when all of the baby boom will have retired, there will only be two covered workers supporting each HI beneficiary, so this problem is very real and very predictable.

The problem is so large that there isn't any painless way at this point to solve the problem. To place income and expenditures in balance even over the next 25 years, which is the easy part, is going to require either an immediate 30 percent reduction in expenditures or an immediate 44 percent increase in the HI tax rate, or some combination of both. And even then, the financial problems beyond 25 years would still remain unsolved.

Some have suggested that the apparent recent slowdown in the rate of growth in health care costs and the recent favorable experience in the Medicare program may be enough to save the government from having to make these decisions. That isn't going to happen. During my twenty years as a government actuary I observed that, when there was a threat of government action, health care costs always behaved very well. This occurred with the wage-price

controls of the early 1970's, the threat of hospital cost containment legislation during the late 1970's, and during the discussions of health care reform in 1993 and 1994. Once the perceived threat is past, the rate of increase in expenditures once again accelerates.

In deciding how and when to take action to make the HI Program solvent, one of the difficult questions that needs to be addressed is the issue of generational equity. Generational equity can be measured by comparing each generations' contributions to the program with the benefits they receive from the program. We measured generational equity under four combinations of the following policy options: 1) act immediately or delay action and 2) increase taxes or reduce benefits. Our studies show that the solutions resulting in the greatest generational equity involve taking immediate action rather than delaying action and reducing the growth in benefits rather than increasing taxes. The table below shows the impact of various policy options on generational equity for persons retiring in 1994, 2014, and 2034.

Ratio of Benefits to Contributions

		Person Retiring in:		
	Proposed Change in Financing	1994	2014	2034
1.	Do nothing until trust fund depleted, then increase taxes.	5.19	2.93	2.17
2.	Do nothing until trust fund depleted, then reduce benefits.	3.25	1.31	1.14
3.	Reduce benefits immediately.	2.10	1.36	1.54
4.	Increase taxes immediately.	5.19	2.20	1.68
5.	Reduce benefits immediately, then index tax rates.	2.10	1.61	1.94
6.	No changes (hypothetical)	5.19	3.45	3.90

Supplementary Medical Insurance (SMI) Trust Fund

Because of the way it is financed, through a combination of premium payments by individuals and debt financing by the Federal Government, the SMI program is not in immediate danger of insolvency. However, the growth rate in the cost of the program is so rapid that it is not sustainable in the long run. During my time as Chief Actuary the outlays for the Supplementary Medical Insurance Trust Fund (Part B of Medicare) increase from $7.8 billion in 1978 to $61.8 billion in 1994. This is an average rate of increase of about 14 percent per year. During that same 16 year period, benefits paid by the SMI Trust Fund increased from .32 percent of the U.S. Gross Domestic Product (GDP) to .93 percent of GDP. This occurred despite the fact that some of the costs of the program (such as for most home health benefits) were shifted to the HI program. Even during the last five years, which have been relatively favorable, expenditures by the program have increased 53 percent in the aggregate and 40 percent per enrollee. According to the 1995 SMI Trustees report, SMI expenditures will be 3.18 percent of GDP by 2020 when the Post World War II Baby Boom has begun to reach age 65 and will be 3.97 percent of GDP by the middle of the next century when the Baby Boom will have been fully retired. As with the HI Program, these projections are being driven now by the coming demographic shift and the Baby Boom rather than pessimistic health care cost projections.

If some adjustments had been made to the SMI program years ago, this problem would never have developed to the size it is today. For example, if the SMI deductible had been indexed to increases in per capita program costs, and steps had been taken to ensure that Medicare supplemental plans did not neutralize the cost-saving features of the SMI deductible, then the outlays of the SMI program would be more than 25 percent lower than they are today. This would have allowed maintaining the SMI premium at $4.00 instead of the $46.10 it is today. At the same time, the government contribution to the program could have been nearly $5 billion less than it is today.

The outlays of the SMI program are excessive today due to two design features of the program which interact with each other to result in significant waste and abuse. These are the same two factors that are driving up health care costs for private sector health care plans.

The first factor is third party payment. When patients and providers are spending other peoples money, they don't concern themselves with either the price or the quantity of services provided. Today, even the very modest cost sharing provisions of the original SMI Program have been eroded because they were not indexed to keep up with costs and because health care is, in effect, free for the 80 percent of SMI enrollees who buy Medicare supplemental policies or are eligible for Medicaid. Research conducted by HCFA's Office of the Actuary on the Medicare Current Beneficiary Survey found that, even when controlled for self-reported health status, Medicare beneficiaries who did not have Medigap plans, and who thus were subjected just to the (severely eroded) cost sharing provisions which exist in the Medicare program today, have significantly lower overall health expenditures. Moreover, an important research paper which will be published in Health Affairs, coauthored by Mark Freeland, Ph.D. and Al Pedon, Ph.D., shows that the acceleration in the rate of growth in health care expenditures in the United States has been highly correlated with the shift toward third party payments. Their research shows roughly that every ten percentage point shift from out-of-pocket payments to third party payments results in an increase in the rate of growth of health care costs of about two percent, and this accelerated rate of growth persists for about ten years. In my opinion, this is the most important research conducted yet on health care costs because it explains the reason for the rapid growth in health care costs in the United States.

The second factor contributing to rapid growth in health care costs is fee-for-service medicine. This factor interacts with third party payments to allow for unlimited increases in the volume and intensity of services provided to patients, without regard for the efficacy or cost effectiveness of those services. During the entire history of the SMI Program, most of the increase in per-capita costs have arisen from increases in the volume and intensity of services rather than price increases. During the ten year period ending in 1992, over three fourths of the increases in payments to physicians arose from volume and intensity increases.

The cost of health care can theoretically be controlled by removing either of the two offending factors---third party payments or fee-for-service medicine. Increasing coinsurance and deductibles is an example of dealing with the third party payment factor; introducing capitated services, as in the TEFRA Medicare Risk Program, is an example of dealing with the fee-for-service factor.

The problem that I have observed with the second approach is that the TEFRA risk sharing program is structured in such a way that, even if there were no risk segmentation, and with a 10 percent capitated penetration rate the most that could have been saved would have been 1/2 of one percent. However, because of risk segmentation, the TEFRA risk program has increased expenditures of the Medicare Program rather than reducing them.

If the costs of the Medicare Program were going to be controlled by using managed care, then the structure of the program would have to be changed so that savings accrue to Medicare. This would have to be done in a way that didn't discourage managed care plans from participation in the program. Because of the extreme difficulty of balancing these conflicting goals, managed care alone cannot be relied upon to control costs in the Medicare program.

This concludes my formal remarks and I'll be pleased to answer any questions you may have.

Mrs. JOHNSON. Thank you for your testimony. I want to recognize the Chairman of the Subcommittee, Mr. Thomas.

Mr. THOMAS. Thank you very much, Madam Chairman. First of all, I want to thank the three of you, and Guy, you do not mind if I focus on Mr. Ross and Mr. Walker for a minute.

I believe you sat through the entire hearing today, or certainly most of it. I was watching you sitting over there. First of all, on behalf of the American people, I want to thank you for the time that you put in serving as the public trustees. Second, I know that you have been involved with an attempt to create an environment for a solution to this problem for some time.

I have in front of me a softback called "Proceedings: Conference on the Future Income and Health Care Needs and Resources for the Abled," sponsored by the public trustees of the Social Security and Medicare Trust Fund. I believe it is a 1993 publication. This basically gives you the parameters by which you can begin to focus on solutions.

You heard, perhaps, then the dialog between the Health and Human Services Secretary and Members of this Committee on both sides.

The question I guess I would ask you is one that you can either choose to answer or at least ponder over. Mr. Walker, you repeated a number of times that the solution has to be bipartisan. I agree with you, since we have got a Republican Congress and a Democrat President, if it isn't perceived at least as minimally bipartisan, it isn't going to become law, and all of us should be ashamed if something doesn't become law, if not in this first session of the 104th Congress, certainly in the second.

You folks have probably been as close to this issue as anyone. You have looked at a number of options. Have either of you, or both of you, discussed the role of service that you could perform for the American people, for the Congress and the President in terms of offering options, a set of solutions from your perspective presented as both a Democrat and Republican?

It certainly hasn't functioned that way on the public trustee role on these trust funds, and provide an agenda for discussion rather than this Gadsden-Alphonse business of who goes first. Have you thought about that? Have either of you thought about offering a series of solutions? The old business of no pride of authorship, here are some things, and you should at least consider them and we would expect you to consider them. Either of you.

Mr. WALKER. I will go first, Mr. Chairman. There are two dimensions of the problem. One dimension is short term and what type of things can and should be done in the short term until we have had time to conduct the massive public education campaign to educate the American people as to the nature and need for the dramatic reform.

With regard to the more dramatic reforms, which is the second element, I think we need to do something similar to what was done in 1983. I think we need a Greenspan-type commission.

With regard to the short-term issues, Stan and I probably both have personal views as to some things that should be considered and are more than willing to answer questions in that regard. We have not specifically talked about whether we should come up with

a package on our own for formal or informal submission to the Congress as a basis for the Congress to begin debate on this issue. I think it is critical that something be done and I will let Stan respond, and I am open-minded to anything that is reasonable, quite frankly, to get this thing moving.

Mr. ROSS. I would point out, first of all, that our role as public trustees is to oversee the integrity of the reports and to make sure they were timely and accurate; and this year was not only difficult, but there have been difficulties in the past over issues like the disability program where our role was to require that studies be done before we would agree to recommend the reallocation that was done.

We have very little staff resources. These are part-time jobs in which we have spent limited time —I have spent about 40 days a year the past 5 years.

Frankly, these are political judgments that are involved and I think that unless a process can be set up, such as a 1983 Greenspan-type commission, where political leaders themselves can be brought together with experts like Mr. Walker and I in a framework in which everybody is going to try to exercise their skills and best judgments, I do not see a way out of the impasse that is presented.

I personally believe that it is more important to focus on the procedural vehicle than trying to get particular substantive ideas, because there are a lot of substantive ideas out there, but until you see how the public reacts to them, it is very hard to make the political judgments.

How will ordinary beneficiaries, workers, doctors, hospitals, pharmaceutical manufacturers, medical device manufacturers react? There are just a whole range of interests as we know from the comprehensive health care reform debate, and in order to make the right political judgments, I think the public needs to see proposals out there.

Something like a national commission might be the way to begin to let the public understand the dimensions of the problem; I think they will get some things out of this hearing, but not the difficulty of the solutions, it is necessary to begin to see which proposals seem to have some staying power and which ones would just be totally unacceptable.

Like Mr. Walker, this job was my fourth stint in government and I would do anything I personally could within the limits of my time and capacities to try to help end this impasse which I think is really not good for the program, not good for our political system, much less for the Nation.

Mr. THOMAS. Thank you very much. One of the more frustrating things that I have been engaged in is looking at the question of Medicare. Mr. Walker, you talked about educating the American people, especially seniors and others, including, to a certain extent, Members of Congress about just what this program is. There is a lot of confusion about it.

One of the more frustrating things, as I have said, is to look at the dollar amounts expended in the HI Trust Fund and part B, the Supplemental Medical Insurance Trust Fund, and the government contribution along with the individual contribution. Examine what

is expended most often by an individual for the medigap insurance policy and look at the total dollars expended in this area. The resources being expended are not in the wisest fashion.

From your perspective, in the relative short-term, is it something that we should look at in terms of a whole new approach rather than keeping it A, B with supplemental, or try to go to the drawing board with a clean sheet of paper. Or, is that really more of a long-term change?

Mr. WALKER. My personal opinion is, you need to make some incremental changes that can help with the short-term problem, and second, you need to put the process in place to be able to engage in more comprehensive and fundamental long-range reforms. It is more than Medicare. I do not think that we can just look at Medicare standing alone.

With regard to the broader range of reforms, we have to keep in mind that we have got some other social programs. Namely, Social Security, that is facing a long-range problem, and our health care arena, to be addressed as well. From a political standpoint, candidly, You are going to have to address a number of those simultaneously in order to come up with a more comprehensive long-term solution.

Mr. ROSS. I would say that it is important to get the process started as soon as possible. The problem is serious and it is going to get worse, not better. The things you can do short term will be incremental. There should be some kind of a Medicare reform package that both does some things and also sets in process larger restructuring initiatives.

We didn't get into this problem overnight and we are not going to get out of it overnight. Unless we start to really work at it concertedly over a continuous period, the problems will not be sufficiently addressed.

You need to focus on what you can do through a separate package. I do not think you can do it all, but you can do some things, and determine what things you could only do through a broader, more complete package down the line and you shouldn't lose sight of the second as you do the first and as you do the first, you should pave the way for the second. It may be a two-set process.

Mr. THOMAS. Mr. Ross, you said this was principally a political function. I have to tell you, I lived through the 1983 Social Security adjustments, and I agree with you, because ultimately it is all political. There are just enormous temptations, especially because of the political volatility in dealing with this area that cries out for a rational, long-term discussion that produces a general consensus.

For example, the discussion over moving the retirement age from 65 to 67, which was long overdue at the time we began the discussion, was then prolonged for another 20 years into the 21st century so that it probably has virtually no significant impact in actually adjusting retirement benefits to retirement age given the way in which retirement age is going to continue to change, one small example that almost broke our political back in trying to achieve some kind of a compromise of solution.

As we look at these options, it just seems to me that people such as yourselves who have spent some time reflecting on this, people who have no particular narrow interest to gain from one option or

another, need to help all of us, and a commission or an advisory group of some sort to—clearly blue ribbon, to present a solution which, if we are going to reject it, would require the unification of Democrats and Republicans for a positive alternative to reject it, which I guess is the best kind of rejection. Short of that, I frankly do not see us coming to either a short term, or depending upon what the future brings, a long term solution.

I am very, very concerned about our ability to fundamentally readjust a piece of the Federal budget which, as the Kerry-Danforth Commission clearly laid out, is a long—an increased path which cannot be tolerated. Frankly, I see the HI Trust Fund as a warning flag that allows us to begin to make these fundamental adjustments sooner than we would otherwise.

I would hope that you folks could think about what other kind of a structure that will help us in terms of a solution.

Guy, you have any comments at all about where we are going? Do you think the commission route, some kind of a blue ribbon, third-party professional option is something that will work once again?

Mr. KING. Yes. It is something that could work. It is very good that you are getting started 7 years in advance of the projected date of bankruptcy, because the problems relating to the HI Program are really much more complicated than those that related to Social Security in 1983 and they require a longer lead time.

Now, the other thing I might say is that, technically, it is not a difficult problem. I am a technician. I am not answerable to the voters, so I could probably think of 100 different ways to solve the problem, but it becomes much more difficult when you are trying to solve the problem and be answerable to the voters as well.

Mr. THOMAS. I do think though that there is perhaps some alternatives or some hierarchy, structuring of alternatives, that provide a better solution for certain problems that do not make it a fundamental political choice. Probably the ultimate mix in the package in terms of who gets impacted in the larger question is clearly a political one, but it seems to me that the changes, the fundamental restructuring in the system, those that give us more mileage for a given dollar do not necessarily have to be partisan.

You said you had 100 of them. I believe that late at night you know that one is better than the other and you can prioritize them along a return on investment, societal investment, in what is given to us in terms of benefits and the rest. That is the kind of help we need to get started in making choices, because without something between us to discuss, as you saw today, we didn't make a whole lot of progress, and that is very frustrating to me as someone who is charged with trying to solve what is a very real problem for a growing number of Americans, and I want to thank you for your past contributions and, hopefully, we can get some more mileage out of you.

Thank you very much.

Mrs. JOHNSON. Mr. McCrery.

Mr. MCCRERY. I thank the Chairlady for recognizing me, and I really enjoyed your testimony, however vague it was. Let me just ask you a few questions and then get into some more general discussion following Mr. Thomas. Let me begin by making a comment,

Mr. Walker, about making sure that what we do is actuarially sound and provides for an actuarially sound system.

If I am not mistaken, when Medicare was created in 1965, they fully expected it to be actuarially sound with the mechanism that was in place, and what has happened is the assumptions they made in declaring that system to be actuarially sound just simply didn't hold water. I am afraid any time the government creates a program or adjusts a program or comes up with a new approach that is actuarially sound, we have proven time and time again that it is almost impossible for us to come up with an actuarially sound program, particularly when it is something as open-ended as Medicare.

Social Security is another thing. We have defined benefits and we have a way to finance those. Medicare is not like Social Security. It is an open-ended benefit. I am not sure that although you are well intended, I am not sure we can create a Medicare system, a government health care system that is actuarially sound that will deliver open-ended benefits.

I am going to give you a chance to respond because I liked most of what you said. In fact, you are using what I call the honest approach, which is very seldom used in this place and is not being used now, in my opinion.

You said—and I do not want to put words in your mouth, you correct me if I am wrong—but you said, we simply cannot afford as a society to provide the current set of benefits or level of benefits in the manner that we provide now, and that, to me, says it all. You are exactly right, that we ought to be, as policymakers from the Speaker to the President on down, honest with the American people, honest with the AARP, with the elderly, and say what we have, and what we cannot afford. We couldn't afford it, I don't think, in 1965, and we darn sure can't afford it in 1995. Where do we go? What is our responsibility, as a public, to deliver to our elderly citizens?

If it is what we are delivering now, Lord help us. We are going to have to change our whole economy and our economic system. I appreciate your using the honest approach. We get further in this debate if we would start using that approach rather than, you know, trying to tiptoe around all these issues and placate the AARP and placate the Democratic Party and the Republican Party. I appreciate your testimony.

Did I mischaracterize your comment?

Mr. WALKER. The only thing I would say is, we have to reengineer the program to make it financially sustainable, and clearly the current program is not. I do not think we can throw enough money at it.

If you look at it in the broader context, we have to fundamentally restructure it, and we have to be candid with the American people and tell them that. In order to do it, we are going to have to ultimately do it within the broader context of more comprehensive reform, more comprehensive health care reform, but we need to get on with it because it is a major job.

Mr. MCCRERY. Well, I am intrigued by your two-step solution here, first do incremental reform and then do more broad-based reforms. You are speaking in codes here and I wish we could get out

of the codes and start speaking in specifics. Perhaps you can supply this Committee with some specific suggestions for incremental reforms, leading to more broad-based reforms and what those might be.

Frankly, I do not think we have time for incremental reforms. We have been incrementaling this thing to death throughout the eighties, chipping away here and there and squeezing providers here and there, and I just think we are about out—you said it yourself, we have about exhausted those. I do not know what you mean by incremental if it is not more of the same, which you said we are out of.

I wish you would get more specific and tell us what kind of incremental reforms you are talking about that could save—or that could buy us some more time to get these more broad-based reforms, and then tell us what the broad-based reforms ought to be.

In my opinion, Mr. King is closer to the solution than anybody else I have heard speak before this Committee. I do not know if you have had a chance to examine his testimony or listen. He did not get very far today in his oral presentation, but, you know, basically Mr. King says we offer something for nothing. Any time you do that, you are going to have a supply problem, and that is what we are doing with the Medicare system.

Mr. ROSS. Could I just add one point, though? One of the great complexities of dealing with this problem is that one of the things that has to be done, as the Congressional Budget Office witness, Ms. O'Neill, said, was to change the incentives, which by definition means that a lot of the public needs to understand what the changes are and how they are expected to react or not to react to a different set of incentives provided by the program.

Therefore, somehow a process has to be started where no matter how technically accurate some of these solutions would be in terms of producing the savings, they have to be shown to the people so that people can understand them.

I was on a panel with Mr. King at the AEI, American Enterprise Institute, recently and it was mainly experts in the field. They offered a great deal of information using phrases like, "risk adjusted vouchers." As I sat there, I said to myself, half of this audience is having trouble understanding all these highly technical ideas. What about the general public that is going to be asked to respond to these changes?

Somehow this process was not properly executed. You need some way of getting these proposed solutions, technical and nontechnical, more broadly exposed, so that people can understand the new regime that they will be asked to be a part of, and that process really needs to start just as soon as possible.

Mr. WALKER. It is important to note that the incentives have to be fundamentally changed, because you have got several things driving health care cost as relates to Medicare, not only the inflationary costs and the costs in excess of inflation; you have got utilization, utilization of procedures, intensity of care, the aging society, and longer lifespans. You have got a number of different factors and, frankly, right now most of the incentives in our system are to do more, in many cases where it is totally economically irrational, or not in the interest of the person receiving the care.

I mean, I can give you one example that is close to home. My grandfather had open heart surgery when he was 89, I believe it cost hundreds of thousands of dollars. The current incentives in the system were to say yes. Obviously, the family wanted to say yes. I mean, we love him and we obviously would like him to be with us for as long as he can.

The doctors obviously are going to say yes because they are going to get paid. The health care facility, even though we are funding it, you know, wanted to say yes because they wanted to keep him around a little bit longer, OK? The Medicare construct incentive was to say yes, but yet that procedure did not extend his lifespan very much, did not improve his quality of life, and after it happened, he wished it hadn't happened.

There are things we can do within the existing structure to be more economically rational and, frankly, more humane in some cases to the people involved.

Mrs. JOHNSON. Mr. Christensen.

Mr. CHRISTENSEN. Thank you, Madam Chairwoman.

I want to thank this panel. This panel has been worth waiting for. After this morning's testimony by the Secretary, I want to tell you how appreciative I am of your attendance and really sharing with us some very important points. I would like to spend a lot of time asking some questions, but I just have one brief question I would like to ask you.

We have heard from some of our friends on the other side of the aisle that there is not really a problem here, that why are we doing all this, why are we rushing to solutions, and I just want to know, if Congress fails to do anything to solve the Medicare situation, what will happen in 2002?

Mr. WALKER. You will not be able to pay benefits on a timely basis in 2002 because you can only, under the law, under present law, you have to use trust fund assets to pay benefits, and if you have a shortfall, you won't be able to pay benefits in a timely basis. It gets much worse every year after that.

One thing real quick if I may, Madam Chairwoman. See this chart? That is the roller coaster ride we are on. We started going downhill and it goes underground and it gets real deep real fast.

Mr. CHRISTENSEN. If payments are not rendered on timely action, what will happen in terms of the consumer?

Mr. WALKER. Coverage will have to be denied. Something will have to be done either—to put it in balance, either you will raise taxes, you cut benefits, or you do a combination thereof. You further mortgage the children's future. There are only so many options you have.

Mr. CHRISTENSEN. Mr. Ross, any further comments?

Mr. ROSS. Well, to me the great danger here is because that will not be allowed to happen. Just, for example, last year, the disability fund was reaching the point where if you did not take action, benefits couldn't be paid. What happened? You reallocated funds from the Old Age and Survivors Fund into disability, which hastens the day which we will run out of money in that fund.

These last minute sort of actions to sort of not allow Armageddon to happen simply deepen the long-term problems. That is why it is wise to begin now so that you are not faced with doing one of these

last-minute things in 2001 whenever you are looking over the precipice, which do not really solve anything but just put it off for a little bit longer.

The spirit of what I am hearing here today, which is that you want to get the process going to try to really address the problems, is absolutely the right thing. Obviously, in a country this size, and with millions and millions of beneficiaries, you are not simply going to say, we are going to stop paying benefits and people will have to start scurrying around with what resources they have. It just won't happen. You will do something last minute that may rob Peter to pay Paul and get you through another couple years.

Mr. CHRISTENSEN. I agree 100 percent, and the testimony I heard this morning did nothing but produce a lot of bickering and presented no positive alternatives. I am looking forward to working with my colleagues to try to come up with an answer. Congressman McCrery is right. We can't tinker with this. We have to have a real long-term solution, and coming up with suggestions like Secretary Shalala suggested to help keep the system alive for two more years is the wrong approach.

We need something that is going to secure the system for not only our senior citizens, but for those people who are going to be depending on the system in years to come, and I truly believe that the administration has abdicated responsibility and leadership in providing ideas. They do not have to lead if they do not want to, but they can produce some ideas so we can work together in a bipartisan fashion, because this is an area where the American people want a solution, and we are going to go ahead and figure out what we can do.

I am open for suggestions, Mr. Walker, Mr. Ross, and Mr. King. Send them our way, because I want to do the right thing, and if you can help, we would like to know what you think. Thank you very much for being here all day.

Mrs. JOHNSON. Thank you. I would like to note, Mr. King, that in your testimony, you do make very clear that to reach balance in 25 years—I mean, we are talking about trying to balance the Federal Government's budget in 7 years—to get this program balanced over 25 years, you would have to increase HI taxes 44 percent immediately or cut expenditures 30 percent immediately or some combination thereof; is that correct?

Mr. KING. Yes. That statement is contained in the Trustees' Report.

Mrs. JOHNSON. It just shows what a dramatic effort is needed. Every year we wait, those figures are going to go up. It will be a 40-percent cut or a 50-percent increase in taxes. We are really talking about decimating health care services for seniors or an extraordinary new burden on their grandchildren, and that is exactly where we are.

I was pleased that at the end of your testimony, Mr. King, you mentioned that if the costs of the Medicare Program are to be controlled by using managed care, then the structure of the program has to be changed so that savings accrue to Medicare.

Well, what we are really trying to do is just slow the growth of costs, and according to another study that was done, we are spending about $3,500 per capita per year now, and over the next 7

years, we could afford to spend $5,000 per capita per year. That takes into account the new numbers, but also allows almost a 50-percent increase. We just can't allow an increase to $6,000 per capita.

We are really talking about allowing a rational increase, actually more than the increase of the past 7 years. This is not draconian if we do it now. It can be done responsibly now. It can allow an increase that is still 50 percent of what we are spending on every individual senior now and still bring us to balance.

In this portion of your testimony, Mr. King, wouldn't it be possible if we were able to, for instance, dissect the amount of money that actually pays for senior care from both the hospital reimbursement and the physician portion, Medicare part B, and use that money to allow seniors to buy a plan in the private sector that would give them prescription drugs and other things if they chose that, if we did not allow that premium to grow nearly as rapidly as costs are growing now, couldn't that achieve our goal of reducing costs but assuring seniors current services and also some opportunity to get better coverage through managed care systems? Theoretically.

Mr. KING. Yes. There are different approaches to managed care. There is the approach where every Medicare beneficiary is given a voucher and then that certainly gives you the wherewithal to control the rate of increase in per capita cost in the Medicare Program.

The other approach, I am not—it could work also, the approach where Medicare beneficiaries are allowed to decide whether they want to go into a managed care program or stay in fee-for-service Medicare, has a difficult problem to overcome, and that is the problem of favorable selection where the healthier beneficiaries are induced to enroll in an HMO and the HMO is given the average payment for fee-for-service Medicare. Then we are paying too much.

Mrs. JOHNSON. Of course it depends on how you set that capitated reimbursement rate, and under the Medicare risk programs, that capitated rate has been set high because the companies have only been willing to participate in risk programs where the spread between cost and capitated rate is high.

Mr. KING. Yes, that is true. The capitated rate would have to be set lower in order to produce savings, and that produces a difficulty in the fact that the lower the payment rate to the capitated plans, then the less attractive those plans are, both to the beneficiaries and to the plans themselves, because the way it is right now with these generous payments, they are used to finance the extra benefits that are used as an inducement to the beneficiaries.

Mrs. JOHNSON. Correct. But couldn't you take, for instance, managed care plans in an area, because these will have to be geographically variable, and take an average of those plans that provide the general Medicare benefits and see what that premium is, and if that premium is affordable for Medicare, then that would be the choice of plans that the Medicare recipients would have.

I am trying to think of some shorter way to this than actually factoring down what we spend in Medicare to kind of identify what is cost related, drawing the premium from that and then moving that premium into the private sector. I do not know whether there is a way of looking at what is the average managed care plan in

the private sector and giving seniors the access to that, if when it is multiplied out, it meets our cost test.

In other words, I do not know quite how to get around the problem of giving seniors choices of integrated systems of care without absolutely forcing them to take capitated payments, though not all managed care plans are capitated now, and the noncapitated ones seem to work as well as the capitated ones. In my opinion, capitation has some problems. I wouldn't want to start from the position that we could only have capitated managed care plans participate, and in order to do that, you have to give seniors a premium value and a choice of managed care plans around them.

Mr. KING. Yes. The approach that you mentioned, which is more of a market-based competitive approach, could certainly result in savings for those people who choose to enroll in the plans, and the difficulty is in achieving a large enough penetration rate in order to produce significant savings for the entire Medicare Program.

The problem—the financial problems of the HI program are so large now that we can't just rely on the carrot approach with beneficiaries to induce them to enroll in managed care plans. It is going to require not only carrots but sticks as well.

Mrs. JOHNSON. Interesting.

Mr. Walker.

Mr. WALKER. With regard to the HMO or the managed care process we have now, competitive bidding clearly ought to be looked at as a way to try to get the market involved in determining what—you know, what they are willing to bid at. Right now they get reimbursed for 95 percent or whatever.

Mr. KING. Yes.

Mr. WALKER. Therefore, let the market determine what they would be willing to do.

Mrs. JOHNSON. Certainly competitive bidding would be appropriate if we followed the risk contract model. If we try to actually follow the model of opening up care options for seniors as the market opens them up for companies currently, employers now in the market, we wouldn't need to manufacture the competition through bidding and we, frankly, would get a healthier situation because it wouldn't be based on capitation. If you go into bidding, you are an entirely capitated system then with all the possible problems associated with mass capitation.

Mr. WALKER. Unfortunately, fee-for-service and capitation have both problems, but they are exactly the opposite. One of the problems that we have right now, quite frankly, is that our fee-for-service system, among other things, encourages additional utilization, additional intensity——

Mrs. JOHNSON. I do not disagree with that. I am looking at the midway that many managed care plans are using more the management controls volume that relies on a capitated payment structure. There is a midway there, at least.

Mr. Collins.

Mr. COLLINS. Thank you, Madam Chairman. I will be very brief.

Noticing—listening to the conversation and the questioning between you gentlemen and the Chairlady, it is very interesting and very different from the way this hearing started out earlier today. I assume that all three of you are from the private sector, and

based on the fact that other members of the trust, which I believe Mr. Ross and Mr. Walker are members of the Board of Trustees, but looking at the other members of the Board of Trustees for the Health Insurance Trust Fund, I see public officials or appointees of the President, no matter who the President is, whether it be Democrat or Republican, which puts politics right in the middle of the trust fund.

This gets right to the heart of politics, especially having, I believe, three members of the Cabinet serve on the Board of Trustees. My question to you, each of you, is this; Would you advise the Congress to look at changing the makeup of the board of trustees for this type of trust fund?

Mr. WALKER. You ought to consider an independent board. In 1983, the Congress took part of the step and it created two independent public trustees, one Democrat and one Republican. At that time you had three ex-officio trustees, now you have four. This is no reflection on current or past ex-officio trustees let me make that very clear. The fact is, if you want to try to depoliticize this, if you want to try to get professional bipartisan opinion that is separate and distinct with a separate trustee fiduciary hat on rather than dual hats, that is one way to do it.

Mr. COLLINS. Thank you, sir.

Mr. ROSS. When we testified before the Senate Finance Committee, Senator Kerry came and made that suggestion. Senator Simpson was chairing the Committee and they are working on a proposal for at least addressing the long-term problems of the Social Security system and perhaps the Medicare system too. I do not know.

The Committee suggested they were considering that, and my response was that in part, when the Congress created these public trustee positions in 1983, they could look at it as an experiment to see whether there were values added by having two private citizens, and you could look especially at the last 5 years of the things Mr. Walker and I have done to see whether there has been real value added.

We believe there has been and there is a track record that could be looked at to determine whether you would want to go to the next step and make it independent. You are thinking along the lines that I would be thinking, if I were in your position.

Mr. COLLINS. Thank you, sir. Mr. King, do you have a comment?

Mr. KING. I can remember joking when the—when I was chief actuary at HCFA and the positions of the two public trustees were created in 1983. They said that there was too much politics involved in the development of the trustees reports and they solved the problem by injecting two more politicians into their process, despite that, Mr. Walker and Mr. Ross have made significant contributions to getting rid of the politics in the report, but I do not think that an independently constituted Board of Trustees would go very far toward solving the financial problems in the Medicare Program without giving that Board of Trustees considerably more power to solve the problems than the current Board of Trustees does. All the Board of Trustees can do now is report on the problem. They have very little wherewithal in order to actually solve the problems of the program.

Mr. COLLINS. Well, that is very good. I appreciate each of you making those comments. There was quite a difference between the comments and responses you had when compared to those of Mrs. Shalala. We appreciate that very much and thank you, Madam Chairman.

Mrs. JOHNSON. I thank the panel for your comments, and urge you to provide follow-on information as requested by the Committee.

Thank you for being with us and for your patience.

[Whereupon, at 3:08 p.m., the hearing was adjourned.]

REPLACING THE FEDERAL INCOME TAX

HEARINGS

BEFORE THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

JUNE 6, 7, AND 8, 1995

Serial 104–28

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REPLACING THE FEDERAL INCOME TAX

TUESDAY, JUNE 6, 1995

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, D.C.

The Committee met, pursuant to call, at 10 a.m., in room 1100, Longworth House Office Building, Hon. Bill Archer (Chairman of the Committee) presiding.

[The advisory announcing the hearings follow:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE
May 11, 1995
FC-7

CONTACT: (202) 225-1721

Archer Announces Hearing on Replacing the Federal Income Tax

Congressman Bill Archer (R-TX), Chairman of the Committee on Ways and Means, today announced that the Committee will hold three days of hearings on replacing the Federal income tax. **The hearings will take place on Tuesday, June 6, Wednesday, June 7, and Thursday, June 8, 1995, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m. each day. The Committee will receive testimony from invited witnesses.**

BACKGROUND:

The first Federal income tax was enacted as part of the Revenue Act of 1862 to finance the Civil War. However, the modern income tax was enacted as part of the Revenue Act of 1913, following the ratification of the 16th Amendment. The income tax had a maximum rate of 7% (for taxable incomes over $500,000).

Since 1913, the Federal income tax has steadily expanded, as has public dissatisfaction with it. Major revisions to the Internal Revenue Code occurred in 1938, 1954, and 1986, but significant revisions occur on nearly an annual basis, and minor amendments to the Internal Code are generally made several times a year. This torrent of tax legislation has been followed by a flood of tax regulations, tax forms, and tax litigation.

The cost of complying with the Federal income tax has grown with the complexity of the tax. The cost of complying with Federal taxes is generally considered to be well in excess of $100 billion annually. This compliance burden is particularly brutal for small businesses.

Frustration with the current Federal tax system is widespread. The current Federal income, estate, and gift taxes treat savings and investment too harshly. Many aspects of the current tax code place American workers and businesses at a competitive disadvantage. All the various rules in the tax code have not stopped widespread tax avoidance by the underground economy.

In announcing the hearings, Chairman Archer stated, "I am committed to tearing the income tax out by its roots. If we don't tear it out by the roots, I am afraid it will grow back just as tangled as it is now. Therefore, I intend to have the Committee on Ways and Means carefully examine alternative tax systems that would replace completely the current income, estate, and gift tax system. However, alternative tax systems must not be measured simply against the current tax system. That's too easy. Instead, all of the proposed tax systems considered by the Committee should be measured against four goals: (1) Is it easy to comply with and does it reduce the role of the Federal Government in our lives; (2) Does it encourage greater savings and investment; (3) Does it improve the international competitiveness of American workers and businesses; and (4) Does it pick up revenue from the underground economy and others who currently do not comply with the tax laws? I believe that a broad-based tax on consumption best meets these goals, and every proponent of a new tax system should be prepared to explain how that tax system meets these four goals."

FOCUS:

This hearing will review the problems with the current Federal income, estate, and gift taxes and examine various alternative tax systems, including consumption taxes, a flat tax, and the Unlimited Savings Account tax proposal.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit at least six (6) copies of their statement, with their address and date of hearing noted, by the close of business, Thursday, June 22, 1995, to Phillip D. Moseley, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Committee office, room 1102 Longworth House Office Building, at least two hours before the hearing begins.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages including attachments.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. A witness appearing at a public hearing, or submitting a statement for the record of a public hearing, or submitting written comments in response to a published request for comments by the Committee, must include on his statement or submission a list of all clients, persons, or organizations on whose behalf the witness appears.

4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and the public during the course of a public hearing may be submitted in other forms.

Note: All Committee advisories and news releases are now available over the Internet at GOPHER.HOUSE.GOV, under 'HOUSE COMMITTEE INFORMATION'.

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Chairman ARCHER. The Committee will come to order.

We ask our guests and staff to take seats.

I think most Americans would agree that today could be perhaps one of the most important hearing days in the history of this Committee, because we are undertaking a very ambitious challenge, and that is to look at ways to replace the current Income Tax Code.

Today begins the first of 3 days of hearings. Many of you know that I have spoken out very strongly about this and I have reached the conclusion that after many, many efforts to reform the current system, it is unfixable, if that is a correct English word; that it is certainly too broken to be fixed. And I believe we should look at options to replace it.

It is clear to me as I talk to my colleagues who have returned from two major recesses in their districts that this is a major topic of interest on the parts of their constituents, and it is further clear to me that a large majority of the American people, regardless of party, are willing to support the complete and total elimination of the current Income Tax Code. In its place, I believe that we, the Members of Ways and Means, can design a new Code that will allow our Nation and our people to soar to unparalleled prosperity in the next century.

Today's hearing will focus on the problems that exist in our current complicated and counterproductive Income Tax Code. Tomorrow and Thursday we will hear testimony from various witnesses about their recommendations for replacements of the current Code.

In my opinion, our challenge is to do no less than pull the current Income Tax Code out by its roots and throw it away so that it can never grow back. When we abolish the income tax from the books as an insurance policy, I would not mind seeing the repeal of the 16th amendment to make doubly sure that the income tax won't rise from the dead and ever again haunt the American people. As for what replaces it, I believe the answer is a broad-based consumption tax designed to make America the economic juggernaut or behemoth of the 21st century in the world marketplace.

The new tax would be based on two principles: Freedom and prosperity; freedom from the IRS, the total elimination of the IRS from the individual lives of every single American citizen; and prosperity for all Americans.

As we begin this important search for the best Tax Code for our Nation, we should be guided, I believe, by four objectives. One, the Code, as I said, must get the IRS completely out of our individual lives. The American people should never again have to keep records for the IRS to audit, proving to the government that they are indeed honest people. The people should never again have to fill out a tax form. Withholding taxes from people's paychecks should stop. The government should not have first dibs on the money that people earn. If you make it, you should be able to have the discretion to spend it, all of it, in the way that you see fit.

Two, the new Code should encourage savings. Economists of all persuasions who have appeared before this Committee agree that we need to increase our savings rate in the United States. Our current system of taxing savings, interest, dividends, capital gains during life, and assets at death is harmful to long-term economic

growth. The new Code must encourage savings where savings are found.

Three, the new Code must be able to stop the crimes of tax cheaters and avoiders in the underground economy. Honest Americans who play by the rules and faithfully pay their taxes are forced to pay between 10 and 15 percent more in taxes to make up for those who don't and won't report any of their income. Only a consumption tax can catch the drug dealers and the others who don't report their incomes when they buy their cars and other expensive items. If the police can't put all the bad guys behind bars, then at least the Tax Code should hit them in their wallets.

Four, the new Code should be able to be waived at the border in a GATT-legal manner. That is, remove the cost of government, remove from the price of our products when they are exported, GATT-legal, and, to keep the playingfield level, it should be able to be imposed on foreign products when they enter this country so that they bear a fair share of the cost of our government, again, GATT-legal, without starting a very disastrous trade war around the world.

I have no doubt that if we are able to fashion a new Code in a manner that meets these four criteria, the American people will be greeted by a period of unparalleled economic prosperity the likes of which we have not seen for a long, long time in this country. We will become the economic juggernaut of the world, a sponge for savings, with a fair advantage for our products in competition with foreign products in the global marketplace.

Before I turn to the distinguished Ranking Minority Member, Sam Gibbons, I would like to praise Sam for the bipartisan manner in which he joins this issue. I don't think much of what I have said he will disagree with.

Mr. RANGEL. I assume that allows me to have some time, Mr. Chairman.

Chairman ARCHER. Congressman Gibbons has been a powerful voice over the years in changing the current Code, and I believe that he shares my passion for this issue, and I am delighted to turn my attention to his thoughts.

Sam.

Mr. GIBBONS. Thank you, Chairman Archer.

First, I commend you for holding these hearings. They have been long needed, and I am glad we are on the road to correcting the current tax system.

Second, you are correct; I do not disagree with what you have said. We have talked about this together on many occasions, and you and I are in very broad general agreement.

Third, I want to hear the witnesses so I am not going to speak long, and I appreciate you giving me the opportunity to present what I think is a system that we can both perhaps embrace.

I think we ought to define the objectives that should control our thought process. First of all, I hope this will not degenerate into a debate about the size or the cost of government. We are here to talk about a revenue collection system. There is a time and a place to talk about the size and the cost of government, but this is not the time, so I hope we can control our debate and look at the system.

Too, I think we have to practice in broad terms all the rules of fairness and equity that we have cherished so much. If you look at individual tax distribution burdens over a long period of time, they have been fairly well fixed. I don't think that we want to open a big debate about changing the tax burden here. I think our objective should be that.

Obviously, as you pointed out, we need a system that is a great deal simpler than the present very complex system that requires so many hours of personal attention to just paying the correct taxes. So simplicity both from the individual's point of view and from the business point of view is important.

I believe, like you do, that the current tax system is a heavy impediment upon economy and efficiency in our government and in our whole economic system. We are spending perhaps as little as $300 billion, maybe as much as $600 billion just in administering the current tax system, and that we must get away from.

As you pointed out, we must have a system that suits the international business climate, the business practices that we must comply with, including the World Trade Organization agreements. In 1947, we generally defined what the GATT rules were as far as taxation was concerned, but the United States has not, like the rest of the world, taken advantage of the fact that other nations adjust their taxes at the border and we do not. And this has made us quite a bit uncompetitive in the international economic and trade situation.

So let's try to keep the debate on those subjects short, look for a better and a simpler system, and I commend you for holding these hearings and look forward to participating in them with you.

Chairman ARCHER. Thank you, Mr. Chairman—Mr. Gibbons.

Mr. RANGEL. Mr. Chairman, may I be heard briefly?

Chairman ARCHER. If the gentleman from Florida would like to yield to you. Otherwise, all Members will, by unanimous consent, without objection, have the opportunity to insert any statements in the record.

Mr. GIBBONS. I will be happy to yield.

Mr. RANGEL. Mr. Chairman, first let me thank you for so clearly defining the issues and I don't think that we have to be partisan to state a different philosophy in how we perceive our government should be. Clearly, the voters thought it should be different than it is now and I don't take issue with that.

As we move forward to determine what type of tax system we have, I think that you and the House leadership have truly been consistent with their Contract With America, and it relates to services and soon we will see as relates to taxes. And the reason I thank you is because you are clearly defining the differences and that is what America is all about. That is what elections are all about, and you are not moving to any great area in order to see what one party stands for and what the other stands for.

So far, this Committee, joining with other House Committees, have made it abundantly clear that the Federal Government should not be involved in what has been called entitlements. I think the leadership has said being poor, being old, being sick, does not entitle you on the Federal level, and local and State govern-

ments, of course, being closer to the problem, should be able to find better answers to these problems.

For those reasons, entitlements are over and now we have shifted that responsibility to local and State governments with the understanding that even if they cannot properly deal with the problem, the problem should be dealt with by charitable organizations, churches, synagogues, mosques, and those people who have taken different types of oaths to deal with the sick and the poor.

Having said that, we see ourselves facing whether or not they should enjoy tax exemption, but that is further down along the line. What makes this day important is to see whether or not, after we have shifted the responsibilities, there is no need for us to continue to take this much money from the taxpayers. And so we have a tax bill that would dramatically reduce the revenues.

By reducing the revenues, it makes it clear, driven toward a balanced budget, that we won't be able to revisit these programs, so once they are gone, they are gone. This is the last, not nail in the coffin, but I would say this is the last thing we have to do to tighten up that difference of opinion. We are saying now that income is not a factor, that we just want a broad-based tax. That if we want to throw in progressive lumps in the tax system with deductions, taking into consideration poverty and ability to pay, that we are getting right back involved in a complicated tax system which we don't want.

What we are saying is, rich and poor, working and nonworking, everyone find his common level and do the best we can because, after all, our government would only be to protect the national interest and only to collect enough taxes to do that.

So, Mr. Chairman, let me thank you. No one should have to go back home on any of these issues and be asked, Which side are you on? The way these hearings are going we will never have to worry about the Roosevelts, the Kennedys, and the Johnsons; their time is gone, and I think the voters will have to soon decide whether they want them to return.

Thank you, Mr. Chairman.

Mr. GIBBONS. I didn't realize that we were all going to make long opening statements. I hope we can get to the witnesses.

Mr. Rangel, I hope you will be here tomorrow to hear my presentation because Mr. Archer and I generally agree, and I don't see that this should be a big partisan issue. Maybe I am wrong, but we need a better tax system. That is not a debate about the size of government or the role of government as far as I am concerned. This is simply a debate about which is the best way for the American people to pay the dues that they have to pay and I hope we can focus the debate on that.

There is an appropriate and proper time for us to debate the size of government and the role of government, but this debate is just about the way you finance the government. We want to stress fairness and similar issues in all of this.

So, Mr. Chairman, I yield back the balance of my time.

Mr. RANGEL. Since you referred to me, could I briefly respond?

I had always thought, Mr. Gibbons, that when the Chair allowed the Minority to speak that somehow it would be interpreted as representing "the Minority," and since you made it abundantly clear

that these are your personal views, I am sorry that I went into this long exchange.

Mr. GIBBONS. That is all right, Charlie. We know each other and will get along fine.

Chairman ARCHER. Without objection, any opening statements may be submitted in writing in the record.

[The opening statements follow:]

BENJAMIN L. CARDIN
3D DISTRICT, MARYLAND

COMMITTEE ON WAYS AND MEANS
SUBCOMMITTEE ON HEALTH
SUBCOMMITTEE ON OVERSIGHT

COMMITTEE ON STANDARDS OF
OFFICIAL CONDUCT

Congress of the United States
House of Representatives
Washington, DC 20515–2003

COMMISSIONER
COMMISSION ON SECURITY
AND COOPERATION IN EUROPE

DEMOCRATIC CAUCUS
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ASSISTANT DEMOCRATIC WHIP

STATEMENT OF THE HON. BENJAMIN CARDIN
AT COMPREHENSIVE TAX REFORM HEARINGS
OF THE COMMITTEE ON WAYS AND MEANS
JUNE 6, 1995

Mr. Chairman, these hearings could mark the beginning of an historic effort to bring genuine and comprehensive reform to the way the federal government raises revenues.

Most of our tax debates in this committee skirt the fringes of tax policy. We concentrate on narrow aspects of the tax code, seeking to encourage some activities and discourage others, responding to concerns raised by various segments of the economy. Or we debate fiscal policy, trying to determine the macroeconomic effects of the different levels of federal taxation.

The hearings you have scheduled this week, which, I trust, will be only the first round of what will be an extended and ambitious project, go to a more basic question. For eight decades now, we have built a federal tax system on the premise that a progressive tax on personal and corporate incomes, mixed with an evolving number of tax preference items, is the best means of raising the revenues needed to fund the essential services of government.

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Today we begin a reexamination of that basic premise. We will start, appropriately, with consideration of the degree to which the current system meets our expectations. The unfortunate fact is that repeated, strenuous efforts to simplify and reform the Internal Revenue Code have failed. Small businesses, pension plan sponsors, partnerships, issuers of tax exempt bonds, and investors in real estate are only a few of the categories of taxpayers for whom the Code remains a labyrinth to enter only at their own risk and considerable expense.

The debate has already begun on the question of alternatives to our current tax system. Most of the attention thus far has focused on two proposals -- a flat rate tax, or a broad based consumption tax, such as a value added tax.

I begin this process with a favorable view of value added taxes. Most of our international competitors collect most of their revenues through a value added tax. By implementing a VAT here, we can avail ourselves of some of the advantages it offers.

In addition to broadening the base of economic activity covered by the tax system, a VAT will help achieve three major objectives. By taxing consumption instead of income, it will help spur savings. All of us who are concerned about the dramatic difference between savings rates here and in Asia and Europe must give careful thought to developing a tax regime that rewards savings.

Another advantage of a value added tax is that it will help U.S. exporters. A border-adjustable VAT will put U.S. companies on an even playing field with their international competitors. A

value added tax would certainly be far more simple to administer and enforce than our current foreign income tax structure.

As we consider these issues, we must consider a number of caveats that arise. State governments, which depend heavily on revenues from sales taxes, have always viewed the imposition of a broad-based federal consumption tax with great concern.

It is the same taxpayer who pays all levels of taxes. We should look to better coordinating federal and state taxes and expenditures. For example, to avoid a needless and counterproductive competition between states and the federal government over consumption-based revenues, the committee should look for appropriate trade-offs.

One such trade-off could be based on the states willingness to repeal their sales taxes, in exchange for having the federal government assume complete responsibility for Medicaid. While sales tax revenues currently exceed state Medicaid expenditures, the gap has recently narrowed as health care costs have risen much more rapidly than sales tax revenues. Before acting on any such proposal, we must have full and open public hearings, including close consultation with our nation's governors.

The other significant objection to a value added tax has been concern about its regressive nature. Since low- and middle-income families must devote a much higher percentage of their incomes to consumption than upper-income families, a consumption tax, like a sales tax, can make the tax system regressive. These effects can be neutralized through a number of means, such as a low and moderate income credit, and/or retaining

income-based taxes for high income taxpayers.

Thus far, this debate has been characterized as pitting flat tax proponents against those who favor a VAT. We may find that the effort to ease any potential regressive effect of a VAT would be to marry the two notions. By joining a VAT with a flat individual income tax that applied only to relatively high income Americans, we could achieve the goals of revenue neutrality and distributional progressivity that, in my view, must be part of comprehensive tax reform.

I believe a well-structured VAT will make our federal tax system more fair, more simple, and more sensible, and I look forward to working with the chairman and the members of the committee in this historic effort.

JON CHRISTENSEN
2D DISTRICT, NEBRASKA

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OPENING STATEMENT
BY
REP. JON CHRISTENSEN

On
Replacing the Federal Income Tax

Before the Committee on Ways and Means
June 6, 1995

I enthusiastically applaud Chairman Bill Archer for commencing this historic set of hearings on what is wrong with our federal tax code and how we can fix it.

President Jimmy Carter was right on target when he called the income tax "a disgrace to the human race." Few will argue that our current tax code is simple and easy to understand. We have gone from just 14 pages of federal income tax law in 1914 to over 9,000 pages today. This complexity is extremely costly to all Americans and wastes scarce resources that could best be spent elsewhere. A 1985 IRS-commissioned study found that the economic cost of preparing and filing tax returns for businesses and individuals was $159 billion annually. Economist Walter Williams has estimated that more hours were spent computing taxes and filing tax returns than were used to build every car, van and truck in the United States last year.

Enough is enough.

Today we begin the important task of reexamining the wisdom of our current tax system. We will examine its complexity and inefficiency. We will examine ways to address these inefficiencies and complexities. And we will examine alternative systems of taxation, including a pure flat tax, modified flat tax, national sales tax and value-added tax. I look forward to rolling up my sleeves and working with my colleagues as so that we may get to a federal tax system that is clear, simple, and fair--a system that encourages savings and investment rather than punishing those who plan for the future.

Thank you.

STATEMENT OF CONGRESSMAN JIM MCDERMOTT
SUBMITTED FOR THE RECORD
COMMITTEE ON WAYS AND MEANS
JUNE 6, 1995

Today's hearing will no doubt be the first of many hearings that the Committee will hold to review our current tax system and lay the groundwork for possible reform of the tax code. I think that it is vitally important that this Committee does not rush to eliminate our current tax code for short-term political gain and create long-term economic chaos.

I agree that our tax code is complicated. But when we legislate there is always a trade off between simplicity, fairness and complexity. All of the reform proposals the Committee will be hearing about this week are appealing on a superficial level - who wouldn't want to fill out a postcard length tax form? However, appearances can be deceiving and simplicity should not be a trade-off for fairness and progressivity in our tax code.

If this Committee is serious about tax reform, any new tax system must include (1) distributional equity, and (2) revenue neutrality when compared with our current tax system. In the Tax Reform Act of 1986, this Committee in a bipartisan manner eliminated most of the major corporate and individual tax loopholes, and in exchange lowered tax rates. Furthermore, I find it hypocritical that this Committee is holding hearings on tax reform when the tax cut package which was part of the Contract With America contains numerous, complicated tax proposals that are perfect examples of the types of complexity tax reform is meant to eliminate.

Instead of expanding tax entitlements for corporations and well-off individuals and lowering their rates, this Committee should seek real tax reform. In my opinion, that would include curtailing existing loopholes, simplifying tax laws and maintaining graduated rates, distributional equality and revenue neutrality. I have a list of existing corporate subsidies that I would like to see curtailed, and I would like to work with Chairman Archer and this Committee on real tax reform.p

Chairman ARCHER. The Chair is ready to recognize the witnesses before us today. First I would like to recognize Sharon Beard, president of Hurricane Fence Co., Springfield, Ill., and a delegate to the White House Conference on Small Business.

Ms. Beard, you may proceed. We would like to ask all of you to limit your statements to 5 minutes. If your written statement is longer, without objection, it will be in its entirety inserted in the record.

STATEMENT OF SHARON R. BEARD, PRESIDENT, HURRICANE FENCE CO., AND ELECTED DELEGATE, NATIONAL WHITE HOUSE CONFERENCE ON SMALL BUSINESS

Ms. BEARD. I would like to thank you for holding these hearings today and taking on this issue. One thing I have learned since I have been in the process for the White House Conference on Small Business is that taxation is a big issue. There has been a lot of debate, and a lot of discussion. I hope your schedule gives you an opportunity to listen to it during the conference.

An accountant in Springfield recently completed a study of a small business client and when I told him I was coming here today, he said, I have interesting figures for you I just figured up last week. When asked to rank their most important concerns from one to five, with one being the most important——

Chairman ARCHER. Would you mind shifting the mike a little bit so that you are speaking right into it?

Ms. BEARD [continuing]. Almost 44 percent rank taxation as their number one key issue and almost 19 percent ranked it number two. So that is a big concern for small business.

I don't want my title of president of Hurricane Fence Co. to fool you; we are a very small business. I handle a wide variety of tasks as president, including the various administrative advertising, quotations and sales, and also dusting, cleaning the office, and occasionally cutting pipe.

We did not purchase the fence company because we were financially secure and wanted to own a business. In all honesty, we traded our unemployment checks for a mountain of debt and a dream.

As complicated as our current tax system is, it seems that the corrections that have been taking place over the years add more complexity to the reporting requirements. When I look at my business tax return, I get lost in all the various schedules and sections. Like many small business owners, we sign our return hoping that our tax preparer did everything right because it is beyond our comprehension.

Our current income tax system, in my view—and I have worked a lot on the health care debate over the last year—has led to the problems that we have faced with health care. It treats big businesses so much better than small businesses and individuals with the way that it has been handled. Many of us feel that as you make changes in the tax system, the health care crisis could be drastically improved.

In my written testimony, I have a specific point regarding an employee who is only paying $8.33 a week for his health care coverage. He didn't want to pay that anymore. Within a matter of 1

month, he is off work with a major chronic disease, facing surgery, and it is going to be probably paid for by taxpayer dollars.

Our tax policy used to permit deductions and such for personal interest, but yet we have always treated health care differently. It has to reach 7.5 percent of your gross income. Frankly, there are a lot of people that will pay more for interest on a credit card than what they are willing to pay for health care and that has been largely created by past tax policy; the spending habits still exist. Look at home mortgage rates, and the interest paid by the average person. I think it is a tremendous irony there.

Current tax law makes benefits deductible by many businesses as it relates to doing business but S corporations and self-employed don't get the same breaks, resulting in tax inequities. I hope that you will consider some major changes in this area and feel that expenses are expenses; benefits are benefits. We are dealing with hidden taxes any time business incurs taxes as a cost of doing business, the costs are included in the calculation of the cost of goods sold, and are part of the basis used for markup and profit margins.

Through the White House conference we have had a lot of people discuss the collection of taxes. They were upset with having to do the collection as servitude when we are handling various withholdings and filling out the forms, if it is wrong, you get penalized, you get fined if it is late; yet time is money and it is costing us to do that. I don't have the funds to hire a tax attorney, tax accountant, and all these special people just to handle my taxes, and it is quite complex.

One thing that really bothered us was the way that purchase on real estate for commercial and banking, what it did was we looked at buying a building. Purchased at $110,000 we would pay it in 5 years. Then we would have to carry the depreciation 39 years, which would cause a negative cash flow under the current system.

I have got quite a bit more here in my written testimony. I hope you review it. I think there are some real changes that would help generate the economy and if you allow to where proceeds can be used without taxing, some of the recommendations that, our various ones, don't tax what is being used for capital improvements. You can get that money turning.

There are some concerns about some of the proposals even that you have proposed. The consumption tax—I am sure there would be exemptions that would be allowed. But there is a major concern for paperwork.

And in closing, we always hear if it is not broke, don't fix it; if it is beyond repair, get rid of it. I think it is safe to say our current system is broken and beyond repair so we are counting on you to apply the KISS—keep it simple, stupid—principle to whatever you do.

[The prepared statement follows:]

Testimony by Sharon R. Beard
Hurricane Fence Company
Before House Committee on Ways and Means

First I would like to thank Chairman Bill Archer and the Ways and Means Committee for inviting me to come and speak today. I find this to be a particular honor because later this week I will also be representing Small Business as an elected Delegate to the National White House Conference on small business. Tax Reform and Tax Simplification will be the topic of much debate, as it has been throughout the conference process. As you begin looking at alternatives please consider the broad impact of your options. Sometimes initial impressions and views don't take the total ripple effect of the solution into account. Unfortunately those ripple effects can have consequences worse than any of the benefits realized.

White House Conference on Small Business

I hope you are capable of taking some time from your busy schedule and sit in on some of the debate that will take place in the taxation issue area. The taxation issue area is one of the largest issue areas at the conference. There are aiso tax related issues in other areas such as capital formation, community development, human capital, technology, and the open forum. The timeliness of your hearings in conjunction with the conference should be helpful to you. Throughout the process there has been a strong cry for tax simplification and major changes in what is considered TAXABLE income. Tax simplification is a major issue for most if not all small business groups represented at the conference. I hope you will also help simplify the taxing Independent Contractor issue. The problems are based on tax issues. An accountant in Springfield recently completed a study of his small business clients. When asked to rank their concerns from 1-5 with 1 being most important 43.75 percent ranked taxes as #1 and 18.75 percent ranked it #2.

My Background

Don't let my title of "President" fool you. Like most small business owners, my job description covers a wide array of tasks and functions within the company. I handle the wide assortment of administrative tasks, answer phones, prepare sales quotas, deal with inventory, purchasing, advertising, and many other functions including dusting and cleaning the office. Hardly the typical CEO who testifies before you. We did not purchase a fence company because we were financially secure and wanted to own a business. We traded our unemployment checks for a mountain of debt and a dream. Like a growing number of small business owners we did it for survival and because we didn't have many other options.

We fit the typical educational background of many small business owners who have completed high school and possibly some college. Owning our small business however, is a never ending educational experience.

Simplification

As complicated as our current system is, it seems that some corrections of apparent deficiencies can add more complexity to the reporting requitements. When I look at my business tax return, I get lost with all the various schedules and sections. Like many business owners I sign a return my accountant has prepared and pray that he didn't goof it up. All the schedules are beyond my comprehension.

Current Tax Policy & Health Care

Our current income tax system is also responsible for much of our present health care problems. It treats big business so much better than small business and individuals that many including myself feel that a fix here could be a major step forward in dealing with the health care problems of our nation.

Case and point: I have an employee who was only paying $8.33 per week for his medical coverage, while the total cost of his health care was approximately $192.00 per month. In April he canceled his insurance because he no longer wanted to pay the $8.33 per week. His coverage ended on May 1st. Currently he is off work and facing surgery for a medical condition called Diverticulitis. He has applied for medical assistance, and Medicaid will likely cover the costs.

When our tax policy permitted individual deductions for interest payments, individuals were willing to pay far more in interest on their plastic than the average worker would ever consider spending for health care related expenses. I see a tremendous irony when you look at the returns on investment and our health care crises.

Current Inequities

Current tax laws make benefits deductible by the business as it relates to doing business. S-Corporations and the self-employed can only deduct a small portion of what they pay for their benefits as a business expense (even though the insurance is the same), and employees can't deduct anything. I hope you would consider a major change in this area and make all employee benefits deductible by the employer and the self-employed and taxable for the recipient, just the same as wages are treated with deductions allowed for their out of pocket insurance and medical costs. In doing so, employees would have a financial interest in containing cost and would have a financial interest in conducting a cost/value review of their health care packages and other benefits. Benefits are an extension of wages and a benefit to the worker, therefore, paying income taxes on benefits at a lower rate is far better than not having the benefits at all.

Uncompensated Collections

Another complaint with the current tax structure is that the average person likely can't tell you their total tax bill for last year. They plan their weekly living around their net pay, and they can likely tell you what they either had refunded or what they paid on April 15th. Small business has the responsibility for withholding, deducting the proper amount, dealing with earned income credits, and making the deposits. Businesses large and small have paperwork burdens related to the collection of taxes for our government. This is more of a problem for small businesses like myself who lack the designated personnel to deal with that as their only task, unlike large corporations who employ payroll clerks and comptrollers. Many of us still lack technology. All this takes time and in the business world, time is money. I have heard some small business owners refer to it as servitude and are adamantly opposed to the collection of taxes and performance of government tasks without some form of compensation. This is especially true when you consider the penalties and fines that businesses are assessed if the deposit and returns are late or incorrect.

I, like many other small business owners I know, cannot afford a tax accountant or a tax attorney or a bookkeeper to solve my government paperwork problems. Complications, problems and current inequities threaten our very existence.

Current Tax Policy Creates Negative Cash Flow

Our current policy has forced undercapitalized and capitol intensive businesses to borrow. Over the past several years, with the disappearance of community banks, replaced by large national banking chains, and the tightening of the money supply to discourage inflation, we are seeing small businesses afraid of debt. Many like myself have made decisions to operate leaner or to do away with interest expenses being paid to others. We are attempting to get ourselves into a better cash position.

When we purchased our business we leased the property with an option to purchase it later. I sat down and worked with a few numbers. I found that the current tax system adversely affects the ability of small business owners to purchase property. This is especially true with existing property in need of capital improvements. The property I leased was available for me to purchase for $110,000 and the average interest rate over the year in question ran approximately 2-3 percent above prime or 10-11 percent. I would be required to deduct the building and the capital improvements over a 39 year period, even though it was a metal building well into the second half of it's economic life. Bankers explained to me they really prefer five years on commercial property loans but could go as long as ten. Can you imagine the negative cash flow while principle is being paid off so much faster? We would be getting taxed on the principle which cannot be deducted as an expense for another 28 years or so. I decided that current depreciation and tax laws with regard to real estate are terribly unfair to small businesses.

This is a major factor for many small homebased businesses. I moved our offices into our home. Other businesses are coming to the same realization, and avoiding borrowing at all costs.

Net Result on Money Supply and Inflation

Going against the traditional borrowing practices and using profits for capital purchases as opposed to debt is drawing attention. William Dunkelberg of Tempel University has stated that much of the current recovery in small business is a direct result of projects being funded by profits rather than increased debt. Helping small business fund improvements with before tax profits would drastically improve the longevity of recovery without the inflationary pressures caused from interest rates.

Increasing the ability for businesses to use pre-tax dollars for expansions and capital improvements would in effect create wealth by increasing the velocity at which money flows through the economy. This would create jobs and increase wealth.

Regarding Consumption Taxes

While a national sales tax will be debated, myself and others share a concern that it could create even more paperwork for us. Additionally, it would have an effect on the consumer which could jeopardize our businesses. A customer who pays let's say 20 percent sales tax on an installed fence job would be far more likely to do it himself on a weekend. There are also some fears that the complications experienced with current sales taxes regarding tax exempt entities, agencies, and programs would become far more complex under a national system.

Another concern is that it would have the capability of turning into a value added tax and become a paperwork/regulatory nightmare. Various services which are not currently taxed in many states would become taxable, and an underground economy in these service industries would likely result.

I would also be concerned about the impact on lower wage earners who spend a larger percentage of their income and lack the reserves to save any substantial amounts. A National Sales Tax could have a regressive tax effect when you figure that those who make more have the ability to save more, so the percentage of their total earnings paid in taxes could be less.

Regarding Flat Tax

The flat tax being proposed raises concerns as well. I have heard opponents say they want a progressive tax. The notion that flat tax proposals are not progressive is not entirely true, however, because many such proposals retain exemptions and allowances. The allowances and exemptions allowed on a family of four with an income of $45,000 per year, for example, would be far less than the 17-20 percent of total income, and someone who makes $300,000 would pay far closer to the full percentage.

Elimination and Simplification of Paperwork

While opponents may oppose the reduction of the ability to take deductions, others may find that by eliminating a large percentage of the paperwork, major simplification would allow them to complete the return far easier, there would be less chance for error or fraud and we might be able to fully understand the tax documents which we sign. Some concern must be given to the transition process for whatever changes are adopted. A change to a national consumption tax would mean a whole new way of doing business. All new forms and a whole slew of new regulations. Increased consumption taxes paid by businesses in the course of doing business will need to be reflected in prices and costs, and passed onto the consumer. Some business operations will likely become less profitable while others may become unprofitable because of hidden taxes.

Regressive Vs. Progressive Taxes

State sales taxes have been criticized as being regressive because those on the lower portion of the wage scale typically consume a higher percentage of their pay. Those individuals who are more wealthy have the ability to invest and save a larger portion of their earnings. Under a regressive system it is the rich who benefit.

Progressive taxes benefit the lower and middle income. The flat tax could have this progressive effect because of increased exemptions.

FAILURE TO APPLY THE K.I.S.S. PRINCIPLE
COULD RESULT IN A DISASTER FOR SMALL BUSINESS AND THE ECONOMY!
we are counting on you...

Chairman ARCHER. Thank you, Ms. Beard.

Our next witness is Ray Tyler, a small business man in Washington.

STATEMENT OF RAY TYLER, OWNER, TYLER BUSINESS SERVICES, INC., AND MEMBER, SMALL BUSINESS SURVIVAL COMMITTEE

Mr. TYLER. Good morning, Mr. Chairman and Members of the Committee. My name is Ray Tyler, owner of Tyler Business Services, Inc., located in Washington, D.C. I am also a member of the Small Business Survival Committee, a nationwide, nonprofit, nonpartisan, small business advocacy organization that fights against the growing burden of taxes and regulations on our Nation's small businesses and entrepreneurs.

Tyler Business Service is a full-service printing shop which has been operating in the Nation's capital for 35 years.

First, let me thank you, Chairman Archer, for inviting me to speak before the Committee today.

Second, I congratulate you for holding these hearings to address the important issues of overhauling our Nation's tax system. Your leadership in this area is critical to not only today's small businesses and entrepreneurs, but also the well-being of future small business owners who indeed will need this Committee's help to increase their chance of success and survival.

Of course, my time must be factored into these overall costs as well, which takes away from my productive time actually running the business. Let me add that these are just compliance costs, not actual taxes. Today's small business persons almost always have to pay professionals to navigate them through the complicated tax compliance maze. This is a never-ending, changing maze, I might add.

According to the Tax Foundation, over the past 40 years since the passage of the Internal Revenue Act of 1954, which puts the income tax at the center of the Federal tax system, 31 notable tax changes have taken place, on average a major change to the Federal Tax Code every 1.3 years. Not surprisingly, the increase of the size and complexity of the Tax Code has caused an increase in my tax compliance cost.

The uncertainty and instability of the tax system, the number of taxes that I must pay combined with my total tax bill and compliance cost is enough to drive anyone out of business. I am not sure how a person starting his or her own business can quite make it these days. Fortunately, my business has grown and with it I have been able to factor in the cost of taxes and taxing plans in my overall business cost.

I am almost sure that many business failures are the direct result of our Nation's excessive and burdensome tax system. The current system creates disincentives to save, invest and pursue risk-taking entrepreneurial activities. Many, many times in my business I tried to do the right thing for my employees by creating incentives for them to stay with the business and, while with us, to be more productive employees.

When I first created a pension plan for the business, I used to manage it, but because of the complexity of the tax laws I had to

turn it over to the bankers and our lawyers. Now I just sign reams of paperwork for the bank. At the end of each month, if the business turns a profit, I give bonuses to my employees. The government makes even this difficult because I have to renegotiate salaries to comply with the misguided regulations.

The bottom line to the costly and burdensome tax system is that my employees are hurt through lower wages and my customers are hurt through higher prices. My business is only one example of how the government is depressing our Nation's standards.

Is the time up?

Chairman ARCHER. One minute.

Mr. TYLER. I would say one good thing about all these taxes and all these regulations. Let me say one good thing about it from my standpoint. One good thing from my standpoint, a person who has been in business 35 years, is that it is keeping other people from going into business. It is also keeping other competitors who don't run as well as I do out of business.

So today in the District of Columbia, where practically no printers are left, only small copysetters, I have a wonderful business partially because of what the government has done to my competitors.

Thank you.

[The prepared statement follows:]

TESTIMONY OF RAY TYLER
SMALL BUSINESS SURVIVAL COMMITTEE

Good morning Chairman Archer and members of the committee. My name is Ray Tyler, owner of Tyler Business Services located in Washington, D.C. I am also a member of the Small Business Survival Committee, a nationwide, nonprofit, nonpartisan small business advocacy organization that fights against the growing burden of taxes and regulations on our nation's small businesses and entrepreneurs. Tyler Business Services is a full-service printing shop which has been operating in the nation's capital for 35 years.

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I say this Chairman Archer, because I have been a small business owner for over 35 years and have seen the increased tax and regulatory burden placed on my own business. The only way that I have been able to keep the doors of my business open has been through the paid assistance of professionals who specialize in the tax compliance area -- namely a Certified Public Accountant (CPA), a full-time bookkeeper, an attorney and bankers.

Last year my CPA cost the business over $9,000. At least 10 percent of my staff bookkeeper's salary -- about $4,500 -- is dedicated to dealing with lawyers, bankers and IRS issues. The company pension fund, which I used to manage myself as well as pay someone $1,000 to do actuarial work ten years ago, cost me $26,000 last year because of changes in the way the IRS administers the tax fund. My billing department also incurs hefty tax code compliance costs. And, of course, my time must be factored into these overall costs as well which take away from my productive time actually running the business. Let me again add that these are just compliance costs -- not the actual taxes!

Today's small businessperson almost always has to pay professionals to navigate them through the complicated tax compliance maze. And, this is a never-ending changing maze I might add. According to the Tax Foundation, over the past forty years (since the passage of the Internal Revenue Act of 1954 which put the income tax at the center of the federal tax system) thirty-one notable tax changes have taken place -- on average, a major change to the federal tax code every 1.3 years. Not surprisingly, the increase of the size and complexity of the tax code has caused an increase in my tax compliance costs.

The uncertainty and instability of the tax system, the number of taxes that I must pay, combined with my total tax bill, and compliance costs is enough to drive anyone out of business. I'm not quite sure how a person starting his or her own business can quite make it these days. Fortunately my business has grown, and with it have been able to factor in the cost of taxes and tax compliance into my overall business costs. I am almost sure that many business failures are the direct result of our nation's excessive and burdensome tax system. The current system creates disincentives to save, invest and pursue risk-taking, entrepreneurial activity.

Many, many times in my business I try to do the right thing for my employees by creating incentives for them to stay with the business, and while they are with us be more productive employees. When I first created a pension plan for the business (as mentioned above) I used to manage it, but because of the complexity of the tax laws I had to turn it over to the bankers and the lawyers. Now I just sign the reams of paperwork from the bank, and pay a lot to do simply that.

At the end of each month if the business turns a profit, I also give bonuses to my employees. The government even makes this difficult because I have to "renegotiate" salaries to comply with misguided regulations.

The bottom-line to the costly and burdensome tax system is that my employees are hurt through lower wages, and my customers are hurt through higher prices. And my business is only one example of how the government is depressing our nation's standard of living and hurting economic growth and job creation.

I, like many other small business owners, agree that something must be done to make our tax system less-costly, less-burdensome and more efficient. That is why Chairman Archer you, and other leaders in the Congress who are advocating far-reaching proposals to overhaul the tax system have certainly won the hearts of many small business owners. And, although you may have won our hearts, lawmakers have not yet won our minds. Because many small business owners believe that the federal government is incapable of making a tax system fair and less-burdensome. This is only an honest assessment of how many small business owners feel.

However, I remain confident that perhaps this will occur in my lifetime. By the way, I am 75 years-old and would appreciate it if you put these tax overhaul efforts on the fast-track.

While at this point in time I do not advocate one tax system over another, I agree with some basic principles which have been well presented by the Small Business Survival Foundation. Two leading proposals which "score" high against these principles are a flat tax and a consumption tax -- or the national sales tax. The basics of a sound tax system developed by the Small Business Survival Foundation, and based on Adam Smith's maxims of a taxation in 1776, include:

- ***Low Flat Tax Rate to Promote Economic Growth***
- ***No Taxation of Capital***
- ***Inflation Factor***
- ***Clarity***
- ***Simplicity***
- ***Limited Bureaucracy and Intrusiveness***
- ***Minimum Incentives for Tax Avoidance***
- ***No Additional Boost to Government Spending***

I'd like to leave with you Chairman Archer, and I am sure that the Small Business Survival Foundation would make this available to all members of the committee, a copy of a Preliminary Report prepared by the organization's chief economist called *"The Great Tax Debate: Making Sense of Competing Tax Plans."* This report details each of the above principles in greater detail, and how leading proposals score against the basics of a sound tax system.

Once again Chairman Archer I thank you for inviting me to be a part of these important hearings today. While typical Washington observers will say that overhauling the nation's tax system is an impossible task that will never happen, I am just thrilled that we have entered a political environment where this debate is actually occurring.

Most hard-working taxpayers agree that something must be done to make the U.S. tax code more fair, less-costly and less-burdensome. For our nation's small business owners, the current tax code is a mess and totally out-of-control. I am so pleased that you are taking a lead to help reward our nation's risk-takers and job creators which will lead to greater economic opportunity and security for all Americans. I would be more than happy to answer any questions you or committee members may have.

Chairman ARCHER. Thank you, Mr. Tyler.

Our next witness is Constance Skidmore from San Francisco. You are recognized. You may proceed.

STATEMENT OF CONSTANCE E. SKIDMORE, PARTNER, COOPERS & LYBRAND, L.L.P.

Ms. SKIDMORE. Mr. Chairman and Members of the Committee, I am Connie Skidmore, a partner of Coopers & Lybrand, L.L.P., and partner in charge of our firm's tax compliance practice. Coopers & Lybrand, L.L.P., is one of the world's largest accounting and business advisory firms and provides indepth expertise to individuals and business enterprises. In our practice we resolve business tax problems in a wide variety of industries and for individuals of all levels of income categories.

We have been asked today to address the need for reform of our current income tax system, not to address any particular alternatives. I would like to share our perception of the frustrations facing individuals and businesses based on today's system. I will share some examples of both inconsistency that we believe exists in the system as well as the high levels of complexity.

During an individual's life cycle there are many natural changes that cause people to question the fairness and simplicity of the system. For example, our complex rules require that when a child reaches the age of 1 year, he or she must have a Social Security number and if that number is not placed on the tax return, the refund could be delayed and the parents could be assessed a $50 penalty. You can imagine that for a couple that has just had a child, they probably don't have the time to figure out the rules for filing for a Social Security number. To obtain a child care credit the parent must also understand the multiple levels of complexity, defining who is a qualifying person, what are dependent care benefits and what are qualified expenses. Even when one determines the foregoing, there is a six-point test that must be met.

As a child gets his first job he or she is likely to come home and ask, "How many exemptions should I be claiming?," and the correct answer to that question is even a different answer than the rule for a dependent. Finally, the child contemplates marriage and faces the choices of filing jointly, filing separately, or single, or head of household.

As my written testimony explains, life goes on and so does the complexity of interfacing with the tax system. As a person has children, moves, buys and sells a house or other assets, and maybe even gets divorced, the rules must be adhered to. Upon retirement, major decisions must be dealt with concerning taxation of retirement pay, when, how much to receive, how long a period of time to receive it over, whether in lump sum, as a rollover, or as an annuity, and what the contribution recovery rate should be.

As one faces receiving Social Security, an individual has a complicated formula to determine annually how much, if any, is subject to taxation. The calculations are so convoluted as to greatly aid in the misunderstanding of the scope of the provision; and finally, death brings many tax complexities.

The kinds of basic and normal changes in an individual's life also exist in the normal evolution of a business enterprise. I will just

mention three issues. As a business starts up and becomes incorporated, little thought is given to the tax consequences either because of lack of knowledge or advice regarding these complex choices. Every week businessowners show up in our offices owing a double level of tax because they have sold a company and have chosen the wrong form of business. The business should have been organized as a passthrough entity, but there is nothing we can do to retrieve the prior taxes that have been paid unnecessarily. We generally solve this problem going forward by suggesting an S corporation be elected.

Now, there are new rules that have been instigated in certain States allowing limited liability companies, and these same companies are facing the question, "What choice do we make in choosing our business entity"? As a company moves through its operating lifetime, it may also encounter as many as a half a dozen definitions of a given term. For example, the term gross receipts has many different definitions in the tax law.

As a company winds down and comes to the end of its life cycle, we can give a good example of how overly complex the rules are that create confusion by looking at a bankrupt company for which we filed returns.

The company's actual losses were so significant there was probably no possibility it would ever pay taxes under the regular tax system and it was destined for liquidation. Yet, because of the alternative minimum tax system, which is a system that imposes a minimum level of taxes in spite of allowable deductions, the company's alternative minimum tax liability took preference in liquidation over the debts to unsecured creditors. In other words, even though there was no benefit or income for those allowable deductions, the government was paid an income tax while the business' suppliers and other creditors of the business got nothing. The stakeholders obviously were baffled by this complex set of rules.

I hope this perspective of normal everyday events both on the individual and business side gives you a feel for the frustration that taxpayers face. We propose that in your deliberations regarding tax reform that you consider the underlying principles of both simplicity and consistent policymaking.

Thank you for giving me the opportunity to testify. I welcome any questions you may have.

[The prepared statement follows:]

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Statement on "Replacing the Federal Income Tax"

Constance E. Skidmore
National Director of Tax Compliance
Coopers and Lybrand L.L.P
before the House Ways and Means Committee

June 6, 1995

Mr. Chairman and members of the Committee, I am Connie Skidmore, a partner at Coopers & Lybrand, L.L.P., and partner-in-charge of our Firm's Tax Compliance practice.

Coopers & Lybrand, L.L.P., provides expertise in Business Assurance, Tax, Consulting, Human Resources Advisory and Process Management for individuals and business enterprises. We have over 66,000 partners and staff worldwide, with more than 740 offices in 126 countries. Our tax practice serves a wide variety of clients and assists them in complying with U.S. tax laws in a cost effective manner. Since 1898 we have been assisting clients with tax consulting and tax compliance.

A general overview of my 22-year career in taxation includes over three years as an IRS tax auditor, two years practicing estate and trust taxation, and many years in the fields of real estate, individual and general corporate taxation, tax shelter consulting, and high technology and venture capital taxation among others. My experience has exposed me to the difficult and frustrating problems encountered by taxpayers when complying with our current tax laws.

In our practice, we see complexity problems on the corporate side, as well as problems associated with lower and middle income returns of individuals. We do tens of thousands of individual tax returns of business employees as part of our expatriate practice, as well as thousands of returns for our client's children.

We have been asked to address the need for reform of our current income tax, not to address any particular alternatives. I would like to share with you our perception of the real world problems facing individuals and businesses that try to comply with tax rules and provide some examples that demonstrate the importance of the reform effort that this committee is undertaking today.

Income Tax Complexity and Fairness

The extreme complexity of our current system is a source of frustration that becomes particularly acute for taxpayers when they feel that the complexity has not produced the best result for those in their circumstances.

Our current income tax has many sources of complexity. Some complexity is inherent in the structural components of the tax system. For example, any tax that adjusts for family status or family size must define "married", "head of household", and "dependent". These distinctions are not easy ones and are the source of complexity and hardship for many average taxpayers. Similarly, once adjustments are permitted which attempt to address the tax burden for different family circumstances, additional definitions are required and judgments can be made about when other events imperil the individual's ability to pay. Examples include the definition of "medical" expense, "casualty loss", and

the different AGI tests included in the Code today to determine when these costs are deductible. Additional complexity is added by provisions intended to influence behavior, such as those permitting favorable tax treatment for savings, an itemized deduction for mortgage interest and charitable contributions, and so forth.

Individual -- Life Cycle Complexity and Fairness

For many individual taxpayers, the income tax is relatively straightforward and the form 1040 A or 1040 EZ relatively simple, as long as they have mostly wage income and do not have to dwell on their filing status or the dependency tests. Unfortunately there are significant elements of the population who each year face some sort of complexity. Our normal basic changes in life which give us pleasure or perhaps tension are compounded by tax complexity. Let me give you a few examples that arise with our life cycles:

- When a child reaches the age of 1 year, he or she must have a social security number. If that number is not placed on the parent's 1040 tax return, their potential refund could be delayed and they may be assessed a $50 penalty.

- On special occasions, the child receives gifts. Even when these amounts are relatively small, we as tax practitioners are asked if these gifts are taxable income. Few people understand the delineation between the gift tax and the income tax.

- When the child is growing up, the parents may incur child care expenses. To receive a child care credit, one must understand who is a qualifying person, what are dependent care benefits and what are qualified expenses. Even when one determines the foregoing, a six point test must be met.

- Then the child gets his or her first job. How many of you have had a son or daughter come home or call asking how many dependents they should claim for withholding?

- Finally the child is contemplating marriage but faces the choice of filing jointly, married filing single, single or head of household. We have a secretary in my office who asked her boss to review her 1040 since she incurred an inordinate amount of medical expenses. Her boss looked over the return and mentioned that he did not realize she had been married or had children to claim the head of household filing status. Her honest reply was that "she owned her own home so surely she was head of a household".

- When the married couple have children they now have dependents which may or may not give them an exemption deduction. Clients often ask us whether someone is a dependent. As simple as this question sounds, I must respond with a series of questions to determine 1) relationship, 2) marital status, 3) citizenship, 4) residency, 5) income, and 6) support. These questions take on a whole new complexity if the child was of divorced parents.

- What if a spouse loses a job. What is the tax status of any unemployment benefits. Moreover, in these low income years, there is the possibility of qualifying for the earned income tax credit. We observe, however, that this credit is far too complex for the population it targets.

- Later in life the married couple moves. It's bad enough that the couple must file split year state returns, but they must also face two additional complications on the federal return. The first one is the moving expense deduction. To calculate this deduction, there is a distance and a time test and of course exceptions thereto.

Then all expenses must be broken down into categories to determine whether some, all or none are deductible. The second is reporting the gain on the sale of the personal residence and the replacement property. This calls for the compilations of all the records relating to expenditures of the sold residences. Fortunately, once a person has gone through this exercise, they generally keep better track of their house expenditures thereafter. Still, one of the most frequently asked questions is "How long and what records do I need to keep for income tax purposes?"

- Unfortunately our theoretical couple become separated or divorced which creates a series of difficult and theoretically complex issues such as: gain recognized; sale of residence and reinvestment; alimony; what constitutes child care expenses; who gets the deduction for the children, etc.

- When our theoretical taxpayers become elderly, the tax complications compound along with the normal complications of aging. Upon retirement, major decisions must be made concerning the taxation of retirement pay: when, how much, how long, lump-sum, roll over, annuity, contribution recovery etc. Upon receiving social security, a complicated formula needs to be done annually to determine how much, if any, is subject to tax. The calculations needed to determine the taxable portion of social security benefits are so convoluted as to greatly aid in the misunderstanding of the scope of the provision.

- For the elderly a credit is possible if one meets an age test, a filing test and an income test which takes into account nontaxable income.

- And finally, death brings upon several tax complexities, especially in the estate tax area. Practically no one in the United States really knows how to prepare someone for our estate tax law other than those who practice in this area.

"Main Street" Business Issues -- Life Cycle of a Business

The kinds of basic and normal changes in an individual's life, also exist in the normal changes during the life of a business from its birth (choice of entity) to its death (bankruptcy or liquidation). The current system, which generally requires the taxpayer to understand and to fully comply with tax rules, has procedural and definitional difficulties that many taxpayers must learn by experience - sometimes too late.

- ***Choice of Entity - starting the business***

Basic Business Forms.

All taxpayers are experiencing an undue burden with respect to tax filing requirements. These onerous requirements begin the moment a business starts operations. Choosing the proper business entity from a tax viewpoint can perplex even the most sophisticated entrepreneur. Most decisions are made with little or no knowledge of compliance requirements. And typically, no financial or tax advisors are consulted at the time the decision is made.

Many startup businesses are incorporated with little thought about the tax consequences. Every week, business owners show up in one

of our offices owing two levels of tax as a C corporation when the business should have been organized as an S corporation. The businesses have effectively overpaid (sometimes hundreds of thousands of dollars) because they were not focused on the tax consequences and did not have adequate tax advice from the start. These are resources that could have been reinvested in the company; yet there is nothing we can do to get back the prior tax liability already paid. We can only solve the problem going forward by advising the company to elect S corporation status.

Now that states are adopting new legal entity rules to permit a new kind of pass-through entity, limited liability companies (LLC), some of the same companies are again having difficulty with the federal tax rules. These new entities have all kinds of competitive advantages in the marketplace (*e.g.*, the types of employee fringe benefits and investors that the federal tax law will allow them to have), yet S corporations can generally only convert to this LLC status by paying a very significant federal income tax toll charge.

Selecting A Tax Year.

The change made in the law to require a December 31 year end for businesses that operate as pass-through entities is an example of how a tax procedural rule can run completely afoul of business interests. A retailer who has a huge Christmas season and January clearance sales will use a January 31 year end for solid business reasons, but for tax purposes a December 31 year end must be used (or a complex alternative under Section 444). This has not worn well in practice. It causes difficulty for the taxpayer as well as workload compression for tax practitioners which translates into workload compression for the IRS.

Elections Generally: do they communicate fairness to the taxpayer?

Our current tax code and regulations are filled with complicated elections that must be made with the first return filed to which the election could apply. This causes tax directors of major companies many sleepless nights. They worry that they have missed a possible election that would benefit their company. They worry that they made the wrong election because they had so little time to make it that they had to guess. It gives tax professionals an uncomfortable feeling that the tax code has a Las Vegas mentality -- heads I win, tails you lose. This sort of burden is hard to quantify but adds much angst to the system. Why couldn't an election be made or changed anytime before the statute of limitations has tolled? Is it really in the government's interest to make taxpayers feel tricked when they are trying to comply while paying the least amount of tax legally owed?

- ***Net Operating Losses -- early year operations***

A usual scenario for the entrepreneurial company includes operating losses in the early years. When the entrepreneurial venture shows some signs of real success, the company frequently needs an infusion of additional investors to compete successfully enough to assure that the any of those benefits will materialize. Enough new investors can mean triggering the change of ownership rules in Sec.

382. The lengthy and complex rules requiring reporting under Sec. 382 (even for years prior to utilization of the net operating losses), assume the resource-constrained young company can accumulate and analyze the appropriate records to comply. We hear many justified complaints from taxpayers about the wasted resources spent on Sec. 382. In many cases, companies with limited resources will not pay to have a proper analysis performed, or provide data for adequate information reporting, and noncompliance may result.

- ***Depreciation and AMT -- building a manufacturing business***

During the growth cycles of companies, they quickly are confronted with significant compliance for fixed asset reporting. These same problems affect mature companies that are capital intensive. For my California clients, they must sometimes track 7 depreciation methods, one for financial statement purposes and 6 under federal and state tax law. This usually creates such a burden that to comply with the tax law requires a full-time employee just to work on fixed assets. Maintaining ongoing records for assets owned when each depreciation change is made in the law is an undue burden. Bottom line -- having one set of rules for depreciation for regular tax purposes and another set of rules if you are not profitable enough to pay the regular tax is a compliance nightmare.

The best real world example of how badly the current AMT works involves a bankrupt company for which we filed tax returns. The company's actual losses were so significant that there was no possibility that it would ever pay taxes under the regular income tax system, and it was clear that the company was destined for liquidation. Yet, because of AMT preferences, the company owed alternative minimum taxes. The AMT tax liability took preference in liquidation over the debts to unsecured creditors. There was no income and no benefit from the so called "tax preferences", yet the IRS got paid an "income tax" while the business suppliers and other creditors of the business got almost nothing.

As soon as the company becomes profitable, the myriad of estimated tax payment rules must be dealt with. It is not out of the ordinary that these rules require the financial books be "closed" within a matter of days in order to make the calculations (usually more than one calculation including AMT analyses) and arrange for payment by the 15th day of the following month. This assumes the availability of accounting personnel as well as hardware and sophisticated accounting software.

- ***Employee Benefits -- adding and attracting employees as the business grows.***

There are a myriad of reasons why the addition of employees to any business increases the compliance burden and potential problems with the IRS. We cannot hope to do justice to the entire topic today. This Committee is well aware of the problems of classification of workers as independent contractors or employees. It is one of long standing and difficult to resolve. It will persist in any tax system that involves distinctions between these classes in terms of deductibility of compensation paid or in the treatment of benefits provided. However, and more importantly, the so-called "qualified plan rules" in the federal tax code have changed an inordinate amount since 1981, causing many to "give up the ghost" and eliminate their retirement plans altogether. The small businessperson today has little other choice given the very complex set of tax criteria faced in setting up a plan and even in determining which employees can participate in a plan. These complexities can extend to other sorts of employee fringe benefits as well.

An employer that offers married employees a choice of benefits can find that instead of improving the lot of their workers as intended, they have created a nightmare. According to the IRS, if an employer gives a married employee a choice between health insurance and improved retirement pay, so that employees who have superior coverage through their spouses can benefit in another way, the company has inadvertently caused the employee who chooses to stick with the health plan to be taxed on that benefit which is a totally counter intuitive result.

- ***Ongoing Complexity -- during a company's operating lifetime.***

The federal tax code is full of rules for which the balance between complexity imposed on the taxpayer and federal revenue benefit is highly questionable. We have a trillion dollar plus per year tax system, with parts of it adding complexity for U.S. business enterprises that are an anathema to the rest of the world.

Uniform Capitalization Rules.

IRC Sec. 263A requires taxpayers that carry inventory, such as manufacturers and retailers, to capitalize a portion of their indirect costs. If you have an off-site storage facility, the costs of that warehouse must be capitalized into inventory. Similarly, the salaries and payroll taxes of the person purchasing the inventory must be capitalized. The inventory accounting system for tax purposes is generally not acceptable under accounting principles, so that taxpayer generally does not even have the option of conforming book accounting to the tax accounting system. Therefore, the taxpayer must maintain both systems. This discrepancy causes major difficulties for small businesses and entrepreneurs.

The best example of this problem is the company that paid their accounting firm $200,000 to perform an analysis of their inventory accounting system which concluded that the uniform capitalization rules required the taxpayer to make an additional one time payment of $50,000. What this means for a company with a constant level of inventory is that the federal government gets a one time revenue pickup and the taxpayer gets an additional accounting system for tax purposes that, legally, must be maintained in perpetuity. Furthermore, the company may have taken a business deduction for the $200,000, in effect costing the government rev. .e.

Larger and more sophisticated businesses can reach an acceptable compliance level after working with complex rules for a number of years, as long as those rules do not change. But new businesses and large existing companies that must face complicated new rules struggle and spend inordinate amounts of time and money to implement such rules. A timely example is the interest capitalization component of the Sec 263A rules that are newly effective 1/1/95. The IRS, eight years later after enactment of the provision, has finalized rules for capitalizing interest that depart dramatically from current practice and will require much adjustment by many taxpayers in different industries. Real estate developers will be required to keep detailed records of construction costs incurred as of certain "measurement dates" in order to decide how much interest must be capitalized. This data would not be kept for any other purposes. Additionally, in some cases, entities without construction activities

must capitalize interest because of construction activities of related companies.

Basic Definitional Issues.

Whenever definitions are a key component of a tax rule, problems and complexity result and sometimes these are out of balance with the benefits to the system. A recent example is the excessive difficulty, time and money taxpayers have spent to determine their non-deductible "lobbying" expenses and to allocate the proper costs thereto. Definitional issues arise in many parts of the Code. Today we see problems even in the definition of those activities that everyone agrees should be most promoted, such as basic and experimental research.

A recent meeting I had with a seasoned, highly qualified CEO of a high technology firm which is developing state-of-the-art technology in a field historically dominated by Japanese companies, is illustrative of this problem. In order for him to be comfortable with our tax advice on the company's research and development, he spent 20 hours understanding the tax regulations on the issue. He was most disconcerted that our tax system is so complex that he must re-allocate his time to this effort instead of adding real value in his field of engineering. Not only was his time not well spent, but he also lost the training and coaching time he would have spent with either his engineering or marketing teams.

"Passive Activity."

These rules are complex, some would say impenetrable. And the rules affect anyone who has a piece of rental real estate or a limited partnership interest, no matter how small. It is virtually impossible to calculate without a computer program. This source of complexity affects all types of taxpayers. A great many middle and lower income retirees, in an effort to maximize the rate of return on their savings, have brokers and investment advisors that have invested them in a small interest in a limited partnership, typically $5-10,000. An experienced tax advisor can easily spend 20 hours performing the calculations that can have little impact on ultimate tax liability. We run the calculations on powerful computers, and even then the time it takes to input the data seems ridiculous. This breeds non-compliance often involuntarily.

Fundamental procedural complexity.

Procedural rules should be measured against a common sense standard. The best example of a procedural rule that communicates the wrong message to a taxpayer when discovered is perhaps the rule for the due date of tax deposits. Taxpayers who must make multiple deposits of taxes during the month frequently send a messenger to the bank to make sure the payment is there on time. Few taxpayers understand that the payment is treated as if made at a bank and recorded when the bank closes its books, not when it closes its doors.

For example, the company that dutifully sends a messenger to the local bank before it closes at 3:00 PM is one day late if the bank has closed its books at 2:00 PM. Worse yet, if the company sends its payment directly to a Federal Reserve bank at 2:00 PM and the Federal Reserve bank closes its books at noon, the taxpayer is one day late even though its check is in the system faster than if the company deposited on time in the local branch office. Imagine the reaction of extremely compliant taxpayers when the IRS assesses large penalties and interest on all the taxpayers' past tax deposits due to the taxpayers' misunderstanding of the system.

- ***Multinational Businesses -- growing into foreign markets.***

The income tax system is currently inordinately complex and burdensome for U.S. companies trying to do business abroad and we urge the Congress to assess the nonproductive costs it is placing on these companies. Even within the constraint of our current system, significant improvement can be made to the workability of the rules, reducing the areas of uncertainty and excess burden.

For U.S. multinationals, the present rules make it very hard to get foreign earned dollars back to the US efficiently. Frequently, rather than repatriating cash earned by foreign operating subsidiaries, and thus making this cash available for U.S. investment and job creation, companies are investing this cash abroad in active businesses so as to avoid other tax costs that would be incurred if the cash were repatriated.

For example: Many U.S. parent companies experiencing U.S. net operating losses often choose to let their foreign operating subsidiaries invest their earnings offshore rather than paying dividends into the U.S. Payment of a dividend very likely would result in the permanent forfeiture of the ability to utilize foreign tax credits properly associated with the dividends. Repatriating the earnings to the U.S. would result in double taxation and a significant waste of the companies' investment resources.

In a number of ways, the current system presents obstacles to US companies trying to penetrate foreign markets. First, the foreign tax credit rules require companies to deal with the tax implications of any international investment and the result is that many investments can not meet the company's so-called "hurdle" rate of return because of the tax costs involved. In this regard, the rules for allocating expenses, including interest, to foreign source income tend to overallocate these expenses to such income. This has the effect of unfairly and inappropriately reducing foreign source income to the point where foreign tax credits associated with this income are rendered unusable. The expense allocation and other FTC rules do not have to be as complicated or harsh to serve the tax policy purpose for which they were conceived.

International joint ventures in particular are frequently further discouraged because of the effect of the rules under the Code's "toll charge" rules. All too frequently, the transfer of technology to an international joint venture cannot be done without incurring "deal breaking" tax costs. In essence the global exploitation of US created technology is greatly undermined because of our tax rules. These rules simply have not kept up with the developments in the world and the need to enhance the position of US companies, products, and technologies abroad.

Summary

The current tax system has grown over the years with layers of sometimes conflicting policy, most of which were designed to raise revenue within the constraints of whatever political compromise could be reached at the time. That layering of policy creates a compliance nightmare and breeds both voluntary and involuntary non-compliance. The additional burden affects U.S. taxpayers on at least two fronts: unnecessary compliance burdens drain business and family resources from more productive endeavors; taxpayers often must compete on price with someone whose tax situation is less complex, or who is less compliant, or in the case of multinational companies, with a foreign firm which bears less tax burden.

We suggest that your Committee adhere to two principles regardless of whether you decide to replace the current system or merely reform it:

- Make clear consistent policy choices - conflicting policy goals create complexity and unnecessary burden.

- Strive for simplicity in every aspect of your policy decisions. Tax complexity, when it competes with the time individuals have for work and family or the time that business executives and others have to compete in an ever more complex global economy, reduces GNP and breeds significant voluntary and involuntary non-compliance.

It is with great respect for the process ahead of you that I must observe that completely replacing the current tax system is a legislative initiative that no Congress has attempted. It will require the best economic and policy analysis plus your base of experience with constituents. Fundamentally, it will require you to shape a tax system that comports well with the American ethos.

Thank you for the opportunity to testify and I would be pleased to respond to any questions.

Chairman ARCHER. Thank you.

Our next witness is William Dakin, senior tax counsel for Mobil, Fairfax, Va.

You may proceed.

STATEMENT OF WILLIAM G. DAKIN, SENIOR TAX COUNSEL, MOBIL CORP.

Mr. DAKIN. Mr. Chairman, distinguished Members, it takes 57 man-years at a cost of $10 million to prepare Mobil's Federal income tax return.

Each year we study the changes that Congress has made to the Internal Revenue Code—five major tax bills since 1986—the new regulations and rulings published by Treasury and the IRS, and the court decisions. At yearend, we send revised instructions and forms to 260 U.S. incorporated companies and 475 foreign incorporated companies. It takes 250 pages of instructions and forms just to collect the information we need to prepare the return from each of our U.S. incorporated companies doing business in the United States. It takes 330 pages of instructions and forms to collect the information we need from our U.S. incorporated companies operating outside the United States because the foreign provisions of the Code are so complex. And it takes 200 pages of different instructions and forms to collect the information we need to file on behalf of each of our controlled foreign corporations.

We keep our books according to generally accepted accounting principles. As soon as our books are closed in March, accountants throughout the world spend the next 2 to 3 months adjusting our financial accounting to the special accounting that the tax law requires and sending the results to our tax group in Dallas. This tax data is collected, analyzed and reported solely for the IRS. It is of no use to our creditors, our investors, any foreign government or the people who run our business.

From May through September, 40 tax return preparers—they are over there in that photograph—verify the data received from the field locations and do the tax calculations. Each of our companies' taxes has to be calculated twice, once for the regular tax and again for the alternative minimum tax.

[The following was subsequently received:]

On September 15, 1994, the tax return for 1993 that you see before you was delivered to the IRS offices in Dallas and Austin. It consists of 9 volumes; it totals 6,300 pages and it weighs 76 pounds. That is this, also in the picture.

The return itself, however, is just the tip of the iceberg. It could not be prepared without doing the work to connect it to Mobil's books and records. This stack consists of the workpapers for just 1 of our 745 companies. The total workpapers for the 1993 return consists of 146,000 documents. This is a 27-percent increase over 1986, the last year before the Tax Reform Act of 1986 took effect. I might say that our return was two-thirds of this size prior to 1987.

However, to the costs of filing the return must be added the costs of conducting the audit. Mobil maintains 16 full-time employees in Dallas, assisted by 17 full-time equivalents in other locations to work on the audit. Our total costs of conducting the audits run about $5 million per year, and this figure does not include litigation costs or outside counsel fees.

Due to the complexity of the tax rules in our last audit cycle, 1987 through 1988, we received requests for information on 8,000 different items. Each request required Mobil to produce one or more documents from various locations around the world and to prepare written responses to the questions asked.

In our current audit cycle, 1989 through 1991, requests are running about 30 percent ahead of where we were at this point in the last cycle, which would give us something over 10,000 items being looked at.

We are currently working with the IRS to finalize unresolved issues which date to 1974.

Mr. Chairman, Mobil's experience in complying with the tax law since 1986 is that it has become far more complex than it needs to be to protect the revenue. This complexity creates serious problems for both taxpayers and the IRS.

We look forward to working with you and your Committee in making the tax law less complex and reducing the heavy compliance costs that U.S. taxpayers now bear.

Chairman ARCHER. Mr. Dakin, thank you for your presentation.

Our final witness will be introduced by our colleague, Congressman Nethercutt.

Mr. NETHERCUTT. Thank you, Mr. Chairman and Members of the Committee.

It is my pleasure today to have the opportunity to introduce to you and the Committee, Wayne Williams of Liberty Lake, Wash. Mr. Williams is here to testify about the economic impact of Federal estate taxes on closely held family businesses.

Mr. Williams is not only an inventor and an entrepreneur and a community leader, but he is also the president of a company called Telect, which is a company very heavily involved in the telecommunications industry, and he is uniquely qualified, I believe, to testify about the effect of Federal and State taxes on family held businesses. It is my honor and pleasure to introduce Wayne Williams today.

Chairman ARCHER. Mr. Williams, you may proceed.

STATEMENT OF WAYNE E. WILLIAMS, PRESIDENT, TELECT CO., LIBERTY LAKE, WASH.

Mr. WILLIAMS. Thank you, Mr. Nethercutt.

I commend Chairman Archer for initiating this hearing. I come before the Committee today representing my family and the nearly 13.5 million other family businesses in the United States. I am also here on behalf of my employees, who represent a few of the nearly 20 million family business private-sector jobs that were created during the eighties. Telect is a closely held S corporation. With the exception of one outside family member, all of the members of the corporation are family. We have grown from 3 employees 12½ years ago to nearly 600 employees today. We compete on a national and international basis. Our 1994 sales were over $41 million. We are a company that offers good jobs and good benefits. This has happened solely with the dedication, planning, and efforts by my parents and me as well as the efforts of our number one asset: Our employees. We may appear to be a large business to some, but we are a mere tadpole amongst killer whales in the emerging telecommunications and videocommunications industry.

When my father decided to start Telect in 1982, he was concerned about where his kids would work and what opportunities would be available to them. On September 13, 1982, he started a family business. My mom, a housewife of 20 years, entered the workplace and collected no salary for nearly 2 years. I was directly out of high school and went to work on the first day.

Our philosophy has been to reinvest our profits into new products, employees, and our expanding international opportunities. We pay millions of dollars in taxes every year. The government looks at my family's tax returns and sees millionnaires. We look at our family's tax returns and see over 600 families living productive lives.

In 1986, we began the onerous task of planning the succession in our company. This included leadership and ownership of our family business. The leadership is the part of business that every business should be concerned with. The ownership and death planning efforts of the business are areas that should not have to take up time and money. It has been estimated that compliance costs of the transfer system, including compensation to attorneys and accountants, amount to approximately 65 percent of the revenues received [Payne, Unhappy Returns, 91 TNT 264–57, at 4 (1991)]. We are proud of what our family has accomplished during the last 12½ years. The opportunity for the family business is thriving, but the perpetuation of the business into the future is at jeopardy due to the costly effects of our silent partner, Uncle Sam, waiting to cash out upon the death of my parents.

I am sure that each of you are already aware that with a privately held family business, the majority of family net worth is tied up in the family business. The business offers little, if any, liquidity. Uncle Sam has really done nothing to help our business and has already been for that contribution paid.

I chuckle when the issue of estate taxes comes up and our government says that we have allowed you to pay estate taxes for over 15 years. That doesn't mesh with our philosophy of trying to reduce our debt, rather than to increase it. It appears Uncle Sam wants

business to go into debt rather than to reinvest into economic enhancing and asset building opportunities.

I understand that two countries that the United States competes with on an international scale, Germany and Japan, have made it much easier for their family businesses to thrive from generation to generation. We have made an effort to maximize gifting and are much further along in estate planning than most other family businesses.

My parents have used their maximum life exclusion of $600,000 each which is basically the value inside the business and are using gifting allowances on an annual basis in order to mitigate the estate taxes that would be levied upon their death. In addition, a life insurance trust, costing our company and the employees nearly $250,000 annually, has been set up to allow the heirs to cover potential taxes. The trouble is that as the company grows, soon it will be impossible to buy enough insurance to cover the death tax obligations. At the same time we pay enormous amounts of income tax yearly on the profits of the company and still face a threat to the longevity of the company because of estate taxes.

If you kill the company at the time the owners die, you are losing the golden egg of future taxes that the company would generate plus income taxes of employees. This ultimately affects the government because it is short-term gain but long-term pain by eliminating the company, the jobs, and the annual taxes.

If my parents died today while I am testifying before you, I would have to go back home and prepare a check to Uncle Sam for approximately $6,793,000. That seems ridiculous considering the fact that their estate is mostly made up of nonliquid assets in a business that is thriving. Not only does it seem unreasonable to tax someone for their estate based on business interest, death is the worst time to be trying to pay such exorbitant taxes.

Please eliminate this tax from the estates of closely held family businesses. If the competitiveness of the United States is to increase, please quit thinking that this is taxing the wealthy and realize that it is affecting millions of jobs. And please realize that closely held family businesses are managed not against quarterly results, and many times not for the financial return to the shareholder, but are managed for the greater good of people and products.

Thank you for allowing me this opportunity to speak for family businesses. I realized one thing as I prepared this testimony. I am going back to Spokane, Wash., to work on a new product, a product that would let the founder and family members of closely held family businesses live forever, because if this product was developed, we would never have to worry about this tax.

Chairman ARCHER. Thank you, Mr. Williams.

Mr. Crane will inquire.

Mr. CRANE. Thank you, Mr. Chairman.

I want to salute our witnesses today and express appreciation for their testimony. I was brought up, I think, the way every one of you was as a kid, and I tried to indoctrinate my kids in the same manner: Namely, don't squander the paycheck at the end of the week on instant gratification but put something away for the proverbial rainy day.

I remember when my son was a teenager and he got his first check, and I am counseling him thus, and he said, "That is nuts, daddy." I said, "What do you mean, that is nuts, George?" He said, "If I blow it at the end of the week on instant gratification, they only get at it once." I reflected on that, and then came to the realization that if he invested, say, in Motorola or Mobil when they make a profit, it gets hit a second time, dividend distribution it gets hit a third time, sell your stock, enjoy a capital gain a fourth time, and the ultimate obscenity in the Code is when you have the audacity to die and leave them, they come in and bash your bereaved spouse and loved ones.

Our Tax Code does profound violence to all the values we believe in in this system. And for that reason I am grateful for these hearings. I have promoted a flat tax bill for 25 years and I called it a tithe tax. It was only a 10 percent hit and admittedly that wouldn't have covered revenue losses, but my argument was we are brought up to believe we had an obligation to tithe because the Bible taught us so and that if God asked for only 10 percent Caesar should ask for no more.

But I am willing to listen to the variety of options. And I salute especially our Chairman. I know his reservation about the flat tax concept is you have left the roots in the ground and some future Congress might come back and try to recreate the complexities of our current Code.

So I will happily listen to the input on other proposals such as Sam's proposal for a value-added tax. All of this is, to me, designed to address pulling the IRS out by the roots and the whole crowd cheers as the Chairman was saying.

People have had it up to here with this stupid Tax Code we have. Simplification is part of it. I agree equity is a part of it. But I would argue on the flat tax, if you were only taxing above the poverty line and the poverty line was $10,000, you make $20,000, and under my tithe tax you pay 10 percent, you would owe $1,000. If you made $100,000, you pay $9,000. You are not buying anything more from government by making $100,000 than making $20,000. So there is a distinction made based upon your income level. But on the question of pulling the roots out, I am intrigued by our Chairman's line of argumentation there.

One final question I would like to raise, and I have heard Milton Friedman say it many times, is it not accurate that only individuals pay all of our taxes? Businesses, in my flat tax bill, are not taxed because they don't pay taxes. That is a cost of doing business. You've got to figure out how to pass that load through and get a fair return on investment or you are out of business. That being the case, people need to open their eyes up to the fact that you are either paying for it with your tax hat on or paying for it with your consumer hat on. People also need to focus on the total magnitude of the burden and that is the burden of the waste involved in all the paperwork and all the man-hours invested by a business to be in compliance.

Is there anyone that would find fault with that argument, especially Mr. Dakin?

Mr. DAKIN. Mr. Crane, I think my purpose this morning was to provide the Committee with facts and figures and statistics to con-

vey what the magnitude of the corporate tax compliance burden is on filing returns and conducting audits, particularly for those companies that conduct business overseas. I think I will have to limit my answers to questions along those lines, sir.

Mr. CRANE. Well, let me add one further question. I have heard that two-thirds of the revenues paid by business, two-thirds of that amount above and beyond what is paid in taxes, is the cost of being in compliance with our Code.

Mr. DAKIN. The figures that were in my testimony today were the actual costs of filing our returns and conducting our audits on an annual basis. And I was really focusing on the system by which we collect the revenue and not talking about the—of course, the taxes we pay are much greater than that.

Mr. CRANE. Well, my time has expired, but again, I thank you all for participating today.

And, Mr. Williams, did you have a comment?

Mr. WILLIAMS. Yes, I would like to respond to that. I think that is a competitive issue, even from an international standpoint, that just OBRA 1993, the retroactive tax portion, cost our company an additional $300,000 during that year. That is something that we had not planned for. That was—with the new tax based on—at the individual income level, because we are a sub S corporation—was about a $112,000 increase anyway; but being retroactive, that is nearly—that is a product line for us.

We will spend $200,000 to $300,000, typically, in development of passive product lines. And today, like in 1990, we did that with one particular product. We have about 90 jobs dedicated to that one product line today. So when you take the $300,000 just in the retroactive portion out of it, we had to push off research and development on some products, and it ended up affecting the jobs of 90 people.

Mr. CRANE. Well, what you are suggesting then is there is a potential for big job expansion and all of the people who are tax lawyers and CPAs can find more productive work. Thank you.

Chairman ARCHER. Very briefly, Mr. Dakin, just to be sure the Committee understands. Are the documents, the papers that you have in front of you there, 1 year's tax return for your company?

Mr. DAKIN. These four piles are our tax return.

Chairman ARCHER. Is it possible, without falling, for you to stack them all on top of one another?

Let me be precise in my question: That is the return, that is none of the workpapers and everything else that went into developing the return. That is simply the tax return itself. Is that correct?

Mr. DAKIN. Yes, sir. It is 76 pounds of return. It is nine volumes, each of which is about 5 inches thick. And this is simply the return per se for 1 year. Obviously, we may—it does not include anything else. This is simply the return, strictly defined.

Chairman ARCHER. Well, once, when we were in tax reform hearings back in 1986, our colleague, Andy Jacobs, when they began to talk about all the workpapers that had to be filled out before you could get to filling out your return, commented that by the time you get to the point of filling out your return, it is "Miller time." And I just wonder, the workpapers and everything behind getting

to this point of having this return must be far more voluminous than the return itself.

Mr. DAKIN. Indeed they are. Let me just stop this constant balancing act which I always——

Chairman ARCHER. Yes, sir, I don't want to jeopardize your physical well-being there.

Mr. DAKIN. Mr. Chairman, these are the workpapers for one company, for 1 year. The company is Mobil North Sea, Ltd., which produces crude oil in the UK sector of the North Sea. This is one company for 1 year. We have about 745 companies for which we have to prepare returns. The return—the workpapers are very voluminous.

Chairman ARCHER. Thank you for physically demonstrating the cost of compliance with the current Income Tax Code.

Mr. Gibbons will inquire.

Mr. GIBBONS. Mr. Chairman, I don't have any questions of this panel. I thank them for coming and for the information they have imparted.

Chairman ARCHER. Mrs. Johnson will inquire.

Mrs. JOHNSON OF CONNECTICUT. I appreciate your testimony; it has been very, very vivid and very helpful, and certainly we are keenly aware of the need for simplification. But as we move in this direction—and you don't have to answer this now, but if you will get back to us—what will be the impact of eliminating, for instance, research and development tax credits; and should we really try to wipe out everything, such as the deductibility for health insurance premiums?

Where do we draw the line? What really does affect economic activity? Where is the line between an absolutely simple flat tax, what Mr. Dakin has showed us, and a Tax Code that fosters economic activity, personal security, and strong families? Anyone who wants to respond—Ms. Beard.

Ms. BEARD. We get into all these schedules like when you develop or purchase a capital item, or something, you get these credits, then you have to depreciate your expenses over the income period. If you could take those expenses as the money leaves, because you no longer have the cash, and do it as cash, or on an as you go basis. Get rid of the schedules. I mean research, capital equipment, employee benefits are a cost of doing business—and should be treated as such.

When I buy a vehicle or when I make a capital improvement, the money is gone. We don't have that money, but yet we are paying income tax on that money and we are depreciating, taking it forward and getting benefits years later. Business is on a day-to-day, month-by-month basis, and I think we need to drop the complexity and allow our taxes to reflect that.

Mrs. JOHNSON OF CONNECTICUT. Thank you.

Mr. Williams.

Mr. WILLIAMS. I think in—if the whole Tax Code is completely revitalized and just, as Chairman Archer has brought up, torn out by the roots, I think there are issues that we could deal with, even on research and development tax credits and health insurance credits.

I know it is basically—I think everybody in the United States is so fed up with the system right now that we are willing to look at anything. Our—it is interesting the impact, even at a personal level, because I have got like one of my sisters, she made—she is not with the company right now. She made about $15,000 a year, and just the income from the company that got put on her tax return prevented any charitable deductions for her, prevented any of the normal expenses that somebody else would get at $15,000, because of the income of the company. And she never saw that.

You know, no one sees that. That is the way—so there are so many things that are still impacting us besides this Federal Code, in that we still deal with the State regulation, the State taxes.

In Washington State we have a business and occupation tax which is just crazy. I think that we are willing to look at about anything at this point, and offer any suggestions, too.

Mrs. JOHNSON OF CONNECTICUT. Thank you. We will look forward to your input.

Mr. CRANE [presiding]. Mr. Bunning.

Mr. BUNNING. Thank you, Mr. Chairman.

This is a question for anyone on the panel who wishes to answer. If we just took the Tax Code, both the corporate and the individual Tax Code, and started from scratch—and that is what I think that the Chairman has in mind—what would be the first thing that you would suggest?

Ms. BEARD. To keep it simple.

Mr. BUNNING. Right. Well, flat tax does that very well, but whether it is fair or not is a question for individuals. I am not sure how we handle the corporation end of it.

Ms. BEARD. There has not been a whole lot of detailed information on the flat tax. When I was at the airport, I started picking up magazines and getting more information on the way here. There is a lot more information coming out this week, regarding both national sales and flat tax proposals. But I think that as I look at the national sales tax, we have a State sales tax in Illinois on retail. It is not all that simple. You have all these different groups that are tax exempt. So as I do business, if I put in a fence for a school district, church, State or city government, they are tax exempt. When I buy a product, I don't say, oh, this is going for a tax-exempt job or this isn't. I usually order all materials into stock with tax paid at source, because we are in construction.

Mr. BUNNING. That includes your local and State taxes also?

Ms. BEARD. Yes.

Mr. BUNNING. So there would have to be some kind of coordination?

Ms. BEARD. But then trying to get the deduction back or get the credits back once it is paid. It would have to be simple and timely. For example: On a $20,000 project, a 17 percent sales tax would be $3,400 that I would lose use of and for small business this could create big problems.

Mr. BUNNING. It takes longer to get it back than to pay it.

Ms. BEARD. We don't get it back from them. I mean, it is a complex hassle.

Mr. BUNNING. Mr. Dakin, in the tax bill that we recently passed, we phased out the alternative minimum tax over a period of time.

How much would that phaseout of the AMT affect your corporation?

Mr. DAKIN. The AMT is one of the two major sources of complexity in the Code, the other being the foreign provisions of the Code. So that phasing out the AMT and eliminating the need to calculate each tax twice would be a major reduction in workload.

Let me ask—let me ask my prompter here if I can get a better estimate for you.

Mr. BUNNING. Certainly.

Mr. DAKIN. It should cut our workload by about 30 percent.

Mr. BUNNING. Thirty percent?

Ms. Skidmore, in the alternatives that we have been discussing back and forth, like flat tax, consumption tax, VAT tax and other things, is there one that would make life simpler for the accounting group and/or tax lawyers and/or anyone else that has to worry about compliance—correct compliance, anyway?

Ms. SKIDMORE. As all these alternatives are in the formative stage, we are analyzing details of each one. And certainly the peculiarities of these systems will be analyzed for our clients. At that point, we will be able to determine if one provision under one system versus another will have a dramatic impact on complexity and what the economic impact would be on certain of our clients' industries.

Mr. BUNNING. Let me ask the whole panel, what percentage of your employees pay more in FICA tax than they do in Federal income tax?

Ms. BEARD. All of them, including my husband and myself.

Mr. BUNNING. What about you, Mr. Williams?

Mr. WILLIAMS. I would say it is a significant amount in our case. The same, I don't have the exact figures on that, but that would be an interesting——

Mr. BUNNING. The reason I ask that is that when we get into looking at the overall tax burden of an individual across this country, we find that more people pay more money in FICA tax than they do in income tax. And I just wondered how it was with the businesses that you are involved with.

Mr. DAKIN. If you are referring to the employee share of FICA, we would estimate that few of our employees would pay more FICA than——

Mr. BUNNING. I am looking at both ends, the employee and the employer, since you match.

Mr. WILLIAMS. That is right.

Mr. DAKIN. If you combine the two, the number would be even smaller. Not many.

Mr. BUNNING. Ms. Skidmore, since you do the taxes, how do you find that? Are more of your clients paying more in Federal income tax than they do in FICA?

Ms. SKIDMORE. I don't have any of those statistics available, unfortunately.

Mr. BUNNING. I thank the panel for their input.

Mr. CRANE. Thank you.

Mr. Rangel.

Mr. RANGEL. Thank you, Mr. Chairman. I assume that if we were able to pull this system out by the roots, we would have to get back to some type of system.

I will assume that all of you would support a system that will remove the investments that you are making in the business and the salaries you pay for employees and that that should be allowed to be deducted as relates to the income. There are no objections to that, all right?

And further, if indeed we are trying to discourage consumption and encourage savings and investment in plant and equipment, that if we manipulate the Code so that it would cost you less in taxes to do it, no one would object to that, since the whole idea is investment. My question then would be to Mr. Dakin and anyone else, if you take advantage of all of the things that we would try to do in order to encourage investment, at some point you would have no tax liability, it is possible, under many of the scenarios we have today; and that is the reason why we say that, well, there should be at least a minimum tax, because if a business takes advantage of all the incentives, you know, it could be the government owes them money.

Would you consider having an alternative minimum tax under those scenarios?

Mr. DAKIN. I would suggest, sir, with respect, that it might—it might be better to try to get it right the first time in the regular tax so that you don't need a minimum tax. If you——

Mr. RANGEL. But what I am saying is, one way to do that is not to give the deductions for certain of the expenses or investments that we do now. Would you suggest that we look at that and perhaps avoid a particular taxpayer from having no liability at all?

Mr. DAKIN. I think you have to take a look at the totality of the special provisions which Congress has written into the Code over the years.

Mr. RANGEL. Forget that, because we are pulling that up by the roots. So it won't be there.

Let me just ask this question: When we pull the darned thing up, what sounds closer to you as being the most fair way to go, recognizing that any system is going to have its problems, but if the options were flat tax, sales tax, consumption tax, value-added tax? And since I know that you have given some thought to the replacement, could each of you just say what comes the closest, assuming we still would have to make adjustment as to what the replacement would be for the existing system?

Ms. Beard.

Ms. BEARD. I think—a flat tax is what I see, and part of my reason for that is, if you keep it simple enough, those that are not high-wage earners, your middle-income, family households and such would not have the ability to reduce taxes through savings. They don't have the money that they can save at such a high percentage.

People who make the most would have the ability to save the most, therefore reducing their tax burden the most.

Mr. RANGEL. With this flat tax, would it take into consideration the number of employees, wage earners in a family? Or the size of the family, would you want that to be considered?

Ms. BEARD. You would take the family income and then allow exemption, you know, for head of household, single, married and so forth, and dependents.

Mr. RANGEL. You would have exemptions. Would you have deductions?

Ms. BEARD. There would be the deduction for so many people, and then what remained in excess would be taxed at a flat rate.

Mr. RANGEL. How about when you get a new home, first home, young and just getting married, do you think the interest for that home should be deducted?

Ms. BEARD. Well, what you pay for rent is not deducted at all. When you buy a home, you have something in the end to—where you won't be paying rent forever. I mean, there is a decision that is made——

Mr. RANGEL. No, I just asked—so the answer is no?

Ms. BEARD. Personally, I am not opposed to doing away with the mortgage. I know a lot of people would be. There would be a dramatic impact on the housing, real estate, and banking industry if abolished.

Mr. RANGEL. How about the Social Security deduction, should we continue that?

Ms. BEARD. I think Social Security should go through a major transformation.

Mr. RANGEL. How about the health care for the aged that is deducted, should that be eliminated?

Ms. BEARD. I think health care deductions are for the benefit of all. With the crisis that it is, we need to encourage individual responsibility. If health care is not deducted, it is too often going to be paid for by someone else, including tax-financed programs.

Mr. RANGEL. And regardless of the income, you believe that even though wealthy people have more disposable income and spend a lesser percentage actually on things like food and clothing, that it should be just one rate fits all incomes?

Ms. BEARD. On consumption, in Illinois, sales tax has been viewed as a regressive tax, because an extremely low-income family would pay more for clothing and different essentials that they need, while not having any ability to save.

Mr. RANGEL. You would make adjustments based on——

Ms. BEARD. Well, if you start making adjustments, "in fairness," you are going to complicate the system to where, as a storeowner, it would become a bookkeeping, administrative nightmare. You say, this guy only makes so much money, therefore I can only charge him x amount of sales tax. Then the documentation in reporting could prove to be far worse than our current system.

Mr. RANGEL. Would you not want to make adjustments based on fairness?

Ms. BEARD. Well, then you get a paperwork nightmare for the small business owner and the shopowner that has got to say——

Mr. RANGEL. You want to avoid the nightmare and still be fair?

Ms. BEARD. Yes.

Mr. RANGEL. You would like to be fair?

Ms. BEARD. I think it ought to be fair.

Mr. RANGEL. Everyone believes the tax system should be fair? I mean, there is no objection to being fair and equitable?

Mr. WILLIAMS. Mr. Rangel, I would like to comment, too.

I think, in place—in talking about the wealthy Americans, in a subchapter S corporation, because of that, I think it gets—it is a picture that is not true with the income tax on the corporation.

I think, in proposing something like the flat tax, I think we need to get to the point where the States collect the taxes, and we give this body here a proportionate share of the services that we are gaining from the Federal Government; and that we have to look at—the businesses and individuals need to be looked at separately, but they are both benefiting, the jobs. And I mean, we are looking at this with the advent of GATT, with the World Trade Organization, with lots of discussion going on.

We have to look at our corporate competitiveness. I even question why Mobil has 750 corporations and, in many cases, why all these companies have to be set up because of the Tax Code to do that.

Mr. RANGEL. What function do you believe the Federal Government should actually——

Chairman ARCHER. The gentleman's time is about to expire.

Mr. RANGEL. Son of a gun. I will get another chance, I think.

Thank you, Mr. Williams. I thought you were thinking the same way I was.

Chairman ARCHER. Mr. Hancock will inquire.

Mr. HANCOCK. Thank you, Mr. Chairman.

Mr. Dakin, you are aware of the fact that you are not under oath in this hearing. If you were under oath, would you be willing to swear that that tax return is absolutely 100 percent in compliance with all the tax laws?

Mr. DAKIN. I am delighted that you asked that question, because the person who signed that return is sitting right behind me, Mr. Book, of our Dallas accounting office. And I am—I am happy to say that it is Mr. Book who signs the return, rather than me.

We do the very best we can. We comply to the limits of our ability. Is there a number wrong in these 6,300 pages? No doubt there is.

Mr. HANCOCK. You think maybe the depreciation schedule might be off just a little bit, you missed a month or two someplace?

Mr. DAKIN. But we do take the obligation to comply very, very seriously, and Mr. Book particularly, because he is the one who signs it under oath.

Mr. HANCOCK. Ms. Skidmore, do you think it is even possible to fill out or to complete an income tax return that is, you know, just a little small one like 85 or 90 pages; do you think it is possible to complete that and absolutely say, this is 100 percent in compliance with the law?

Ms. SKIDMORE. At this point, the complexity of interpretations of the law are such that one person's idea of what one interpretation is versus another is not clear.

Mr. HANCOCK. Well, has anybody on the panel ever just gotten a notice from Internal Revenue saying the penalty for noncompliance, $4,500 or what have you, you don't have the vaguest idea what they are talking about?

Ms. BEARD. My accountant, when he gave me those figures from his survey, one problem that he has run across is a lot of times when they send out those penalties or those notices, they are incor-

rect. But when you send back your reply, it is difficult to get a timely response. Currently, what has been happening, is they have really sped up collection. Instead of five notices before they start nailing you, they have dropped to three. And you cannot get a response back from the IRS in that timeframe.

Mr. HANCOCK. I have a background in small business. I have been in Congress a little over 6 years. And frankly, Mr. Chairman, I have been looking at this thing since I got into business. I never dreamed in my lifetime there would ever be a hearing like this in the Ways and Means Committee in the U.S. Congress; and I think—I hope the public realizes the historical impact of what is happening here.

A few years ago, 15, about 25 years ago, I started a small leasing company. You are in the telephone business, and anybody that is in business understands that when you are leasing, it is capital intensive. Normally it takes 5 years before you get your volume up to where you could even possibly have profits.

I wonder how many tax returns are completed, thousands of dollars spent, to prove to the government you don't owe them any money.

I tried to make a deal with Internal Revenue. I said, look, you know, rather than me filling out all these reports, it costs me $20,000 a year to tell you I don't owe you any money. Why don't we split it, you take $10,000 and I will take $10,000; everybody is happy. They wouldn't do that. So for 5 years, I spent $20,000 a year to tell them I don't owe them any money.

How many thousands of dollars are spent each year with our Tax Code in that area? Would anybody want to just—Mr. Williams, I am sure when you all got started, for several years that is what you did.

Mr. WILLIAMS. We were actually pretty fortunate that we were profitable within the fifth month of business. And since 1982 and in our marketplace, we have owed—we have—we have owed taxes. But I think the—you know, there are two things that we have that are in life and that is life and death, and we are taxed to death while we are here and then we are going to be taxed half again when we die; and the—that is the issue right now.

We are talking about substantial costs. And I think I measured over $6 million if my parents were to die today, that I would have to go back and if we did not have any estate planning going on right now, we would have to write a check and we could not afford to do that. I don't know many businesses out there that, as their value continues to increase, they could afford to do that.

Mr. HANCOCK. One final question: You talk about the millionaires and the fact that you are saying, yes, we have been successful, we worked hard, but we look at it as 600 employees. How many times—and I am just guessing here—on April 15 have you paid taxes on the previous year's profits without having taken from the business enough cash money to even pay the taxes on it?

Mr. WILLIAMS. Oh, I think that in the last 4 years that has been the case. In fact, this last year we got hit pretty hard.

And I might add, in talking about from a millionaire status, based on the value of this company, we have got a 401(k) contribution that gives 54 percent return to every dollar that the employees

put in. We pay quarterly profit-sharing bonuses to the employees. We changed the 401(k) contribution, instead of taking people at 21, we put it to 18, so we can encourage savings.

We have got over an 80 percent contribution right now in these employees investing for the future. We have got excellent medical benefits. They take—they understand this; they see it. And when you take and look and have to pay nearly $1 million, like we did this last April 15, in income tax and have to borrow to do it—I mean, we operate off—all the profits in the company are rolled back into the company, and we operate off a line of credit like most businesses do. And when you have to borrow to pay the income tax, I mean it significantly hits your company, because there is nothing that is benefiting out of that.

Especially, I might add, we are not publicly held. And when you operate that way, you take that money right out of a company that—that is their cash flow. You are operating off cash flows all the time. That is the future business and the growth.

This year we are projecting 35-percent growth, and we could be hindered because of not having the cash necessary to maintain a sustainable growth rate in the business.

And all these things, you know—the employees, they are benefiting; I would rather see them benefit, the employees benefit, have the money go back into their pockets than I would to have the substantial amount of cash being outflowed to the Federal Government at this point.

Chairman ARCHER. The gentleman's time has expired.

Mr. Johnson may inquire.

Mr. JOHNSON OF TEXAS. Thank you, Mr. Chairman.

I would be interested to know, Ms. Skidmore, why you favor this with the ultimate result of possibly downsizing your business. Can you tell me about it?

Mr. TYLER. Who are you talking to?

Ms. SKIDMORE. To me.

Mr. JOHNSON OF TEXAS. The young lady next to you, sir.

Ms. SKIDMORE. In our advisory capacity for our clients, we anticipate that we want our clients' businesses to grow and prosper. And with the level of undue complexity that we have today in this current system, it is very counterproductive for our clients. That is really why we propose that the Committee look at both consistent policymaking as well as simplicity in its deliberations.

Mr. JOHNSON OF TEXAS. Well, do you anticipate talk that accountants are going to go out of business? I don't think that is true at all. But can you talk to that question?

Ms. SKIDMORE. As each of the alternative systems is looked at, it depends on what details will be components of each system. And only then can we really ascertain just what level of compliance is going to be required at the basic level or beyond.

Mr. JOHNSON OF TEXAS. Even in a sales tax situation, you would still be required to help companies put their tax systems together, right?

Ms. SKIDMORE. Very likely, if there are any such details that require definitional interpretations or other interpretations.

Mr. JOHNSON OF TEXAS. Yes, OK. Thank you.

In the case of Mobil, I like the question that has been asked about how can you verify the authenticity of all that information. And, you know, from an individual standpoint, I know filing an income tax return is difficult at best. I mean, just from a personal standpoint, you have got a whole pile of papers, so you are relying on your employees. All those employees in that picture, I presume are full-time employees, year-round?

Mr. DAKIN. All of the employees in the picture are full-time employees, but not all of our full-time employees are in that picture. That is just all the folks that were in the shop on the date that the picture was taken.

Mr. JOHNSON OF TEXAS. So they are not all there?

Mr. DAKIN. No, sir. And it does not include those people who are not located in Dallas. We have people in Fairfax and we have people all around the world that contribute to this.

Mr. JOHNSON OF TEXAS. I kind of like Dallas. Why don't you move them all down there? You don't want to answer that, do you?

Listen, I appreciate your input, because I think you have given us a vivid demonstration of what is wrong with the system. And I hope that you all can help us put it together. And I thank the Chairman for doing these hearings and for your approach to the process. Thank you, sir.

Chairman ARCHER. Mr. Levin will inquire.

Mr. LEVIN. Thank you, Mr. Chairman. I am glad we are holding these hearings. I very much believe we have to look at our present Code to strive to do better and, if possible, much better. I think one of the goals should be simplification. I hope we don't get too simplistic as we seek simplification.

So, Mr. Dakin, let me ask you a few questions. This is a panel that mixes small and perhaps medium and big business; and I guess you represent big business here. Do you file returns in other countries?

Mr. DAKIN. Yes, sir, we file tax returns in more than 100 countries outside the United States.

Mr. LEVIN. Is there any other country where the system is a bit complex?

Mr. DAKIN. There are some countries that have systems that are a bit complex, but the majority—there are no countries that have systems anywhere near like ours.

Mr. LEVIN. So you think, for you, ours is the most complex?

Mr. DAKIN. Very much so.

Mr. LEVIN. You mentioned the cost of $10 million. I think this is public, not proprietary information. If it is proprietary, don't indicate it.

How much did you pay in income taxes last year to the U.S. Government?

Mr. DAKIN. I have the information on how much we paid in taxes for a series of years, back at my office, and I would be happy to send it to you.

Mr. LEVIN. Give me an estimate.

Mr. DAKIN. It comes to hundreds of millions of dollars a year.

Mr. LEVIN. And the cost you say here was $10 million?

Mr. DAKIN. Yes, sir.

Mr. LEVIN. Is it possible your tax liabilities were over $1 billion last year?

Mr. DAKIN. I do not have with me the exact figures on what our tax liabilities were, Mr. Levin, but I will be happy to send that to you this afternoon.

Mr. LEVIN. How about the gentleman, Mr. Book, do you have any idea what you paid in taxes? I am just trying to get some idea of what percentage of your taxes is represented by the $10 million.

Mr. DAKIN. If you would give me a moment, I will see if I can look it up for you.

Mr. LEVIN. While you are doing that, let me ask Mrs., or Ms. Skidmore, you mentioned the principles, two principles, consistent policy choices, and simplicity. How about equity?

Ms. SKIDMORE. Equity is a principle that I hope this Committee will ponder as it makes the choices and as it looks at both simplicity and consistent policymaking.

Mr. LEVIN. Well, would you raise that to the level of clear, consistent choices, and simplicity?

Ms. SKIDMORE. Without looking at each alternative system and understanding the details, it is difficult to——

Mr. LEVIN. No, no, but should the—should the system be equitable? Do your clients care about——

Ms. SKIDMORE. We are going to be studying for our clients, on our clients' behalf, what each of our clients ask us to look at in each system with regard to what they perceive as being fair, based on each detail of the systems. But at this point——

Mr. LEVIN. I am not asking you which system is more fair than another. I am asking you, don't the American people want a system that is fair as well as consistent and simple?

Ms. SKIDMORE. I hope that is a decision that this Committee will make with care—you will make the decision as to what is equitable or not.

Mr. LEVIN. You think that is an issue, whether it should be equitable?

Ms. SKIDMORE. I think that what is equitable is a decision for the Committee.

Mr. LEVIN. But should it be a guiding principle?

Ms. SKIDMORE. That is a decision for the Committee, Mr. Levin. Thank you.

Mr. LEVIN. All right.

Let me go back to Mobil, if I—my time is running out. Do you know?

Mr. DAKIN. The total income taxes that we paid, according to our annual report for 1994, were somewhat in excess of $2 billion. That is worldwide taxes on worldwide income.

Mr. LEVIN. And it costs you $10 million-plus, I don't mean to minimize that; I just think we want some perspective here.

Let me finish by asking you, some of this complexity is the relationship of the taxes you pay here to your foreign operations, right?

Mr. DAKIN. Yes. The——

Mr. LEVIN. You want some deduction for what you pay in other countries, for example?

Mr. DAKIN. Yes. We do not wish to be taxed twice on the same item of income.

Mr. LEVIN. And so any system that we impose, new system, would have to have enough complexity so you don't pay twice, right?

Mr. DAKIN. It can be handled two ways. If you wish to have a system by which the United States taxes all of the income of its residents, wherever that income is earned, then you must have a foreign tax credit system so that if the country in which the income was earned, where the economic activity took place, exercises its prior claim to tax that income, you don't tax it a second time in the United States.

Other countries have gone to a territorial-based system where they have elected to tax only the income which is derived from the economic activities carried on within their borders.

Mr. LEVIN. And to just finish, do you think your company should pay any tax, any income taxes to the U.S. Government?

Mr. DAKIN. Do I think we should pay any——

Mr. LEVIN. Do you favor a system under which you would pay any income taxes or should the shift be entirely away from any taxation to the corporation?

Mr. DAKIN. We do not have an official company position on the alternatives that have been put forward. Our focus this morning is really on compliance rather than on the alternative systems. But to the extent that we earn income in the United States, we are perfectly happy to pay tax on it. The problem is that figuring out how much tax we pay is more expensive than it ought to be.

Mr. LEVIN. OK.

Chairman ARCHER. The gentleman's time has expired.

Ms. Dunn.

Ms. DUNN. Thank you very much, Mr. Chairman. And I too want to thank and congratulate the Chairman of our Ways and Means Committee for giving us the opportunity to hold these hearings, and I thank all of you for coming back for them. We are going to spend the next 3 days trying to figure out the pluses and minuses of all the different tax systems, and there is nobody better in this room today to help us understand these pluses and minuses than you, members of the panel.

In the last 2 months, I have held about 13 townhall meetings in my district in Washington State, and there has been consistent support for the simplicity and the clarity of a flat tax system. There are points that have come up on behalf of all the systems that we are looking at in these—beginning with these hearings, during the next 3 days, but there are some important negatives to each of the systems that I think we have the responsibility of investigating.

For example, when you come to a consumption-based tax, senior citizens have gone through their income-producing years and they have paid income taxes and they planned ahead for their future incomes and they are living on a set income; and that would be seriously invaded by a consumption-based tax. But I am very, very interested in learning the pluses of that system but naturally would like to investigate it from all points of view.

I have heard your testimony that the flat tax—that any kind of tax system that replaces the income tax system should be simple and should be fair, and my constituents would agree with you. You have brought up an additional factor that is very important to our

considerations, and that is the compliance costs as you try to comply with the requirements of the IRS and this strange and convoluted tax system that we have right now.

I wonder if those of you who are representatives of companies have had your companies examine the costs of the various systems we will be considering and looking at—the value-added tax, the national sales tax, the consumption tax and the flat tax—and you have calculated how your costs would be affected by our replacing the current income tax system with any of those other alternatives.

Mr. Williams, since you are from my State, maybe you could talk to me first about this.

Mr. WILLIAMS. This was measurement on the three different types of taxes and what the costs would be? It is interesting, because hearing different comments from each of the representatives, we haven't done that evaluation, but it seems like—that no matter what, there are still the comments leading back toward, well, do we leave this in or take this out. And so it would be really difficult, without seeing true proposals for each of the three, to do the measurement on what our compliance costs would be. That is why we are interested in almost seeing something come out if there is a true proposal on what the consumption tax would be and seeing all those, to measure those up.

Because I have heard comments, well, should businesses be exempt from any income tax at all or should they not be, and so which one of these, is this from a flat tax, I didn't have to ask the question, are businesses going to be charged with one flat tax and people going to be charged with another flat tax, or everybody charged with the same, and we haven't had a chance to measure those.

Ms. BEARD. I did find the question earlier, it relates to yours, there is an excellent article that is in the new Fortune magazine that I picked up at the airport, and an economist, James Payne of Standpoint, Idaho, estimates total costs for the Nation to prepare our Nation's tax bill that we send as we write our checks and pay our taxes, an astonishing $593 billion a year. That is a lot.

But I have to agree that we do need to see what exactly is in the proposals. I do think if we could do something like a flat tax on a cash basis for a business and get rid of a lot of these schedules and the complications that go into it. This would also help spur the economy and would also create additional jobs.

Ms. DUNN. Mr. Tyler.

Mr. TYLER. Yes.

Ms. DUNN. Do you have any—has your company taken a look at which of the alternative tax systems would be less expensive for you as far as compliance goes?

Mr. TYLER. Well, you know, when you are in small business, it is a little different than being—with our friend here, these other, there is an angle to everything. Now, in my case, I don't care what you do; I am going to figure how to make some money.

However, it is obvious if I didn't have to spend so much money on other things dealing with the government—to my accountant and lawyers—not only my lawyer for taxes, but if I get in trouble with the National Labor Relations Board or any of these other peo-

ple, it is costing money. That money does not go to my employees, it doesn't go into my pension fund.

I have a pension fund I give 3 percent a year to. I pay full hospitalization for one person. Now, I also have profit sharing. One year I had a very successful year; I put 14 percent into the profit sharing and 3 percent into the pension, which are both—are fed into the same thing.

Now, I could—these people would have a lot more money for retirement if I didn't have to spend all this money on compliance.

I don't really spend that much money for taxes. This year, I spent $20,000 Federal and $4,000 District franchise tax. So it isn't a big deal with me, except that all this money I am spending in compliance on these things would go to the employees. If you are smart, take care of your employees.

One thing I think this Committee should think about has nothing to do with actual taxes, which I don't like to bring up. There is a tremendous—there is a tremendous backlash at the government today. Now, one reason for this is fear. Fear. Every time I have a thing go across my desk, it says Bureau of Internal Revenue—I have no trouble with the Bureau of Internal Revenue—a fear sets in. I have got to open that envelope right away.

If I have any envelope that comes from OSHA, whatever you call it, the fear sets in there. If it is anything that comes from the Department of Labor, fear sets in there. And a lot of it is because it is so complicated.

I have had two cut fingers in my—in 35 years, and I still was fined by OSHA this year when they came in, which—it is another compliance, it is cost. So I think this Congress should start thinking a little bit about the Internal Revenue striking fear into the hearts of people.

The first thing that happens when you are afraid, if you have ever been in combat, your first thing is fear, you are frightened. The second thing is embarrassment. The third thing is resentment, and there is a lot of resentment in this country toward this government. So that is another tax factor.

Chairman ARCHER. The gentlelady's time has expired.

Mr. Thomas.

Mr. THOMAS. Thank you very much, Mr. Chairman. I have been visiting for the last few minutes with some friends to this country, and if I might I would like to ask the visitors from Russia and the Ukraine and the other republics to stand up briefly, please, in the back of the room. We have a dozen young leaders from the former Soviet Union.

In listening to Mr. Tyler in terms of fear of government, what I have been learning over the last few minutes is basically what not to do to make sure that we avoid the mistakes of others. Mr. Chairman, I am just absolutely pleased that these hearings are underway. I thought over the years as we talked about our desire to examine the tax structure, that it would probably take a change in the Majority in the House of Representatives to actually have this occur. And guess what? It did.

Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Cardin.

Mr. CARDIN. Thank you, Mr. Chairman. I also want to offer my thanks for your leadership in holding these hearings. I come to these hearings committed to looking at significant radical change in our tax structure, because our tax structure is too complicated. My constituents don't understand it, and they feel that people in similar economic positions are treated differently and they don't like it. The system adds to a lack of confidence in our tax structure.

I applaud your leadership on broad-based consumption taxes. I think that is a better way to go than our income tax base. I think we can take care of some of the regressivity problems associated with consumption taxes through tax credits which are not very complicated or difficult to enforce. I think these hearings are extremely important because we must understand the impact of changing from our current tax structure.

I think Mrs. Johnson's point as to what impact it will have on business decisions related to either health insurance or pension benefits are important questions on which we need to get expert information before we act. I must tell you I am also concerned as to what impact the change will have on our State and local governments, and we need to take a look at the impact of tax changes in that regard.

With the panel before us, though, I would like to concentrate on the small business decisions. I have heard from many small businesses in my district about the concern that so much of the small business entrepreneur's time is spent in dealing with government that it drains their ability to deal with their business. But I must tell you, I have heard about that in many contexts, whether it be in tax compliance or dealing with environmental regulations or dealing with Workman's Comp. issues or dealing with tort liability concerns. It seems to me that the leaders of small business spend an exorbitant amount of time in dealing with these issues. So I would like to at least get some sense from our panelists on the relative importance of the tax issues to the other concerns that you must deal with as small business individuals.

Understanding Mr. Gibbons' caution, we are not talking about the level of taxes, how much taxes we are going to collect, but the compliance costs, how much time you must spend in dealing with our tax structure, how the current tax structure lines up in relationship to some of the other concerns that small businesses have about simplifying the way in which government interferes with your lives. Perhaps—I have 1 minute left on my time, but perhaps the panelists who represent small businesses could give me some help in that regard.

Ms. BEARD. Earlier, I provided you with actual numbers from the survey completed by an accountant in Springfield, Ill.

Mr. CARDIN. I heard your percentages, but I am concerned that that may be coupled with——

Ms. BEARD. But that is actual——

Mr. CARDIN. Yes, that may be coupled with the tax burden. People don't like to pay taxes.

Ms. BEARD. No, that was primarily, where do you need help; as far as when they pick, they had different services and different areas of concern for small business, which included increasing

sales, payroll, inventory, cash flow, bank loans, capital, various things to choose from.

Mr. CARDIN. Mr. Tyler, could you help me in this issue as far as small business concerns?

Mr. TYLER. Well, all I can say is this. I think you have got too many people running around this Congress with a doctor's degree from Harvard's Economic—School of Business.

If I agree to pay my employees, I agree with the government to pay my employees 3 percent a year taxes on their—I mean, retirement on their salaries, I also have a vent there for extra profits of a profit sharing where I can pay—1 year I paid 14 percent, as I have told you, on the profit sharing, which builds up a nice little tax-deferred thing.

I don't see why everything has got to be so complicated. I have a degree from George Washington University. I have night schools of another year and a half credits. And I have to take a thing this thick from my bank to pay 3 percent a year on the retirement?

Let's get with it. What in the world is all this about? I mean, what are they trying to—am I trying to prove that I am honest? I mean, what is this all about? I mean——

Mr. CARDIN. How much of your time is spent on this?

Mr. TYLER. It used to be more than it is now. I will tell you why. I used to do the pension plan myself and pay an actuarial lawyer $1,000 a year to figure it out. All right. So I took the time. I used to pay my taxes; this is 30 years ago, I used to pay my own taxes, and this took a little time. But now, I don't do this anymore. I paid the bank $26,000 last year to take care of the pension fund, because I wouldn't dare do it.

I pay another accountant $9,000 a year to advise me and do my taxes. I pay a lawyer, another lawyer, if I need anything else. A couple years ago I paid $40,000 to a labor lawyer to get me out of a mess which I shouldn't have been in in the first place. I fired a man and—very justifiable, and people even testified. I tell you, the cost of all those complications you have got going on around here——

Mr. BUNNING [presiding]. The gentleman's time has expired.

Mr. English will inquire.

Mr. ENGLISH. Thank you, Mr. Chairman. And I appreciate all of the panelists participating today in the opening of what I think is going to be a series of historical hearings on our tax system, which will ultimately lead the way for Congress to fundamentally overhaul our Federal tax system.

I wanted to particularly discuss with this panel some of the problems of excess burden, that is, the extent to which the tax system distorts decisions in a way that may lead to an unproductive allocation of resources. I wonder if each of you would, from your own experience, offer some examples of how the current tax system, beyond what you already have, in your testimony—of how the current tax system distorts decisions, allocates resources into lower priority areas and leads to an inefficiency in your productive enterprise—starting with Mr. Williams.

Mr. WILLIAMS. I would say that probably for the owners and our board, which consists of my parents and I and our vice president/general manager, we probably spend 20 percent of our time dealing

with the issues that are related to—25 percent of the time related to the "future planning for the estate" issue. It has caused us in the last 8 years to start a couple of corporations, make sure that the value inside those corporations are selling a lot of the products, merge the corporations in so that we can plan for the future, to work in all different areas, figuring out how much money we are going to have to spend this year and what the income tax burden is going to be. We have to plan for that ahead of time, you know, and almost be paying quarterly amounts that are going to be for next year's liability.

And so it takes up quite a bit of our time, while the rest of the employees are hopefully running the business the way that you want to, and in our case they are. But it is significant.

Mr. ENGLISH. Ms. Beard.

Ms. BEARD. Well, I know we have—and as I said, I am a real small business, with only six employees and two crews that go out and put up fence. I know at one point we had a 401(k) program, and actually what we discovered is it was costing us more to keep it in place than what any of the workers were willing to put into it. With a tax system as complicated as ours, it makes compliance even more costly and burdensome. Even with the "tax incentives" available—the administrative compliance is more of a disincentive. I hate dealing with them.

Mr. ENGLISH. Mr. Tyler, have you had this experience in your company?

Mr. TYLER. Well, let's get back to the time I have been in business. I have been in this business 35 years. Prior to that, I worked for—I was a secretary to one of the heads of Anaconda Wire & Cable Co. I got a lot of information from them. And prior to that, I worked for a Senator as a secretary. So I got around a lot of big people. So I got—I am going to repeat, there is an angle to everything.

Now, when you pay pensions for people, you have got an angle; there, you are trying to help those people become better workers. When you pay bonuses, you are trying to help them be happier and make more money and so forth. When you pay overtime, quite often this is the case there, too.

Now, one thing that should interest you is—a very simple thing, is the—I just purchased—now, let's see, this year I purchased a $55,000 press. I am in the small press business. I put $30,000 in the typesetting. I put—I bought another inserter for $35,000.

Now, I have to pay taxes on all this cash, and then I write it off in 7 years. Well, now that meant that I had to pay taxes of $20,000 corporation tax, and $4,000. If I could just take this cash that I have made and just pay for this stuff and then not have to worry about all these taxes, it would be a lot better, I would buy more equipment, or a lot of people would.

Mr. ENGLISH. Thank you, Mr. Tyler.

Mr. Dakin, with regard to the alternative minimum tax which I know has an enormous impact on many capital-intensive companies like yours, what is the cost of having to maintain an extra set of books and what impact has the AMT had in general terms on your investment decisions?

I know it is always touchy to ask any enterprise how, specifically, they make investment decisions, but in broad terms can you enlighten us on how AMT and other provisions in the Tax Code have distorted your behavior and pushed you into less productive activities?

Mr. DAKIN. To answer your first question, the AMT is about 30 percent of our compliance burden, so without the AMT, we would cut the cost of preparing our return by about $3 million per year.

To answer your second question, our management has no difficulty in making it clear to the tax department that the tax tail will not wag the business dog, so our management makes its investment decisions based upon their view of the long-term strategic goals of the company; and if it winds up that by making that investment, we owe minimum tax, then paying minimum tax is just one of the costs we bear in making that investment. It is a cash flow deterrent, but I could not honestly say that our management has been deterred from making an important investment for the long-time viability of the company for tax considerations.

Mr. BUNNING. Thank you, Mr. English.

Mr. Ensign.

Mr. ENSIGN. Thank you, Mr. Chairman. I come to these hearings excited because, as a small business person that had never been involved with politics—I am a veterinarian and own my own animal hospital; as you go through different processes and you learn, as a small business person, you are trying to run your business, you are trying to be a success, you are trying to see what the customer wants, especially when you are brandnew in business.

All of a sudden you get a notice from the IRS, you think, oh, no, have I done something wrong? A lot of times you have done something wrong and you had no idea there was a law that even concerned that.

Now you have to pay a penalty, pay the fine because you had so many employees, now you have to report more often; and the complexities—I can relate to what you are saying because I experienced all of those complexities, not only to do with IRS, but OSHA.

My family has a closely held corporation that they recently sold to a public company that had a lot to do with the estate laws, because it was not liquid; and the chances, we felt, of holding on to that were very little without the market to be able to sell in. When you are in a public market you are in a liquid market and can do that to handle the tax burden.

I think we are pointing out a lot of problems at all levels. Whether you are talking about the size of a company like Mobil or six employees, we are talking about an incredibly burdensome tax system that hurts productivity.

In my own company, if we are looking at buying maybe a piece of equipment that would allow us to practice a higher quality medicine and, instead, we are looking at how much we have to pay the accountant each month and how much we have to pay to comply with these tax laws, that may be something we don't buy that year, or for 2 or 3 years, simply because of those costs involved.

We had a profit-sharing plan and we had the same kind of experience, where I stopped the profit-sharing plan. I was contributing 15 percent a year to employees, but the costs got to be so great for

administering it and the incentives were taken off because it is either pay the tax now or pay the tax later; it looked like taxes were going to go up over the years, and I decided to pay the tax now. So my experience has been virtually the same.

I want to champion this cause as far as doing away with the current tax system. Whether that is a national sales tax or a flat tax, to me either is better than the current system as long as we look at issues that deal with fairness.

On the issue of fairness, I have not heard anybody address dealing with flat tax, whether it is 10 or 20 percent or whatever it is. If the same percent isn't fair for all income levels, then what percent is? Should rich people pay 30 percent, 40 percent, 50 percent, 90 percent, 100 percent? How can you define "fairness" by putting a percentage that is different for different income levels? I have never heard that issue addressed from a "fairness" standpoint.

Ms. BEARD. There was an older version of a flat tax, although people just are hearing about it; within the last couple of years, there has been more and more talk about a flat tax. There was a flat tax back in 1982 that was talked about. What they did with that was, from the gross income they deducted an amount and then charged a flat tax on everything above that amount. So, yes, it was a flat tax as far as there was one consistent rate on income over a certain amount, beyond that deduction; but in effect what happened, those who have been on the lower edge of the wage scale were paying a reduced tax and it was still progressive, but not nearly to the degree as what we have seen today.

Mr. ENSIGN. OK.

Mr. WILLIAMS. I think that measurement, too—in talking about the percentages for the wealthy, I think it is significant to know that 60 percent, I read at one point, of the gross national product comes from small businesses and a dominant amount of those businesses are subchapter S corporations—I don't know what the exact percentage is. But when we talk about taxing the wealthy, when we look at the taxing of wealthy people, you mentioned yourself that you needed to go, public offering. We are looking at the value of the corporation. It is not liquid. I can't sell it. We are looking at keeping this business on, generation through generation, providing jobs, and it is significant.

So that element needs to be taken out and maybe we wouldn't have all these corporations to have to worry about if the tax system were completely overhauled. Because we are changing some of these avenues—why are you an S corporation, why are you a C corporation—and the effects that that has on each business that is out there.

Mr. BUNNING. The time of the gentleman has expired.

Mr. McDermott.

Mr. MCDERMOTT. I thank the Chairman for having these hearings. I don't think there is anybody on the dais who wants to pay taxes, so we share with our constituents a common feeling. It is nice to have a discussion about not paying any taxes.

Mr. Dakin, what are the total worldwide revenues of Mobil? Because it is a rare opportunity to have you here. We don't generally get an 800-pound gorilla. If I could get unanimous consent to enter your tax return into the record, I would do it.

Mr. DAKIN. What do you mean by revenues? Do you mean gross receipts from all sources before——

Mr. MCDERMOTT. I am not an accountant or a tax lawyer. How much money comes in to you?

Mr. DAKIN. The total gross receipts in terms of what we collect from the total amount we sell during the year in 1994 was about $67 billion.

Mr. MCDERMOTT. And you paid $2 billion in taxes?

Mr. DAKIN. That is why I asked you what you meant, because that is not profits, that is not the income we made. That is our total sales.

Mr. MCDERMOTT. But out of all that, on that $67 billion you paid $2 billion in taxes?

Mr. DAKIN. Our income on those sales was about $1.7 billion.

Mr. MCDERMOTT. So you lost money paying taxes; is that what you are saying?

Mr. DAKIN. No, sir.

Mr. MCDERMOTT. You are saying profits after taxes were $1.7 billion; is that what you are trying to tell me?

Mr. DAKIN. Yes. I am having a little trouble finding my place on tables on the annual report.

The income after tax would have been $1.7 billion, $1.7 billion income after paying all expenses and after paying all taxes.

Mr. MCDERMOTT. And you spent about $10 million in compliance?

Mr. DAKIN. We spent $10 million preparing our U.S. Federal income tax return.

Mr. MCDERMOTT. So you are spending less than one-half of 1 percent to produce a tax document to give $2 billion to the Federal Government?

Mr. DAKIN. Sir, to put this in focus, we are a worldwide company, and you asked what was our worldwide income. We have to distinguish between the total worldwide taxes we pay on our total worldwide income. That was the figure that I was giving. The $10 million——

Mr. MCDERMOTT. Let me move to my next question, because I know that they would not run a bill through here if you had not had a chance to review. This Committee passed a bill which included a provision to eliminate the alternative minimum tax. What tax break does that give you? What is your benefit from the bill that passed out of here?

Mr. DAKIN. I was called here to testify on the compliance costs. I can tell you that the compliance costs of just filling out and filing the data on the AMT is 30 percent of our total compliance costs of about $3 million a year.

Mr. MCDERMOTT. It would help us if we knew how much you would save in taxes out of that $2 billion that you pay?

Mr. DAKIN. We haven't saved anything in taxes.

Mr. MCDERMOTT. You mean that AMT proposal that went out of here had no impact on Mobil?

Mr. DAKIN. We don't pay on proposals, Mr. McDermott.

Mr. MCDERMOTT. It must have been submitted to you and you ran it through your tax department and they said, under this pro-

posal, we would pay only $1.4 or $1.1 billion or $600 million or something.

Mr. DAKIN. Because we are a very heavy investor in the United States to the tune of about $1 or $1.1 billion every year, we throw off a lot of depreciation. The AMT depreciation recovery rules are so slow that that is what causes us to become an AMT taxpayer. So obviously allowing better capital recovery for investment in the United States would reduce the amount of AMT that we pay.

Mr. MCDERMOTT. So you would get a big tax break. I find it hard to believe that you would want a system to be thrown out in favor of a flat tax when you can come here and adjust it down and get it so it works just right for you—maybe I don't understand corporate mentality.

One of the things that troubles me about the flat tax business is the question of equity. The Coopers & Lybrand witness really factored herself out. She is not willing to comment on whether they believe in fairness or not.

I would like to hear the rest of you, because I have a report from the American Enterprise Institute and one from Treasury which say, under every flat tax, whether you are talking fat or you are talking a flat tax, you wind up with 80 percent of Americans paying more taxes and the top group getting the tax break.

Does that trouble anybody at the table?

Mr. TYLER. Why do they get a tax break?

Mr. BUNNING. Your time has expired. We need to move on.

Mr. Christensen will inquire.

Mr. CHRISTENSEN. Thank you, Mr. Chairman. I applaud Chairman Archer for instituting these hearings, because I believe, as Mr. Tyler said earlier, that our tax system is too complex and it causes fear in the American people. We need to institute a system that is simple, fair and one that is a whole lot less in size; I think our current system has roughly 10,000 pages, compared to the one in 1914 that had 14 pages. The amount of money that is spent in compilation and time is money put down a drain, and we need to fix that.

I knew sooner or later that this discussion on an alternative tax system would turn to a class warfare argument. I think that is unfortunate. I think we need to focus on the fact that the system we have today doesn't work. We need to find a more simple, more fair system.

I think Mr. Dakin's testimony was well received, in the fact that it is not the amount of tax that they pay or don't pay. We are talking about the type of system that we have and the complexity and the various props that you brought along, I think, helped add to that system. I want to thank the witnesses today and appreciate your testimony.

More than anything, I compliment the Chairman for bringing in people from the business community—small; large; medium-sized businesses—that had the opportunity to testify first, prior to some of the expert panelists that we sometimes refer to as bringing in some of the policy ideas, that have the Ph.D.s behind their names. Not that they don't have some good ideas, but it is enjoyable, for the first time since I have been on this Committee, to hear from the people in the trenches first, and I applaud the Chairman for that and thank you, Mr. Chairman.

Mr. BUNNING. Mr. Payne will inquire.

Mr. PAYNE OF VIRGINIA. Thank you very much, Mr. Chairman. I too want to commend Chairman Archer for holding this hearing and these hearings that we will have this week. As a former small business man myself, certainly I understand what I am hearing from this panel that the Code today is too complex. We are way behind in terms of providing regulations for the IRS, and because of the complexity, not only is a burden being imposed upon large businesses and small businesses, but upon individuals as well. These are things that we need to look at and things that we need to correct.

I would say, too, that it is very important with a Tax Code that it provide some degree of certainty. Especially when you are in business, it is very difficult when the Code changes or when you anticipate changes as you are trying to make decisions about investment. Even hearings like the ones that we are having this week can create some uncertainty. People who may be thinking about making some investment, hearing what is going on, may say, maybe I should wait because maybe the tax climate will be more advantageous in the future. I think it is important to understand that we are beginning a process that will be a very long process, but a very important one.

I would certainly think, Ms. Skidmore, for you and others in your profession, as people approach you and ask about what is going on in Washington and about investments that they are thinking of, that people need to put this in perspective. They should not make decisions or investments because of things that are going on here. These are important hearings to lay the groundwork for changes that may be made, but at some time in the future, perhaps no earlier than 2 years or more from now.

So I think that is an important thing to keep in mind about hearings like this, that they should not be disruptive to the kind of important activity that is going on in the economy at the present time.

Let me use the few minutes I have left to inquire of the small business people about the taxes, really, in three areas. Let me break these down into three large groups—payroll taxes, income taxes, and other, such as the pension issues that have been brought up by Mr. Tyler.

Would you comment, as you see it, on how much each of these three takes away from your doing business that you would normally do—payroll taxes, income taxes and other?

Mr. Williams, maybe I could start with you.

Mr. WILLIAMS. Again, without having all the timeframe that is there, I think the time that is taken for each of us to even come here, the plane flight back here to have to talk about the issues that are going on in our business today, when we go out and spend time with our employees and work in manufacturing for a day. I ask the same thing, like Mr. McDermott, that he does not have the corporate information and has not been in business. For him to come and to sit down with our people for a day, any one of you, we would give you an opportunity to work inside figuring out what it takes to comply with the costs, payroll and income. It is some-

thing that I did not come here prepared to talk about, each of the percentages.

Mr. PAYNE OF VIRGINIA. Not the percentages so much, but if we look at overhauling the Income Tax Code and leave in place the payroll taxes as they are now, to what extent have you been benefited as a small business. Is it not likely that you would be back saying, this is OK, but what we really need to address are the payroll taxes because of the amount of time that it takes to get somebody on the payroll, the forms we have to fill out, the compliance as well as the amount of money that the employee and we have to put aside in order to pay these particular taxes?

Mr. WILLIAMS. I would say out of our accounting department, which—we have probably 10 people, there are 3½ devoted to just taking care of payables of expenses with our suppliers, and the rest, 80 to 90 percent of their time is dealing with payroll and income tax issues, State, local and Federal, all Federal issues.

Mr. PAYNE OF VIRGINIA. Ms. Beard, could you comment on this, please.

Ms. BEARD. As far as actually adding up the time, I haven't. There were many nights I was in the office until 2 or 3 o'clock in the morning because it had to get done. When you are in business for yourself and you are doing everything, you don't add up the hours; you are trying to get things accomplished. Until a year ago I was doing all the payroll and handling the payroll deductions and getting the reports done. There are many nights when you are sitting there trying to figure out, and it doesn't balance.

We have a gentleman on our delegation who is a veterinarian, and he is very vocal, that this is servitude in his eyes, and he is from England originally.

Mr. BUNNING. The gentleman's time has expired. I thank the panel members for their input today and take the privilege of the Chair to request that Hon. Michael Boskin, David Bradford and Gary Hufbauer would come forward. We know that you are pressed for time. If the other panelists would hold back until we receive testimony from these three gentlemen and we could question them. Thank you very much, panel.

Mr. BUNNING. Mr. Boskin, if you would begin, we would appreciate that.

STATEMENT OF HON. MICHAEL J. BOSKIN, PH.D., TULLY M. FRIEDMAN PROFESSOR OF ECONOMICS AND SENIOR FELLOW, HOOVER INSTITUTION, STANFORD UNIVERSITY, STANFORD, CALIF., AND FORMER CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

Mr. BOSKIN. Thank you, Mr. Bunning. It is a privilege to be back to testify before the Ways and Means Committee.

I want to congratulate the Members of the Committee for initiating these historic hearings. There is a tremendous opportunity to greatly improve the Federal system of corporate and personal income taxation in a manner that will accomplish two important goals: First, dramatically improve economic performance, and second, substantially reduce the compliance and administrative burden on America's families and firms. But it must be accompanied by spending control, devolution of some Federal functions to the

States and localities, less and more flexible regulation and sound money. We have an opportunity to launch a new era of prosperity over the long term in America. Why would a fundamental change in the tax system change our economic performance, improve it?

While tax collections in personal and corporate income tax today total only about 10 percent of GDP, the system systematically affects private behavior, household and firm behavior, affecting the overwhelming bulk of GDP; and the result, overwhelmingly, is that behavior is heavily tilted toward the present against the future, toward consuming today and saving and investing for the future.

I have five standards or tests that I apply to tax reform that I will briefly mention before mentioning a few words about the specific proposals under consideration.

Will the reform improve the performance of the economy? And by far the overwhelming and most important standard of performance is the rate of economic growth because that determines future living standards. There are other goals of economic performance that I won't get into here. The most important way the tax system affects economic growth is through the rate of saving, investment and entrepreneurship, which is heavily retarded by the current corporate and personal income tax.

Will the tax system likely affect the size of government? It is my own view that it is important for the point of finance and the point and purpose of spending to be more closely tied. That, in my view, will be the best brake we can apply to ensure more effective and efficient government.

Will the tax structure affect federalism and, if so, how?

Will the new tax structure likely endure? As this Committee knows better than I, we have had major or fundamental tax reforms eight or nine times since the late seventies. We should be concerned that when we move to a better tax system it won't be undone shortly thereafter.

In 1986, for example, the tradeoff was to lower rates for a broader base. That was undone in 1990 and dramatically worsened in 1993.

And finally, over time, will the tax reform contribute to a prosperous, stable democracy? I have mentioned prosperity. I am concerned that starting from where we are now, as we move forward, the press of demography is going to cause us to have an ever-growing ratio of people receiving, on balance, income from the government to people paying taxes. That will have to be addressed on the entitlement side primarily, but we also should be concerned on the tax side, whether we are collecting the proper amount, we have enough taxpayers, we are getting at the underground economy, and so forth.

The overall burden the tax system imposes on the economy is composed of two parts. You heard mostly this morning about the compliance burden. The lowest estimate I have heard is over $100 billion. I have heard estimates up to $600 billion for filling out forms, the paperwork, and so forth. That is important. It is the thing that affects a large majority of people.

The tax system, however, as one of the last questions asked implied, distorts the allocation of our activity between consumption and savings, consumption and investment, and so forth. The sizes

of those distortions are proportional to tax rates. The cost goes up with the square of tax rates, so we want a broad base and low rates to the maximum extent possible.

What does that imply for tax reform? It seems to me that the two fundamental purposes of tax reform in order to achieve a better system and a stronger growth in the economy should have a much broader base that is equal to or much more closely aligned with consumption in the economy as opposed to income on the one hand, and that we get the rate as low as possible on the other. That will lead to some tradeoffs between what gets deducted, rebated and so on, but I would say that, overwhelmingly, we have an opportunity to make a major improvement. Estimates suggest we could gain as much as perhaps 10 percent of GDP higher in the long run, with a very low rate broad-based form of consumption tax, whether that is done on the retail sales value-added type or through the income side, allowing people to deduct their saving, or through an income-type flat tax that winds up with consumption as its base rather than income.

Quickly speaking, my own view is that simplicity and the underground economy and things of that sort, and GATT border tax adjustment rules, weigh in favor of the retail sales tax. The flat tax would get us partway there; it has a lot of appeal, as well. It raises additional issues.

Each of them would run the risk of having some of the good they do undone by raising rates later or by having to have exemptions, deductions or rebates.

I would suggest the Committee go through the task of fundamental tax reform if we are pretty sure that we will be able to keep that fundamental reform relatively intact for some time to come. I think those opportunities are substantial and I commend the Committee for beginning the education process for the country. I think much education needs to be done before we can get the bulk of the population understanding what we are really talking about.

The gains are large, potentially large enough in my opinion to seriously consider such fundamental reforms. Thank you.

[The prepared statement follows:]

TESTIMONY OF HON. MICHAEL J. BOSKIN
STANFORD UNIVERSITY

Chairman Archer, Ranking Member Gibbons, and other distinguished members of the committee, I appreciate the opportunity to appear before you today to discuss the important question of fundamental tax reform. There is a tremendous opportunity to greatly improve the federal system of corporate and personal income taxation in a manner that will both significantly improve economic performance and substantially reduce the compliance and administrative burden on America's families and firms.

Estimates put the annual compliance burden range well upwards from over $100 billion to almost $600 billion, with well over 5 billion hours of human effort devoted to that task. The cost in distortions of economic decisions is many times higher. And the Internal Revenue Service apparently only gives correct answers to taxpayer inquiries about 63 percent of the time. **The tax system is clearly too complex**. Remarkably, the system of voluntary compliance yields a very high percentage of tax liabilities actually due, especially when viewed relative to other countries. That speaks well of Americans' basic values. But there is widespread concern that the system of voluntary compliance will be decreasingly effective over time unless tax rates are reduced and the tax system made far less complex.

I hope these hearings start an educational process, a national dialogue and debate that will help build a consensus on the need for tax reform and on the best route to it.

Tax Reform and Economic Policy

Tax policy is imbedded in the overall economic system and the overall system of public policy instruments. Taxes--current or future--are how government spending is financed. The tax system affects and is affected by other areas of policy.

The current tax system as well as government spending, deficits, and regulation, are the subject not only of intense legislative political debate currently, but are widely viewed, according to all public opinion polls, as out of control. **Taxes are too high and complex; the government spends too much; it is too centralized and too inefficient; the government borrows too much, and regulates too much private activity too inflexibly.** So an improved tax system has the potential to significantly improve the economy. But it must be accompanied by slower spending growth to balance the budget, devolution of some federal functions to the states and localities, less and more flexible regulation and sound money.

The current tax reform debate focuses on the personal and corporate federal income taxes. These amount to about 10% of GDP, and about a quarter of all explicit and implicit taxes. Total federal, state, and local government spending is about 40 percent of GDP. Current explicit taxes are somewhat less than that, the difference being budget deficits. The current reform debate generally does not focus on the payroll tax or excise taxes. Nor is it explicitly directed at state and local taxes, although some proposals would affect them.

Recall also that there are two partially hidden taxes that we generally do not list as taxes in our budgets. One is the hidden tax imposed by our regulatory and legal system. (Some of those regulations and part of our legal system work reasonably well, but some does not, imposing unnecessary additional costs on families and firms.) The costs are very much like a tax. Estimates range all over the place, but recently have been in the $400 to $500 billion range per year. That is the yield of the payroll tax and a large fraction of the yield of the income tax.

There are also large future tax liabilities implied (but not terribly well measured) by the budget deficit. America was born in a revolution against taxation without representation; who is less represented than the future generations who will bear this burden?

There is a general feeling that we have increasingly seen the point of tax and the point and purpose of expenditure diverge. That is one of the reasons there is so much discontent with government. In the Eisenhower Administration, say 1958, six out of every seven dollars the then much smaller federal government spent was on purchases of goods and services such as national defense and roads. Only one out of every seven dollars was spent on transfer payments. Today, net of interest on the debt, transfer payments are the bulk of the absolutely and relatively much larger federal spending. So one can no longer speak of the tax side of the budget by itself. At the

very least, taxes and transfers must be considered simultaneously; better yet, taxes and spending more generally.

Tax policy interacts with trade and trade policy. In an era of large and expanding trade in goods and services, and investment, more foreign source income flows across national borders.

Finally, tax policy interacts with monetary policy. Tax brackets were indexed in the early 1980's, but not the definition of income. Nominal capital gains and nominal interest are taxed, nominal interest is deducted, historic cost depreciation is used, etc. So inflation still affects effective tax rates.

While all these other areas of policy must also be improved to spur economic growth, the tax reforms currently under discussion would go a very long way to improving the economy. **That is because, while the tax collections themselves are only a modest part of overall GDP, the current tax system systematically affects private sector (household and firm) behavior affecting the bulk of GDP. And the result is that behavior is heavily tilted toward the present against the future.** For example, the current corporate and personal income tax system taxes saving, investment, and entrepreneurship quite heavily. Indeed, some types of saving are doubly or triply taxed. Our tax system is one reason America's net national saving--the amount the nation has available to invest in a more productive future--is so low relative to other advanced economies, a point I return to below.

Five Tests for Tax Reform

I have five standards or tests that I apply to tax reform before I get to the specifics of the tax proposals.

1. Will the tax reform improve the performance of the economy?

By far the most important aspect of economic performance is the rate of economic growth because that determines future living standards. The most important way the tax system affects economic growth is through the rate of saving, investment, entrepreneurship and work effort.

2. Will the tax reform likely affect the size of government?

Tax reforms that more closely tie the payment of taxes to expenditures and get the individual citizen and taxpayer focusing on the fact that their taxes are being used to finance expenditure will better insure a more effective and efficient government. Also, any new tax--a broad-based consumption tax, for example--should completely replace the income tax. Otherwise, there is a risk the new tax will just be piled on the old and used to raise revenue to grow government--the European disease that has so damaged their economies.

3. Will the new tax structure affect federalism?

Closely tied to item 2, I believe it is important to strengthen the federal system. Tax reforms can affect the federal system in many ways and we should favor those that strengthen it and devolve authority to state and local government and private institutions to the extent possible.

4. Will the new tax structure likely endure?

We have had major tax reforms or fundamental tax reforms in each of the following years: 1978, 1981, 1982, 1983, 1985, 1986, 1990, and 1993. We should be concerned that we could move to a better tax system only to undo it shortly thereafter. In 1986, the tradeoff was lower rates for a broader base. That was undone in 1990 and dramatically worsened in 1993.

5. Over time, will the tax reform contribute to a prosperous stable democracy?

I have emphasized prosperity above. Now I want to emphasize stable democracy in the following sense: Are we likely to see over time a change relative to what is currently projected in the ratio of taxpayers to people receiving income from government? We now have a much higher ratio of people who are net income recipients to people who are taxpayers than in any previous time in our history. Fortunately, that number is still well under 50%. But as we move through

time, as we see the retired population grow, the baby boom approach retirement and then retire, the fraction of the population in any given year who are receiving more than they are paying will grow. We must deal with this both on the tax side (underground economy, perhaps too many off the tax rolls), but especially on the transfer payment side, the entitlements programs, and do so soon, or we will get into a spiral of higher benefits, higher tax rates, and a weaker economy and intergenerational conflict.

Before discussing alternative reforms and how they relate to these standards, a simple parable will distill much economic knowledge on the subject of the economic cost of taxation. Suppose the government takes a dollar away from the taxpayer's to finance spending. In order to collect that dollar, the government has to distort the allocation of resources. The tax will affect private decisions: an income tax is well-known to doubly or triply tax saving, and thus distorts the incentive to consume versus save, or alternatively to consume in the present versus in the future. Both income and payroll taxes distort the incentive to work in the market versus the home and/or of employers to hire permanent or temporary workers, etc.

The severity of these distortions depends on two things: first, the size of the tax wedge, how high is the real effective marginal tax rate that drives a wedge between doing one of the activities versus the other, between consuming and saving, between working in the market and working in the home, etc.? And second, how sensitive or elastic is the activity to changes in tax rates? Some activities are well known through numerous studies to be quite sensitive to tax rates; for example, the realization of capital gains and the labor supply of second earners in families. The combination of the size of the wedge and the sensitivity of the activity to it determine the severity of the tax distortion.

Generally, **the overall total burden that these tax distortions impose on the economy goes up with the square of marginal tax rates. The marginal cost goes up proportionally with tax rates. Thus, high marginal tax rates are very bad for the economy.** So, the income tax distorts many decisions. Workers switch between taxable income and fringe benefits; investors between low dividend and high dividend stocks; and so on. A lower bound estimate of the cost to the economy of each additional tax dollar is $1.40 or $1.50. Some estimates go much higher.

Now the tax dollar (which costs us $1.40 or $1.50) is put into a bucket. Some of it leaks out in overhead, waste, etc. In a well-managed program, the government may spend $.80 or $.90 of that dollar on achieving its goals. Inefficient programs would be much lower, $.30 or $.40 on the dollar. This immediately tells us that a key to the quality of the tax system, how badly it distorts the economy, hinders growth, misallocates resources, is the level of **effective** marginal tax rates. **The lower the effective marginal tax rates, the smaller the distortion of private decisions.**

Unfortunately, some examine just the statutory rates rather than the effective marginal tax rates. **The effective tax rates on private activity can be quite different from statutory rates because they interact with the tax base and can cascade across several taxes. For example, there are people who, despite a statutory rate of 28 percent, pay tax rates in excess of 100% on real capital gains, because they have nominal gains but real losses.**

Perhaps nowhere is the current income tax system more harmful than in the taxation of saving, investment and entrepreneurship. One of the nation's most serious problems is that we have a very low rate of national saving. It is low relative to the nations with which we compete. It is low relative to our own historical average. If it was the result of a tax, budget and regulatory and legal system that was neutral with respect to whether people and firms consumed or saved and invested, I would not necessarily see much problem with it. **But the overwhelming evidence is that all these public policies wind up favoring current consumption and penalizing saving and investment.**

Our net national saving rate in the 1990's has been slightly under 2%. That is the sum of what households, businesses, and governmental units add, net of depreciation, to our nation's ability to grow in the future. Two percent is remarkably low. Fortunately, we have been an attractive enough place to invest that our net investment rate has been higher than that, the difference being financed by importing capital.

There are two reasons the nation's saving rate is so low. Most people focus on the budget deficit. The budget deficit clearly is one reason. But just as important has been a decline in the private saving rate. I want to spend one minute on the relationship between the two. **Those who have argued that the best thing we can do to raise the nation's saving rate is to reduce the budget deficit are only correct if they add the proviso: in a manner that does not reduce private saving.**

The 1993 tax increases, for example, clobbered private saving. In addition to the direct limits on 401(k) plans, etc., the rate increases apply to the highest propensity to save groups: well-off households; middle income two-earner households in their peak earning and saving years; and small businesses. 80% of American businesses are unincorporated; 42% of corporations are sub-S corporations. These businesses use the same 1040 form you and I use, and had large increases in their effective tax rates on profits available for re-investment. Not surprisingly, personal saving declined at about a $60 billion annual rate. **So even if the tax increases collect the projected revenues--and my guess is they will not--they had no net effect on national saving. The smaller deficit is being matched by less saving. This is at best circular.**

I favor tax policies that reduce or redress the disincentives to save, invest and innovate in our current tax system, as well as policies to reduce the federal budget deficit. Indeed, that is how I tie the current debate together on whether it makes sense to have tax cuts as well as spending cuts given the budget deficit. **My answer is yes when those tax reductions will increase private saving to complement the reduction in government borrowing from the spending cuts.**

What does all this imply for fundamental tax reform?

As Congress moves forward to debate legislation on various piecemeal tax proposals this year, such as capital gains rate reduction and indexing, expanded IRAs, and other tax cuts, a useful way to think about these reforms as well as the more fundamental reforms, is that they are designed to redress the severe distortion of saving and capital formation caused by the current system of income taxation. Most other countries rely much more heavily on taxes on consumption--so-called indirect consumption taxes such as sales taxes and value-added taxes, and income tax systems that exempt far larger amounts of saving from the tax base (thereby leaving most households' tax base as income minus all saving, i.e. only that part of income that is consumed). Most of their corporate taxes have various features that allow more rapid write-off of investment than does the U.S. corporate tax; some have features by which they integrate the corporate and personal tax; others, such as Japan, have corporations that have much higher leverage and therefore finance a much larger fraction of investment through tax advantaged debt.

The U.S. corporate and personal income taxes (and other taxes at both the federal and state level) tax some types of saving once, others twice, some three times and in some instances even four times. To set concepts, **it is generally understood that a pure income tax would tax saving twice: first when it is earned as part of income, and again when it earns a return in the form of interest or dividends.** An alternative way to think about this is that present consumption is taxed once while future consumption is taxed twice, since the bulk of saving is done for the purpose of future consumption, for example during retirement.

Now consider the separate corporate and personal income tax and a family putting their saving in corporate equities. The family first pays taxes on their own income (perhaps their wages). That is tax one. They save some of that after-tax income in the form of corporate equities. But the corporation pays corporate taxes (on behalf of the family as a shareholder). That is a second tax. Then the family pays taxes again when it receives dividends or capital gains (in this case one has to net out inflation, deferral, the possibly slightly lower tax rate, incomplete loss offset, etc. to determine the true effective tax rate). That is a third tax on the saving. If the family is fortunate enough to accumulate, perhaps at a few thousand dollars a year compounded over a lifetime, enough to leave a taxable estate, the saving is taxed a fourth time.

Of course, there are numerous exceptions to this rule. For example, employer provided pensions, 401k plans, IRAs, etc. are forms of tax deferral (not tax forgiveness) that eliminate one layer of the taxation of saving. But going through the entire complexity of the tax code still

produces the overall conclusion that capital formation is taxed especially heavily in the United States, relative to other uses of income and relative to our competitors.

There are numerous ways to simplify the tax system and remove the distortion between the present and the future, between consumption and saving of households, and among types of investments. That is, there are numerous ways to tax consumption in the economy. We can generally divide these into two approaches--direct and indirect. So-called indirect taxes include a national retail sales tax, various types of value-added taxes, etc. So-called direct taxes would tax households and firms on the part of income which was consumed. They are sometimes called consumed income taxes. **It is important to examine the combination of the business-level tax and the personal-level tax to determine what the final tax base will be.**

Economists use a concept called the circular flow of income and product to describe the economy. Business firms use capital and labor, which they pay wages and interest or other forms of capital income, to produce products, which they sell to obtain revenues out of which the payments to labor and capital are made. One can look at the total value of the production of the firms or the total income received by households as two equivalent sides of the nation's accounts. Thus, households can be taxed at the personal level by taxing their total income, or various components of it such as wages, interest, dividends, etc. Alternatively, households can be taxed by taxing firms on the capital and labor they employ, or on their output. The taxes thus collected would reduce the flow of payments back to households. In this sense, **a tax at the business level should be thought of as a withholding tax on households.** To repeat the old saying, corporations do not pay taxes, people do. Taxes collected at the business level are paid either by shareholders, owners of capital in general, workers, or consumers.

Thus, a tax on output sold by firms is equivalent to an equal rate tax on the wage income and capital income paid by the firm from the sales of the output. Alternatively, households could be taxed when they use the income they receive from the firms to purchase goods and services or to save, the two broad uses that are made of income. Alternatively, since saving equals investment (ignoring complexities of the international economy for the moment), income can also be taxed by taxing consumption plus investment in the economy.

Turning from taxing output or income to taxing consumption, the government can do so in a variety of ways. The most obvious is taxing the purchase of goods as through a retail sales tax. A second option is to tax income of households but allow them to deduct net saving , leaving a tax base of consumed income. An alternative is to tax wage income at the personal level but to tax capital income at the business level (a withholding tax on the capital income of the shareholders) but to make the tax a consumption tax we would allow immediate expensing, i.e. a business tax deduction for investment in the year made.

While these are very different approaches to consumption taxation, with very different attributes, I want to begin by stressing the conceptual equivalence of these approaches to taxing consumption. Consumption equals income minus saving, so the Nunn-Domenici type tax with an unlimited net saving deduction is a consumed income tax (in the case of Nunn-Domenici, levied at progressive rates). Consumption taxes can be levied directly as a retail sales tax on the purchases of goods **and** services. But consumption is also equal to income less investment and therefore labor income plus capital income less investment. Hence, a tax such as the so-called flat tax of Majority Leader Armey, which owes much to my Hoover colleagues Bob Hall and Alvin Rabushka, which taxes wages at the personal level and capital income less expensed investment at the business level also winds up having as its tax base total consumption in the economy.

I noted above the importance of low tax rates. The broader the base, the lower the rate or rates. Thus, a national retail sales tax on all consumption goods, including services, replacing the current corporate and personal income tax, would greatly reduce the drag on saving, investment, entrepreneurship and economic growth. It could be implemented in a manner which is far less intrusive and burdensome on taxpayers. It would, however, be a proportional tax on consumption. If greater progressivity is desired, a refundable tax credit, or exempting commodities consumed disproportionately by the poor, would be the two approaches. The latter is inefficient in the sense of exempting, for example, food for rich and poor alike. The former would require some cumbersome administrative apparatus, and as we have seen with the earned income tax credit, open up opportunities for abuse. I believe each of these problems is

surmountable. Also, while it would not completely eliminate the underground economy, this approach probably would get at more of the underground economy than any other.

The approach of allowing an unlimited saving deduction (sort of a super net IRA) in a system similar to the current income tax system, offered recently by Senators Nunn and Domenici, is a progressive rate consumed income tax. While it has many admirable features (such as offsetting the payroll tax), as currently configured it winds up with tax rates that are too high for the health of the economy (a top rate of 51 percent). A serious complexity issue is the need to track of all pre-existing assets. Also, since a huge part of the complexity of the tax system is in the treatment of capital income, I believe the alternative of taxing labor income at the personal level while taxing capital income minus investment (business cash flow) at the business level would be administratively simpler. My former CEA colleague David Bradford has designed such a tax, with lower progressive rates, which he calls the "X Tax."

This approach to the tax base, with a flat rate, is the so-called flat tax. While common usage calls it a flat rate income tax, as proposed by Majority Leader Armey, the flat tax taxes labor income or wages at the personal level and capital income minus investment at the business level at the same proportional rate. Some of the simplicity is due to the single rate, as various transactions just net out, such as a business deducting interest paid and a household paying taxes on interest received, since these would be at the same rate. Some progressivity is introduced into the flat tax with very high personal exemptions, which therefore remove many households from the income tax rolls. While the tax rate is constant, the ratio of taxes to income rises with income until it gradually approaches the flat rate. For example, if the exemption level for a family of four were set at $25,000, a family earning $25,000 would have an average tax rate of zero; one earning $50,000 would have an average tax rate of 10 percent if the flat rate is 20 percent (20 percent on the $50,000 minus the $25,000 exemption); a family earning $100,000 would have an average tax rate of 15 percent (20 percent on $100,000 minus $25,000); at extremely high earnings, the average tax rate gets very close to the marginal rate of 20 percent.

The value-added tax (VAT), which is in widespread use in other countries, (although as mentioned above is often viewed as the way to finance the much larger government spending) also taxes income minus investment. It does so for each good and service, by taxing income minus investment at each stage of production. Adding up across stages of production and across all goods and services leaves the tax base as aggregate income minus investment, or aggregate consumption in the economy. As a technical matter, among types of VAT's, a subtraction method VAT with destination principle border tax adjustments on balance would be better than the other types of VAT's.

Each of these alternatives has its pluses and minuses. I can only begin to mention a few here, by using the criteria I laid out before. **Each type of tax will require far greater examination from the polity and the public, as they are not yet very well understood.** If it really could completely replace the corporate and personal income tax, a national retail sales tax probably in the end would be the simplest to administer and do the best job at getting at the underground economy. Some argue it would encroach on the states' revenue source. With no income tax, there would be no deductibility of state and local taxes and no tax-exempt bonds (the same would be true in a pure flat tax with no deductions), although lower interest rates would partly offset this effect. A broad-based indirect consumption tax would be rebatable at the border under GATT rules. To the extent refundable credits and/or exemptions were necessary, tax rates would have to be higher, and the advantages of a low rate broad-based consumption tax would be diminished.

The same is true of a value-added tax, which while it has a self-policing feature, is somewhat more complex than the retail sales tax, but still relatively simple compared to income taxes. **In either case, I personally would strongly object to such an approach unless it was used to replace income taxes, lest it be used to expand the scope of government.**

The flat rate tax would be a huge improvement over the existing income tax system, but again to the extent that exemptions, deductions, etc. were left in place, or crept back in over time, some of its advantages would be eroded. And, as with a broad-based sales tax or VAT, I would be concerned that small increases in the rate would raise lots of revenue, and that over time, we would evolve back toward a higher rate system **unless spending was strictly controlled**.

Every deduction in the income tax has its supporters--including the direct beneficiaries--and an apparent rationale. But the general interest in lower rates and a healthier economy overwhelms most, perhaps all, such arguments.

The two I would be most concerned about are the mortgage interest deduction and the charitable deduction. The equity in their home is the largest asset for a majority of American families and home values would fall under a pure flat tax. Perhaps a gradual transition would mitigate this effect. I believe charities strengthen a pluralistic democracy and the evidence (including work for the Filer Commission by Martin Feldstein and myself) is that the charitable deduction yields **more** for charities than it "loses the Treasury," i.e. is an efficient way to finance charities. I would rather have thousands of charities doing their good deeds than have government bureaucracies try to do them. Note that these deductions also vanish with a retail sales tax or VAT. Some of the same federalism issues arise if there is no deduction for state and local taxes and local government bonds lose their tax-free advantage.

The progressive consumed income tax, whether of the saving deduction Nunn-Domenici variety, or the Bradford "X Tax" (a progressive tax on labor income at the personal level plus taxing capital income minus expensed investment, business cash flow, at the **highest** tax rate at the business level), would be improvements over the current system, but not nearly so much as the other approaches. I do believe there is a stronger case for the Bradford approach than the Nunn-Domenici approach for compliance and administrative reasons, but again, recall the general statement made above that **from the standpoint of economic performance, lower effective marginal tax rates are best.** While the tax rates on consumed income get quite high under Nunn-Domenici, it is the only approach that attempts to integrate payroll tax credits to reduce the marginal impact of the payroll tax on labor supply and employment.

What is likely to be gained by moving to one of these tax systems? Will it be worth the substantial political capital and transition costs to various families, firms, industries, and economic disruption that accompany any major tax change? The answer, in my opinion, is that the gains are **potentially** quite large. My review of the literature plus my own modeling reveal estimates of long-run GDP up to ten percent higher per year by replacing the current corporate and personal income taxes with a broad-based, direct or indirect, tax on consumption or consumed income. Perhaps a conservative estimate would be five percent per year, which however, is gained partly by foregoing some consumption. This occurs because the increased saving and capital formation increases wages, and future income. **These are large potential gains; large enough, in my opinion, to begin a serious dialogue and discussion, indeed national debate, on the desirability and feasibility of fundamental tax reform, which in turn might develop the support for legislation in the near future.**

Chairman ARCHER [presiding]. Professor Bradford.

STATEMENT OF DAVID F. BRADFORD, PROFESSOR OF ECONOMICS AND PUBLIC AFFAIRS, WOODROW WILSON SCHOOL, PRINCETON UNIVERSITY, PRINCETON, N.J.

Mr. BRADFORD. Thank you, Mr. Chairman. Mr. Chairman and Members of this distinguished Committee, it is a pleasure to appear before you again to discuss fundamental tax reform. The last time I did so was almost exactly 10 years ago, June 11, 1985.

It may seem that tax reform is always with us. I am hopeful, however, that these hearings reflect the approach of a critical mass of those who favor a thoroughgoing reorganization of the U.S. tax system around the idea of taxing on the basis of consumption rather than income.

In my few minutes, I would like to review with the Committee the main reasons it makes sense to have another go at fundamental tax reform and to explain why a consumption guidepost for writing tax rules provides the key for a tax system that is fundamentally fairer than the one we have now, that is vastly simpler and less intrusive in compliance, and that enhances U.S. living standards.

I will try to make two simple points: First, the present taxation should be viewed in the same light as other structures of regulation in our economy. In this case, the regulatory system is designed to define and protect the revenue base. Our tax regulatory system has become absurdly complex and counterproductive.

Second, a consumption-based tax offers a way to cut through the problems.

So, first, why reform again? In my earlier testimony, I spelled out many reasons the tax system at that time was defective and should be reformed. Most of those reasons persist. Rather than reiterate those here, I describe in my written testimony three examples of the ways in which the tax system now requires simplification and rationalization.

I won't go through the time to tell you about them now, but one concerns financial innovation, as an example. It is one of the ways in which our U.S. economy is most innovative and flexible, and profound changes have taken place. It is a case where the tax rules impede development and the tax rules themselves are the focus of a great deal of very high talent devoted, in effect, to drawing revenue out of the Treasury.

The second area is retirement saving. I give an example there. It is a very, very important area of our lives. Practitioners know this is one of the most complex areas of the tax law. The contractual relations between employer and employee serve a large variety of economic functions, and as with financial innovation, we are, on the one hand, wasting resources figuring out how to make arrangements that most exploit the tax advantages while staying within the law and, on the other hand, tying the hands of our employers and employees in reaching the most effective compensation arrangements.

My third example—and these are just examples—is capital gains. That probably defines itself; I don't need to tell this Committee about capital gains. In view of the interminable controversy

about capital gains taxation, it need hardly be said that the rules involve much more than fees for accountants and lawyers, but enter into every aspect of the business life of the country, with costly effect.

All three of these examples—and they could be multiplied—have in common that they are sources of great complexity and impose serious costs on the U.S. economy. And these costs are borne not just by the businesses and often high-income individuals who must directly comply with these rules. But like the banking laws or the securities laws or the telecommunications regulations, the costs they impose are spread throughout the economy, striking workers and consumers at all income levels.

The second thing these three examples have in common is that the harm that they cause could be easily avoided by adopting a consumption-based tax system.

Why is that? The reason that this is true is because cash flow accounting gets the right answer for implementing a consumption-based tax. I would refer to the written testimony for just a sketch of the details. It is amazing that that apparently technical accounting detail makes all the difference in the world.

Is a consumption-based tax feasible? The answer is yes. There are many ways it could be done. There are currently under active discussion three possible reforms—a retail sales, or value-added tax; the flat tax; the Nunn-Domenici unlimited savings allowance tax. All three have in common that they would replace the existing income tax and perhaps the payroll tax and they would shift the tax system to a consumption base.

I want to emphasize a couple of further points. In my view, a consumption-based tax is fairer than an income-based tax. Equity was much discussed in a previous hearing. In my view, personally, equity is perhaps the most important property of a tax system. If a tax system isn't fair, it won't stick and it shouldn't.

Many people feel that an income tax is the fairest tax, but that we should adopt a consumption-based tax, regrettably, because it would encourage saving. I disagree with this on several counts. Most important, in my view, a strong reason for adopting a consumption tax is that it is fairer than an income tax.

The central principle is this. As between two people who are similarly situated in terms of their economic opportunities, broadly speaking, how rich they are, well to do they are, the tax system should not assign a greater tax burden to the one who postpones consumption relative to the person who consumes. In other words, don't assign a higher tax burden on someone just because he or she saves.

In conclusion, as in other realms of policy, one might decide to impose an unfair tax system if it were needed to serve some other public purpose. I am asserting here that the income-based tax system is unfair relative to a consumption tax. But on all counts—administrability, compliance costs, interference in economic decisions—an income tax, even a much more consistent one than ours, is inferior to a properly constructed consumption tax.

The advantage of a consumption-based tax in terms of improved incentives to save and invest and, equally important, in terms of equalized treatment of investments of all types and by all people,

are going to be emphasized sufficiently by others in today's hearings and beyond. I would like simply to reiterate here the advantages of the reduced regulatory burden. By replacing an outdated and unnecessarily costly regulatory system with a consistent, simple system we can reap gains for everyone in the U.S. economy.

This is the true meaning of international competitiveness, and it has the advantage of allowing us to gain at no cost to the rest of the world. Indeed, if the rest of the world follows our example, the benefits will be multiplied. I hope the time is approaching when we will make the move.

Thank you, Mr. Chairman.

[The prepared statement follows:]

Testimony of David F. Bradford
before the Committee on Ways and Means
House of Representatives
U.S. Congress

June 6, 1995

Mr. Chairman and members of this distinguished committee, I very much appreciate the opportunity to appear before you again to discuss, *again*, the subject of basic tax reform.

The last time was ten years ago almost to the day (June 11, 1985, to be exact). In that case, my testimony concerned President Reagan's reform proposal, which was to emerge as the Tax Reform Act of 1986. As a matter of interest, in preparing for today's session, I pulled that old testimony out of my files.

Since my views have continued to evolve with time and experience, I was rather surprised to see how much of that statement could be delivered again today. Specifically, I said, in effect, that

- The proposed reform failed to deal with a number of serious structural problems of the income tax, such as the need to correct the income-measurement for inflation and to rationalize the treatment of corporations and individuals.

- As a consequence of several inconsistencies in the treatment of various sorts of income, the plan included *ad hoc* patches, such as a minimum income tax, limitations on the deductibility of interest, and a new surtax on distributions from retirement plans, that were sources of complexity and undesirable incentives.

- I foresaw that the accretion of such patches would only worsen in the future, as taxpayers followed their natural inclination to exploit inconsistencies in order to reduce their taxes and the rule-writers struggled to plug the gaps.

In that statement, I also suggested an alternative approach, a phased introduction of something I dubbed the *X-Tax*, a close relative of the Flat Tax that is being debated today, arguing that this consumption-based system represented the sort of genuine transformation of the tax system that was called for.

Ten years later, it seems to me that the predictions have been borne out. And my advice for how to proceed from here is much the same.

It may seem that tax reform is always with us. I am hopeful, however, that these hearings reflect the approach of a critical mass of those who favor a thoroughgoing reorientation of the U.S. tax system around the idea of taxing on the basis of consumption, rather than income. In my few minutes, I would like to review with the Committee the main reasons it makes sense to have another go at fundamental reform and to explain why a consumption guidepost for writing tax rules provides the key for a tax system that is fundamentally fairer than the one we have now, that is vastly simpler and less intrusive in compliance, and that enhances U.S. living standards.

I will make two simple points:

- The present tax system should be viewed in the same light as other structures of regulation in our economy. In this case, the regulatory system is designed to define and protect the revenue base. Our tax regulatory system has become absurdly complex and counterproductive.

- A consumption-based tax offers the way to cut through the problems.

Why Reform Again?

In my earlier testimony (and in other testimony), I spelled out many reasons the tax system at that time was defective and should be reformed. Most of those reasons persist. Rather than reiterate those here, I would like to use three instances of problems in the present law as illustrations of the need to simplify and rationalize our tax system today.

Financial Innovation

The U.S. economy is extraordinarily dynamic. Innovation and flexibility are its hallmarks. Nowhere has innovation proceeded more rapidly than in financial markets. The ingenuity of Wall Street's rocket scientists is legendary.

The tax system relates to these developments in two ways. First, much of the ingenuity is directed toward obtaining the best tax results in connection with any particular economic activity. Indeed, some of the ingenuity is directed to making profit at the expense of the U.S. Treasury. Second, the tax rules get in the way of accomplishing new financial arrangements.

The week before last I participated in a colloquium at New York University Law School on the taxation of new financial instruments. Among the papers was one by a practitioner, David Hariton, in which he took as an illustration of the state of the law the steps involved in advising a taxpayer who owns low-basis stock and borrows identical stock and sells it short. This would seem to be a pretty straighforward, if not exactly everyday transaction. Having first established that any number of possible complicating characteristics of the taxpayer do not apply (the taxpayer is not a controlled foreign corporation, for example), Hariton goes on for nearly fifty pages of options that the tax advisor must resolve, rules that may or may not apply, apparent inconsistencies, and so on. It was quite a convincing demonstration that the law has become unworkable. If the most expert tax advisers cannot establish with certainty how a "plain vanilla" transaction is to be treated by the tax law, how is the IRS to enforce the law? Any particular result has to be essentially arbitrary.

Retirement Saving

When I started as an assistant professor at Princeton University a long time ago, there was a retirement plan that called for contributions that were graded according to age, one rate up to age 30, another to age 40, and the highest rate over age 50. At some point Princeton changed its plan, but let existing faculty elect to continue on the "old plan." The new plan was more generous up to age 50 and less generous than the old plan after age 50. I chose to stay on the old plan. By the time I reached age 50, most faculty members were on the new plan. Those of us who had survived so long at the University were, perforce, in the senior and hence better-paid ranks of the faculty. At that point it was determined that the old plan discriminated in favor of better-paid employees, and was therefore ineligible for favoral tax treatment. We had to switch to the new plan, notwithstanding the fact that we had just reached the point where our persistence in the old plan was about to pay off!

Believe it or not, my objective here is not to plead for relief from this injustice, but simply to call attention to one of the most complex areas of the tax law. Practitioners know how difficult it is to assure compliance with the law, and how much talent is devoted to designing plans that fit within the regulatory constraints. Yet the contractual relations between employer and employees serve a large variety of economic functions. As with financial innovation, we are, on the one hand, wasting resources figuring out how to make the arrangements that most exploit the tax advantages, while staying within the law, and on the other hand, tying the hands of our employers and employees in reaching the most effective compensation arrangements.

Capital Gains

My third example probably explains itself: capital gains. It used to be said that half of the business of a tax accountant or lawyer was converting ordinary income to capital gains. The other half was converting capital losses to ordinary income losses. This was especially true when the difference in the rate of tax applied to the two types of income was larger than it has been until recently. But the difference has widened again. And in any case, because of the necessity to limit capital losses, the rules that distinguish the income according to its ordinary or capital gain "character" have continued in force and account for many inches of tax law books.

In view of the interminable controversy about capital gains taxation, it need hardly be said that the rules involve much more than fees for accountants and lawyers, but enter into every aspect of the business life of the country, with costly effect.

All three of these examples have in common that they are sources of great complexity and impose serious costs on the U.S. economy. These costs are not borne just by the businesses and individuals who must directly comply with the rules in question. Like banking laws or securities laws or telecommunications regulations, the costs that they impose are spread throughout the economy, striking workers and consumers at all income levels.

The second thing these three examples have in common is that the harm they cause could be easily avoided by adopting a consumption-based tax system.

Why A Consumption-Based Approach Offers the Solution

Cash-Flow Accounting Gets the Right Answer in a Consumption-Based Tax

Tax specialists generally take as a standard an idealized concept of a person's income, often referred to as *accretion* income. Accretion income is defined as the *sum* of what the person consumes during the year, and the *increase* in the person's *wealth*. The first component is, obviously, consumption, and the second is the economic definition of *saving*. So accretion income is defined as the sum of consumption and saving.

To the uninitiated, it usually seems odd that what theorists mean by income is something that looks more like *outlay* by the person on consumption and the acquisition of assets (or reduction of indebtedness). To the uninitiated, income is, logically, something that comes *in*, like wages or dividends. This view is almost certainly what the enactors of the income tax had in mind, but in the process of trying to impose consistency on a variety of cash inflows (for example, the proceeds from the sale of an asset like a house), tax rule-writers concluded that it was the underlying power to consume, either exercised currently or accumulated for future exercise, rather than the flow of incoming cash, that constituted the essence of income as a measure of ability to pay. So income tax rules are designed to take information on transactions such as receipt of wages or dividends or the proceeds of the sale of an asset and convert it to a measure that reflects the sum of a person's consumption and saving (increase in wealth) during the year.

In an ideal income tax accounting system, all changes in a person's wealth are tracked and subjected to tax (or tax relief, in the case of a decline in wealth). In the practical income tax world, not all wealth changes are taken into account. The unrealized capital gain in a person's portfolio of stock is a notable example. But practicality is not the only reason the actual tax system contains many deviations from accretion income. The special rules that apply to retirement savings, for example, are intended to alleviate the burden on saving that is characteristic of an income tax. Indeed, one could say that the existing system is notable mainly for its remarkable *inconsistency* in taxing accruing income. To cite just one other example, the corporation income tax, viewed as part of a system to measure and tax people's income, is largely uncoordinated with the individual income tax.

In comparison with a consumption-based tax, an income tax is inherently difficult to administer because in order to tax income consistently accruing wealth has to be measured. By contrast, correctly taxing consumption requires simply keeping track of cash flow.

The importance of this apparently technical, accounting point cannot be exaggerated. The hardest part of measuring income is tracking changing wealth.

Again, capital gains provides a good example. If for no other reason than that it is impractical to measure what has happened to the value of a person's assets except when they are actually sold, gain or loss is taken into account only at that point. This would not necessarily be serious except that where rules for measuring accruing wealth are inconsistent, there is generally an opportunity for taxpayers to profit by taking offsetting positions. One position produces a current loss on the tax accounts, while the other position produces an equivalent gain that is deferred into a future year. Positions that are exactly offsetting from a true economic point of view, are not offsetting from a taxable income point of view.

To plug the revenue leak, Congress and the Treasury have to write special rules. Because there is always some inconsistency left, taxpayers devise further ways to profit at the expense of the fisc. The tax-rule writers are always playing catch-up ball, and the system becomes more and more and more complex.

Contrast this accounting problem with the way a sequence of transactions leading to a capital gain is properly taxed in a consumption-based system. There are basically two possible approaches: Either the cost of the asset is deducted from the tax base at the time it is acquired, in which case any cash proceeds arising by virtue of holding the asset, including the proceeds of sale of the asset, are included in the tax base. Or the cost of the asset is not deducted on acquisition, and the return flow is ignored in the calculation of tax. (This would, for example, be the way the transaction would be treated under a value-added tax.) Either approach is simple, gives rise to no special incentive effects (such as the lock-in effect that characterizes the realization treatment of capital gains in the present tax system), and gives the right answer. In a consumption-based system, we could throw away the distinction between ordinary income and capital gains. Think what that would do to the law books. Think what it would do to the everyday economic affairs of the country.

The rules relating to retirement saving alluded to in my second example, compose another extremely complex area of current law. In this case the source of the problem is the special treatment of retirement saving that we have adopted as a matter of policy. Qualified retirement saving is accounted for on consumption-tax principles: the amount saved is deducted from income (or simply not included, when it is put aside by the employer), and no tax results until there is a cash flow to the beneficiary at the time of retirement. This cash-flow accounting is an entirely natural approach. But it is inconsistent with proper accrual accounting, which would not allow a deduction for (or exclusion of) the amount put aside, would tax the earnings on the savings as the amount grew over the years, and would not tax the benefits, any more than withdrawals from one's savings account are subject to tax.

"Proper" accounting for the pension saving probably sounds bizarre to anyone other than an income tax expert, and I would guess that the treatment of qualified pension plans was thought of as no more than the natural way to handle them when the income tax was young (and had low rates). The problem is that the inconsistency in treatment of this form of saving and, say, putting money in a savings account, meant a payoff to tax planning. There was money to be made by borrowing with the left hand and putting the money away in pension savings with the right hand. The taxpayer's true economic position was unaffected by this combination, but it gave rise to deductible interest payments currently, offset by an inclusion in income in the future.

Games of this sort are worth more, the higher the applicable tax rate and the lower the cost of the needed transactions. When tax rates got high enough, the needed transactions began to be available more cheaply and those with the highest tax rates took most advantage of tax-deferred retirement saving. The result was the phenomenon of highly paid executives making extensive use of pension savings, while low paid rank and file workers did not. Policy makers saw in this absolutely predictable pattern of use of pensions an unfair distribution of a "tax preference," and so we have "anti-discrimination" rules, some of the most arcane provisions of the tax code.

In a consumption-based system, cash-flow treatment of retirement saving is nothing more than one of the two correct and consistent ways of accounting. In a consumption-based system, we could throw away the antidiscrimination rules, along with all the other

retirement income regulations (insofar as their purpose is to limit the use of the "tax preference" in the current system).

A Consumption-Based Tax Is Feasible

Currently, there is active discussion of three reform plans:

- a retail sales tax or a value-added tax,
- the Flat Tax,
- the Nunn-Domenici Unlimited Savings Allowance (USA) Tax.

In terms of implementation, these three reforms have certain features in common. The first approach, a retail sales tax, is a proportional tax paid by businesses. The second and third, the Flat Tax and the USA Tax, both constitute integrated systems, consisting of a proportional tax paid by businesses, more or less similar to a value-added tax, and a personal-level tax, along the lines of the existing individual income tax. In the case of the Flat Tax, the individual tax is imposed only on a person's compensation, such as wages and salary. The individual-level tax in the USA system is an example of what has come to be called a "consumed income" tax, which is to say, it is based on something like the present taxable income with a deduction for net saving (and inclusion of net dissaving).

All three systems are conceived of as replacements for the federal income tax, both corporate and individual. In addition, the USA Tax integrates the social security taxes through a system of credits. All three approaches would shift the U.S. tax system to a consumption base.

Why a Consumption-Based Tax is Fairer Than an Income-Based Tax

It seems to me that the fairness of a tax system is its most important property. If people do not feel that the tax system is fair, they will try to evade the tax, or they will change it through the political process.

Fairness is, however, not a scientific concept, something that we can measure objectively. Some people think the tax system should be more progressive, some less. Some think there should be better provision for charities, or older citizens, or children. The choice between income and consumption as a tax base is independent of these debates.

The administrative advantages of a consumption-based approach really cannot be denied. But clearly administrative advantages are not the only important characteristic of the tax system. Do we perhaps need to accept the huge complexities and wasteful incentives in the present system in order to serve the goal of fairness in distributing the burden of tax?

Many people feel that an income tax is the fairest tax, but that we should adopt a consumption-based tax because it would encourage saving. I disagree with this on several counts. Most important, in my view, a strong reason for adopting a consumption tax is that it is fairer than an income tax.

The central issue is this: As between two people *who are similarly situated in terms of their economic opportunities*, the tax system should not assign a greater tax burden to the person who postpones consumption, relative to the person who consumes in the present.

It seems to me that an argument could be made that the person who postpones consumption, saves, in other words, should be rewarded with a lower tax burden. To listen to the rhetoric about encouraging saving, one would think this would be the position most people would take. I, myself, think that people should be free to decide for themselves, neither rewarded nor penalized by the fiscal system for their choices. That is, in my view, savers and dissavers should be treated alike.

An income tax, by its nature, penalizes savers. To me, this seems inherently unfair. A consumption tax imposes the same burden on the saver and the dissaver. (I

would not describe them as saver and consumer, because the matter is one of timing. The present saver is a future consumer.)

To be sure, the unfairness of an income tax, relative to a consumption tax is not fatal. The two tax bases have much in common. But of the two, the consumption base seems to me to occupy the high ground on the criterion of fairness.

There are many plausible arguments to the contrary. Most of these concern progressivity and are based on a mistaken view that a consumption-based tax is less progressive than an income-based tax. Progressivity is a characteristic that is designed into a tax system (or, rather, into a fiscal system more broadly conceived, encompassing expenditure and transfer programs as well as taxes). There is nothing that makes an income tax inherently more progressive than a consumption tax. The degree of progressivity is a policy choice under either approach.

Under some versions of consumption taxes (for example, the Flat Tax), people are not obliged to report and pay taxes on dividends, interest, or capital gains. It is not surprising that observers would conclude that such a tax must not be very progressive. One imagines a millionaire, sitting on his terrace sipping a Martini, not paying any taxes. But the image is a trick and the conclusion is false, because it is based on reasoning that stops short of looking behind the dividends, interest, or capital gains to the tax treatment of the businesses that create them.

I am told that the American electorate will never be able to understand this point. It may be so, but I doubt it. I think that if political leaders thoroughly grasp the way a consumption-based tax system works, they will themselves be convinced of its superiority and will in turn be able to convince the electorate.

As in other realms of policy, one might decide to impose an unfair tax system if it were needed to serve some other public purpose. But the contrary is the case. On all other counts -- administrability, compliance cost, interference in economic decisions -- an income tax (even a much more consistent one than ours) is inferior to a properly constructed consumption tax.

Why a Consumption-Based Tax is Conducive to National Prosperity

The advantages of a consumption-based tax in terms of improved incentives to save and invest, and, equally important, in terms of equalized treatment of investments of all types and by all people, are going to be emphasized sufficiently by others on today's panel. I would like in this connection simply to reiterate the advantages of the reduced regulatory burden. By replacing an outdated and unnecessarily costly regulatory system with a consistent, simple system, we can reap gains for everyone in the U.S. economy. This is the true meaning of international competitiveness, and it has the advantage of allowing us to gain at no cost to the rest of the world. Indeed, if the rest of the world follows our example the benefits will be multiplied.

I hope the time is approaching when we will make the move.

Chairman ARCHER. Thank you.

Our last witness is Gary Hufbauer.

STATEMENT OF GARY C. HUFBAUER, REGINALD JONES SENIOR FELLOW, INSTITUTE FOR INTERNATIONAL ECONOMICS

Mr. HUFBAUER. Thank you, Mr. Chairman.

I want to generically refer to all the proposals for reform—the retail sales tax, the flat tax and the U.S.A. tax—I want to refer to all of them as taxes on business activity. My statement concentrates on the business side, not the personal side, of tax reform.

There are two strong arguments for a TBA system, a tax on business activity. One is the savings/investment argument. A TBA system will boost savings and investment. And the second argument is the complexity argument. A TBA system will cut through our grotesquely complicated tax system.

I have been invited to discuss the international side of a tax on business activity. There are two broad principles of dealing with the international side of a tax on business activity. One is the so-called destination principle of border tax adjustments. I realize that is a mouthful. The destination principle taxes goods and services where they are used or consumed. What that means, in practice, is that goods or services exported from the United States would be relieved, exempted of any of these TBA taxes. The goods and services will be taxed, if at all, where they are consumed—Germany, Japan, or wherever.

Conversely, goods and services imported into the United States will pay a tax at the border when they come into the United States. Some services will arrive electronically, for example, value-added telecom services. Merchandise will arrive at the various customs districts. Taxation upon arrival is the destination principle.

There is a second principle of border tax adjustment. It could be called a principle of nonborder tax adjustment. Under the origin principle, goods and services are taxed only where they are produced. In the case of a tax on business activity paid in the United States, there would be no adjustment when the goods and services are exported and, conversely, when goods and services are imported there would be no tax placed on them at the border.

The origin principle is the current system with respect to the corporate income tax. We do not remit the corporate income tax when goods and services are exported that are produced in the United States, and we do not impose a corporate income tax on goods and services that are imported from abroad.

Let me discuss quickly how these two different principles deal with three important issues: First, how the principle chosen deals with price distortions which are a feature of nearly every tax system; second, how the principle chosen affects the trade balance, sometimes referred to as the current account balance; and third, how the principle chosen facilitates the transition from one tax system, namely what we have today, to a new tax system, one of the TBA reform proposals.

So, first, the price distortion question. A choice must be made between two evils, if you will. One is distortion of prices in consumption. The origin principle minimizes price distortion at the consumption level. This principle means that the prices in the United

States will be largely dominated by world prices, because goods and services will be imported at world prices, and U.S. exports must be priced to meet world prices, so that export firms will tend to price the same in the United States as they price abroad. So the origin principle minimizes distortion at the consumption level.

But the destination principle minimizes distortion at the producer's level. What the destination principle does is ensure that producers, when they sell abroad, get world prices because the U.S. taxes don't affect them. Meanwhile, when goods and services are imported, consumers pay U.S. tax at U.S. rates, so U.S. producers are not disadvantaged by comparison with their foreign competitors.

Between these two principles, I think it is much more important to minimize price distortion at the producer's level. If there are questions of why that is so, I can give some examples. They are set forth in my testimony. I think reflection will show that reducing price distortions facing producers is a much more important principle in our economy. For that reason, I favor the destination principle.

Let me quickly turn to the issue of impact on trade balances. Briefly, choosing one or the other of these principles will make no longrun difference in the trade balance. The U.S. trade balance is determined by our savings and investment decisions. The change in the tax system will change those decisions. That will affect the trade balance; whether we choose the origin or destination principle will not make a difference. It may make a difference in the extent of necessary exchange rate adjustments, but that is all. So I would dismiss trade balance arguments as a reason for choosing between these two principles.

Let me come to the critical reason for favoring a destination principle approach, and that is the transition from the old system to the new system. Any transition will entail higher taxes on some producers than they pay today. And those producers will be extremely concerned about being disadvantaged in world markets, disadvantaged when they export because they are paying higher taxes than they were before, and disadvantaged by comparison with competing imported goods and services because they are being taxed and their import competitors are not.

So I think it is terribly important to have the destination principle border tax adjustment for a new TBA system. I think that the ability to have destination principle adjustments should work into the evaluation of the various TBA systems.

I think it is quite clear that the retail sales tax is adjustable at the border under the destination principle. I think the U.S.A. tax is also adjustable. However, I have not had time to study the flat tax in this important respect.

Thank you.

[The prepared statement follows:]

TESTIMONY OF GARY C. HUFBAUER
INSTITUTE FOR INTERNATIONAL ECONOMICS

A TAX ON BUSINESS ACTIVITY AND BORDER TAX ADJUSTMENTS

It is a pleasure to appear before the Committee. Today, I intend to briefly discuss the international consequences of reforming the current tax system by replacing large portions of the current system with a tax on business activity (or TBA system).[1] There are two strong arguments for a TBA system: it should increase private savings and investment and it would certainly simplify the grotesquely complex U.S. tax code.

Over the past decades, various TBA systems have been proposed. In 1969 President Nixon considered a federal VAT to finance the reduction in local property taxes or the federal corporate income tax. Other initiatives were considered in the ensuing two decades. More recently, in 1993, Senators Sam Nunn (D-Ga) and Pete Domenici (R-N.M.) propounded the Unlimited Savings Allowance Income Tax System (the USA Tax) and, in 1994, Representative Armey (R-Tx) proposed a flat tax.

My testimony focuses on five issues related to a TBA system:

1. To what extent a TBA system would promote savings and investment.
2. Different principles for adjusting taxes at the border.
3. How border adjustments compensate for price distortions.
4. Whether border adjustments would affect the trade balance.
5. How border adjustments would facilitate the transition to a new tax system.

1. Promoting Savings and Investment

A TBA system would encourage savings and investment. The rationale is simple: unlike the present system, savings and investment would either be untaxed, or taxed at a lower rate, under a TBA system.

A higher U.S. savings rate is widely regarded as an essential ingredient for maintaining annual economic growth at 2.5 to 3.0 percent over an extended period of time. The Competitiveness Policy Council recommends an increase of the national savings rate by 5 to 7 percentage points of GDP in order to finance larger national investment, and hence a higher trend rate of growth.[2] The U.S. investment rate has long been lower than the rates of other G-7 countries. For the other G-7 countries in the 1980s, the unweighted average gross investment rate was 22 percent of GDP versus 19 percent in the United States.

Low U.S. investment rates are directly attributable to the low U.S. savings rate. Even in today's world of high capital mobility, low domestic savings lead to low domestic investment. OECD statistics show that the United States now has one of the lowest gross savings rates of any G-7 country: gross saving as a proportion of GDP averaged 18 percent in the 1980s compared with an unweighted average of 21 percent for the other G-7 countries.[3]

Nearly everyone agrees that reducing the federal deficit is a sure way to raise national savings, at least by 2 or 3 percentage points of GDP.[4] Between the 1960s and the 1980s, the U.S. public accounts (federal, state and local combined) dropped from a positive 1.9 percent of GDP to a negative 2.9 percent of GDP.

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[1]For further analysis, see Gary Hufbauer, assisted by Carol Gabyzon, Border Tax Adjustments and the USA Tax, Institute for International Economics (unpublished), April 1995.

[2]Competitiveness Policy Council, Promoting Long-Term Prosperity, Third Report to the President and Congress, May 1994.

[3]OECD, OECD National Accounts, Paris 1994.

[4]See for example, Competitiveness Policy Council, Promoting Long-Term Prosperity, Third Report to the President and Congress (May 1994).

Recent federal budget decisions, with the implied reduction of public spending, seem likely to reverse this path.

Few if any TBA advocates suggest that a tax on business activity should be added to the existing tax structure. Instead, they see the TBA system as a replacement for personal and corporate income taxes. The debate, therefore, concerns the impact of a revenue-neutral TBA system both on private savings -- namely the combination of household savings (e.g., pensions) and corporate savings (retained earnings) -- and on private investment.

The savings impact of a TBA system depends on how the new system changes private behavior. My opinion is that heightened public awareness of the importance of savings that would come with an historic shift from income taxation to the TBA system would make a positive difference in total private savings of 2 to 3 percentage points of GDP.

By enlarging the US savings pool, a TBA system would indirectly promote investment. In addition, a TBA system would directly spur investment because investment outlays would be expensed immediately. My guess is that the spur to gross investment rates might amount to 2 percentage points of GDP.

2. Principles of Border Tax Adjustments

Adjustments at the border for taxes on goods and services are an established practice in international trade. During the last two centuries, national laws and international agreements have progressively enlarged the scope of permissible border tax adjustments. The rules have been articulated both in national legislation and international agreements such as the Uruguay Round Agreement on Subsidies and Countervailing Measures.

Border tax adjustments are based on the destination principle of taxation which calls for taxing goods or services shipped across an international border only in the jurisdiction where the goods or services are consumed. The destination principle is applied via the non-excessive remission (or exemption) of taxes when goods or services are exported and the equivalent imposition of taxes when like goods or services are imported.

By contrast, the origin principle of taxation calls for the taxation of all goods and services only in the country of production, irrespective of where the goods or services are consumed. Under the origin principle, there can be no remission (or exemption) of taxes when goods or services are exported and there can be no imposition of corresponding taxes when like goods or services are imported. In other words, under the origin principle, there are no adjustments at the border.

There are three main consequences of the choice between the destination principle (which complements taxation at the consumption stage) and the origin principle (which complements taxation at the production stage):

- How the principle chosen addresses the price distortions which are an inevitable complement of almost all tax systems;
- The extent to which border adjustments affect the trade balance; and
- The extent to which they facilitate the transition between tax systems.

3. How Border Adjustments Compensate for Price Distortions

Nearly every tax system distorts prices in an economy. The question therefore is which principle of border adjustment -- the origin principle or the destination principle -- better compensates for tax-induced price distortions.

In select circumstances, the choice between the destination and the origin principle in fact makes no difference. If the tax in question is a general tax, namely one that applies proportionately to all goods and services produced in the economy, or to all factor incomes earned in the economy, and if all prices

and wages are flexible, and if factor supplies are inelastic, then in the long run it makes no difference to a country's economic structure whether it chooses the origin or destination principle. Under these highly restrictive circumstances, the underlying tax system will not distort relative prices, and any border adjustment is akin to an exchange rate change.

However, in most circumstances, these restrictive conditions are not met, and thus the choice between border adjustment principles has important economic implications. Moreover, the short run matters as much as the long run, especially when making big changes from one tax system to another. To be specific, the origin principle will minimize price distortions facing consumers, since purchasers can still buy at world prices. By contrast the destination principle will minimize price distortions facing producers. In my opinion, it is far more important to minimize price distortions facing producers.

Talk of "price distortions facing producers" is, in fact, a rather antiseptic way of describing real world events. For example, if U.S. producers of computer software must pay a 10 percent tax on sales, when other U.S. products are taxed at 5 percent, and if sales taxes are not adjusted at the border, it seems very likely that U.S. software firms will decide to make their diskettes in Canada, Korea, or France. The reason is that any compensating exchange rate change will not affect the heavily taxed computer software firms any more than it affects the average sector. Therefore, computer software firms will have a harder time retaining skilled workers. The result will be the closure of plants in places like Seattle and Boston -- costing thousands of jobs. In other words, when it comes to taxes that are unevenly applied to different activities, only the destination principle can effectively prevent the contraction of industries that are more heavily taxed than other sectors of the economy.

In this example, destination principle border tax adjustments will give a larger export exemption to computer software firms (10 percent) than to average firms (5 percent). Correspondingly, it will apply a higher compensating tax on imported computer software (10 percent) than on average imports (5 percent). These differences will enable Seattle and Boston to retain their competitive edge in the computer software industry. The same illustrative example would be relevant if a shift from tax system A (the current US tax code) to tax system B (a TBA system) resulted in a bigger tax increase on computer software firms than on average U.S. business firms.

To some degree, national and international rules have evolved to accommodate these practical concerns about output effects. Indirect taxes can normally be adjusted at the border. Since the core definition of indirect taxes includes excise and sales taxes, a country can elect to apply the destination principle to those taxes that most conspicuously differ in their burden from sector to sector. However, international rules do not permit direct taxes to be adjusted at the border. Corporate income taxes and social security charges often differ considerably from sector to sector, but variations in their burden cannot be compensated by destination principle border adjustments since these taxes are defined as direct taxes.

The Uruguay Round Agreement on Subsidies and Countervailing Measures makes the distinction between direct and indirect taxes as follows:

> Direct taxes are defined as "...taxes on wages, profits, interests, rents, royalties, and al other forms of income, and taxes on the ownership of real property..."
>
> Indirect taxes are defined as "...sales, excise, turnover, value added, franchise, stamp, transfer, inventory and equipment taxes, border taxes and all taxes other than direct taxes and import charges..."

Where do TBA systems lie on the spectrum between direct and indirect taxes? I cannot comment on all TBA systems, because I

USA Tax, and I am convinced that it is adjustable at the border under current GATT (WTO) rules. The reasons are spelled out in another paper.[5]

4. Impact on Trade Balances

Many businessmen see destination principle border tax adjustments as conducive to a national trade surplus. However, in the long run, the choice between origin principle and destination principle border tax adjustments exerts little or no impact on national trade balances. Instead, trade balances reflect savings and investment balances in each national economy.

The structure of a country's tax system may alter its savings and investment balance; if so, there will be an impact on its exchange rate and its trade balance. But whether or not taxes are adjusted at the border will have little effect on these fundamental forces. If the tax system is reformed, and if the reform alters the balance between savings and investment, and if the new taxes are not adjusted at the border, then the country's exchange rate will change to accommodate the new tax system. Conversely, if the new taxes are adjusted at the border, then the exchange rate may not have to change so much to accommodate the new system. As far as the trade balance is concerned, therefore, destination principle border tax adjustments can be seen as a substitute for exchange rate changes.

To summarize: border tax adjustments are not required to ensure that the trade balance responds to the new savings-investment balance. However, border tax adjustments may facilitate the required adjustment and require less move in the exchange rate.

5. Facilitating the Transition to a New Tax System

These statements about the interchangeability of border tax adjustments and exchange rate changes are sound as long-run technical propositions, but they miss the short-run political economy of radically reforming a country's tax system.

The fundamental reason for border tax adjustments is neither to alter the nation's trade balance nor to find a substitute for exchange rate adjustments. The fundamental reason for border tax adjustments is to deal with the burden on sectors that are more heavily taxed under the new system than the old. Any TBA system will impose higher taxes on many business firms than the current corporate income tax, both because some firms pay little or no tax under the present complicated system and because, under some TBA systems, a larger portion of wage taxes will be paid at the corporate level.

Producers that suddenly find themselves paying more taxes than before will inevitably (and rightly) worry that the new TBA system will erode their ability both to sell abroad and to meet the competition of foreign firms in the U.S. market. This fear is best answered by destination principle border tax adjustments. Such adjustments will help many U.S. firms accept reform of the U.S. tax system. In fact, it is no exaggeration to say that, without the feature of destination principle border adjustments, it may be impossible to gather the requisite political support to enact a TBA system.

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[5] See Gary Hufbauer, assisted by Carol Gabyzon, Border Tax Adjustments and the USA Tax, Institute for International Economics (unpublished), April 1995.

The views expressed in this statement are those of the author and do not necessarily reflect the views of individual members of the Institute's Board of Directors or Advisory Committee.

Chairman ARCHER. Thank you, Mr. Hufbauer.

I understand that both Dr. Boskin and Professor Bradford have to leave in 10 minutes. Do you have any other time constraints, Mr. Hufbauer?

Mr. HUFBAUER. I can stay.

Chairman ARCHER. I would ask that in the limited time available for Dr. Boskin and Professor Bradford that the questions be directed to them.

Mr. Zimmer.

Mr. ZIMMER. Thank you, Mr. Chairman.

Dr. Boskin, you raise the problem of the mutability of the Tax Code in your testimony, and it seems that over and over again in our history we have been subjected to a bait-and-switch technique where there is a flat, low tax imposed and then the rates go up, most recently in 1986 when the deal was that the many deductions would be eliminated in exchange for lower marginal rates which are now more than 40 percent higher than they were at the time.

As we try to get this right, can you advise us as to how we can protect against this phenomenon and the related phenomenon of putting more loopholes in the Code as the nominal rates go up?

Mr. BOSKIN. I think that is a very good question.

I think there are two things. I personally favor a supermajority for tax rate increases. I know that has been discussed and is under consideration, and I would hope there would be an opportunity for the Congress to reconsider that in and of itself, perhaps even in House rules, as opposed to just as a variant of a balanced budget amendment.

Second, in the reform that you move to, if your reform really ties and makes obvious that the taxes are the cost of financing government spending, it seems to me that will exercise some constraint through the taxpayers.

One problem we ought to be worried about is if taxes are very much hidden. There are people who complain that withholding does that in the existing system or that a value-added tax might be somewhat hidden. I personally think that we need to make it more obvious that the tax system is the price we are paying for government spending—or the current taxes and the future taxes, if we are deficit spending, are the price we are paying. And I think that will help ensure that the taxpayers themselves will exercise great restraint through their voting in elections.

Mr. ZIMMER. Mr. Bradford, do you have any thoughts on that?

Mr. BRADFORD. I would join Mike Boskin in saying something like requiring a supermajority for rate changes would seem a reasonable thing to do. One reason it is very important is not simply that politically one may like lower rates, but also in a tax system of the type we are talking about, the incentive effect on investment is very strong. If you anticipate an increase in the rate, let's say, of a value-added tax or a retail sales tax or flat tax, there is a strong incentive to postpone investment; and it would be very important from the point of view of the stability of the economy to assure against very sharp increases in rates. And decreases are mischievous, too. So I endorse that idea.

There is another possible mechanism that could be built into these systems, and that is, in effect, the use of the IRA-type device,

which allows people, in effect, to lock in the rates that prevail at the current time. That would be too far afield to discuss that further now, but I think that could also have a stabilizing effect and that could be very important.

Mr. ZIMMER. Professor, I appreciate your being here, Princeton is in my district. I appreciate your clarity. I must confess that Princeton is the only community in my district where people complain that taxes are too low, but not necessarily their own taxes.

Let me ask you a fundamental question, both of you. When we considered the tax cut legislation earlier this year, some of our friends on the other side of the aisle differed with us on one of our principal premises, which is that changing the Tax Code can actually encourage savings and investment and economic growth. What would you say to those people and how can you convince them that in fact that will happen?

Mr. BOSKIN. I think there is no doubt fundamental reforms like moving to a retail sales tax or VAT or perhaps even to a flat rate, consumption-based income tax would increase the rate of savings and that would have all sorts of beneficial effects. The way I tie together the issue of a tax cut, why we are trying to slow the growth of spending to balance the budget is—the reason we want to reduce the deficit, in addition to the moral reason about liabilities to our children and grandchildren, is to free up saving to make it available to finance investment, so we reduce the government's drag. If you can, through capital gains rate reduction or an IRA or something of that sort, raise private saving—one of the two reasons we have the lowest national saving rate of any country in the world if we could simultaneously do that, then you are accomplishing with another leg of the stool the exact same purpose. That is how the two tie together.

If we could have prosaving, proinvestment, progrowth tax rate reductions and get enough spending cuts to finance them in the short term, before they have a chance fully to kick in and help the economy grow, those two policies complement each other. They are not substitutes.

Chairman ARCHER. The gentleman's time has expired.

Mr. McCrery will inquire and he will be the last inquisitor for Professor Bradford and Dr. Boskin.

Mr. MCCRERY. Thank you, Mr. Chairman.

I have a question that neither of you may want to answer, because Mr. Hufbauer punted on it. The question is "have you looked at the flat tax in terms of our ability to adjust it at the border under GATT rules"? Have either of you done that?

Mr. BOSKIN. I have thought about it. I am not a trade lawyer, but I do believe it is an open question. It may not be.

Mr. BRADFORD. I have the same impression. It is very much a legal question, as you have probably heard from other economists. Economists think, at least this economist thinks, that the distinction on which the rebatability or not of a tax turns is fundamentally a legal and not a real economic one. A tax that looks one way will be rebatable, and if it doesn't look right, it won't be even though it is economically equivalent.

I think that is the situation with the flat tax. The flat tax is economically identically equivalent to a value-added tax and should

therefore be rebatable. I am talking about the business tax rate on all exports and subject to imports, according to the same rationale as applies in the case of a value-added tax. I think it is very much an open issue, legally.

Mr. McCrery. As economists, do you think it is important that we consider that as part of the debate?

Mr. Boskin. I do. Gary sort of said this only affects the trade balance through its beneficial effects on the saving rate, and I would agree with that beneficial effect on balance, on the trade picture. But the notion that somehow this washes in exchange rates envisions a regime of permanently totally flexible exchange rates that totally adjust or a major adjustment in domestic prices. I think the world we live in now is a little bit different than that, and there is a lot of fixing and a lot of pegging and a lot of attempted intervention. So it is something that ought to be considered, but I also wouldn't assume that there would be no adjustment at all in exchange rates.

Mr. Bradford. I think I would be more on the side of saying it doesn't make much difference, but I would agree that the issue where it does make a difference is a matter of transition. Which way we did it wouldn't make any difference 5 years from now. But there are significant differences in the administrative problems that arise. For example, if you have a border tax adjustment and you have a tax of any significant size, or even not too large a size, you then have to assess the tax on the way in and you have all the problems of checking at the border when goods come in, the same as applying a tariff. Tourists would have to declare their goods and so forth. There are problems of that kind and differences in implementation that do matter.

For example, as to where you choose to locate a business, there can be a difference in the way these two taxes work out as a matter of implementation, and I think it is important to pay attention to that.

Mr. Boskin. I would stress that in today's world a larger fraction of firms and more and more industries find it easy and less costly to spatially separate their headquarters from their manufacturing, from their R&D, from their sales and marketing, and so forth. So I would be a bit concerned about being careful that any change we made in its border tax adjustments and its international features didn't wind up creating an additional incentive for firms to outsource some of their activity outside the border.

Mr. McCrery. Thank you, Mr. Chairman.

Chairman Archer. You gentlemen are 4 minutes past your deadline. I just want to quickly ask you this—when you responded to the flat tax, as to whether it is adjustable at the border, what is your definition of a flat tax?

Mr. Boskin. The definition I was using was the kind of Hall-Rabushka archetype that apparently forms the basis for the generic proposal that Majority Leader Armey has proposed, which I think has not been fully specified as yet. And the business side of that has a feature whereby capital income is taxed and wages are deducted and business investment is expensed in the year it is acquired. So it is from an archetype, not from a proposal that I have seen written down by the Joint Committee and laid out in law.

There are many other ways to have a single tax rate besides that, and various people have exemptions and deductions and other things they propose and other ways they would go about taxing some income at the business level, some at the personal level. I was responding to that generic idea, which is perhaps more common in academia.

Mr. BRADFORD. I would say the same. I have in mind the flat tax proposal that was authored by Robert Hall and Alvin Rabushka and appeared about 10 years ago and I think is the basis for systems currently under discussions as flat taxes.

Chairman ARCHER. Isn't that just a modified way to tax income?

Mr. BRADFORD. Yes.

Chairman ARCHER. I am not a legal scholar on GATT either, but it seems to me that when you are just having a modified method of taxing income, they are going to rule that that is not border adjustable and GATT-legal.

Mr. BOSKIN. That is definitely the argument. I think legally that is right, but I am demurring because I am not a lawyer.

Chairman ARCHER. David, I know you have to leave. I want to give you the opportunity to leave; and Dr. Boskin, if you need to leave, certainly take advantage of that.

Mr. BRADFORD. I think I had better go. Thank you very much.

Mr. BOSKIN. I will be happy to take a few more questions.

Chairman ARCHER. Would you like to respond to that, Mr. Hufbauer?

Mr. HUFBAUER. Since this has become an item of interest to Mr. McCrery and yourself, let me summarize what is a very complicated debate.

First, concerning a retail sales tax, there will be no issue in terms of the international rules whether it is or is not adjustable. It is adjustable; that is established international practice. I have a long paper I can give you on that matter.

Chairman ARCHER. Isn't that virtually a sine qua non, inasmuch as a sales tax wouldn't be charged in the first place and wouldn't have to be rebated?

Mr. HUFBAUER. When I use the word "rebate," I include both exemptions and remission. The retail sales tax follows an exemption approach.

Second, concerning the U.S.A. tax, if enacted and if we had destination principle adjustments for it, that will entail a big fight in the WTO. It will be a big issue internationally, and there will be a panel proceeding. When I say it is "adjustable," that is my judgment of how a fairly long international panel proceeding will come out. It will come out that the U.S.A. tax is adjustable. It is similar enough, in its business tax application, to the credit invoice VAT, that it will be adjustable.

The reason I raise a flag of doubt in the case of the flat tax as the one you referred to by my colleague Mr. Bradford, is under the flat tax, wages are a business deduction, which is not true in the case of the U.S.A. tax. With wages being a deduction, the flat tax as imposed on business firms has an appearance which is closer to the corporate income tax than the VAT.

And that is why the battle for destination border tax adjustments for the flat tax will be harder to fight, and harder to win, on legal

grounds. Let me take 1 more minute to step outside of current GATT law.

I also ventured the opinion, and I stick with it, that if the United States undertakes a major reform in its tax system, and if we determine that we want to adjust the new taxes at the border, the WTO will in turn accommodate us. In other words, if we lose the legal case, but we still want to adjust the tax at the border, my belief is the WTO system will adjust to our adjustment.

Now, there will be a lot of consequences of that adjustment. I won't take your time to go into them. But I think ultimately we can, if we wish, adjust even the flat tax at the border.

Chairman ARCHER. I don't want to belabor this issue, but I really worry about your last comment, for the reason that in the case of a consumption tax, you can relate the tax percentagewise to the price of the product. In the case of an income tax, there is no direct relationship to the price of the product. And even if you go to a flat income tax, how do you know what to take off of the price of the product?

Mr. HUFBAUER. This is the core of the legal debate: How closely can you link the tax in question, levied on some kind of income concept, to a product price. And with the retail sales it is a nice and clear link, or at least people think the link is nice and clear, and as you segue over to income taxes, the link becomes less clear.

If a flat tax is truly flat, the U.S. Government can, in its legal proceedings, commission a lot of authoritative studies from eminent economists urging that the tax is passed on, akin to a retail sales tax, in product prices. Therefore, adjustment at the border is appropriate—here I am telescoping a very long debate here into a few sentences—and that argument gives us a possibility for winning.

But the less uniform the tax rate is, the more there are the kinds of loopholes and deductions we have in our corporate income tax system, the harder and harder it is to identify the tax with price shifting effects. In turn, that weakens the legal argument for adjustment at the border.

Chairman ARCHER. Thank you very much.

Mr. Rangel.

Mr. RANGEL. Thank you.

My question is one to both of you as economists. Do you believe that there should be any relationship in the type of tax collection system that we acquire to the type of services the central Federal Government would render?

The reason I ask the question is that I am constantly reminded that governments who use the value-added tax seem to be governments that provide a broader-based social service network. And I am not saying that that is the correct thing to do, but I am really asking, when you are determining a tax system that would be best for the United States, is there any relationship at all to the services that the government provides?

Mr. BOSKIN. Certainly, and the causality I think goes in both directions. If you have a very low-rate, broad-based tax, for example, you are causing much less compliance and distortion in the economy, so that weighs to being able to finance, if you can do it efficiently, other services.

Mr. RANGEL. When you say, Doctor, efficiently, I would want to really know, what would you think those services should be in the first instance. In other words, if we decide that we are not going to get involved in the health care industry, then I assume that someone else would have to think of how do you provide incentives to assure access to health.

Mr. BOSKIN. Well, I think that debate is one we will continue to have, and whether we should do a variety of reforms, allow the private sector to do that, or whether the Federal Government should primarily be an insurer—making sure everybody can have catastrophic insurance and so on, is not an issue I propose to get into here. But I think that is one that is worth enjoining.

My basic point is the history has been that when new tax devices are piled on top of old tax devices, they have not really replaced the old devices. So in my testimony earlier, in my introduction, I said, let's make sure if we move to a new tax which is superior in a number of dimensions, such as a broad-based consumption tax, let's make sure we don't wind up getting both, unless we really want to see a big expansion of government.

Mr. RANGEL. No, I am talking to you, both of you, on the basis that we are starting this thing all over. We are starting from scratch. We are not building on anything. And the question would be, if we were starting from scratch, would you not as economists want to know, well, what is it that you want to provide as a nation before you can determine the system that you are going to collect the revenues?

Mr. BOSKIN. You are exactly right. I say that in my written testimony, we ought to think of the tax system and the outlay side of the budget simultaneously, there is no doubt about that.

Mr. RANGEL. Great. Because my basic question would be, what—as you envision the most effective way and least complex way to collect the tax, what do you believe the national responsibility should be? Besides national defense, which is just number one, is there any other responsibility you think that we should have as a debit? Maybe for political purposes we will keep Social Security so you won't have to worry about that.

Mr. BOSKIN. Well, I think between the Federal and State and local governments, the proper assignment of authority, among which——

Mr. RANGEL. Stick with me, Doctor, because anything that we decide we are not going to do, we would assume that we are going to lower the tax base sufficiently so that local and State government could decide what they would want to do and pick up the taxes. So we will assume anything that we don't do, they can or cannot do.

But I am talking about in terms of mandates, entitlements, do you see anything that we should do as a Federal Government, besides national defense, and now that we are stuck with Social Security, we will keep that for a while, but anything else?

Mr. BOSKIN. Yes, I believe there are a variety of functions the Federal Government should either perform or finance. However, I do believe that in most instances, the Federal—not all, but in most instances the Federal Government has gone too far or they are projected——

Mr. RANGEL. I agree with you 100 percent, but we are starting from scratch. What type of things do you think that we should do?

Mr. BOSKIN. For example, I think there is a national interest in funding certain—in helping to finance certain types of research that individual firms cannot capture the benefits of and would not get done otherwise.

Mr. RANGEL. OK. So we are joined in——

Mr. BOSKIN. I think you have to be very careful about where you draw that line. I think everybody will come in and claim that their research satisfies. And that is a problem in all these cases, sure.

Mr. RANGEL. I know, but let me be more specific. How about education and housing and nutrition programs and health; you think they could come up to the priority of sharing in research?

Mr. BOSKIN. I am a strong believer in a humane but cost-conscious social safety net. I believe we have not been as cost conscious as we should be. We have transfer payments that transfer lots of resources to upper middle income and higher income people. And we are not doing as careful a job at targeting effectively, and from the recipient's point of view and efficiently from the taxpayers' point of view, in our broad social programs to provide that safety net.

Mr. RANGEL. My time has expired, but you are saying that we should continue some of these programs in a more effective way?

Mr. BOSKIN. Yes, although some of them I would devolve to the States, others I would continue at the Federal Government, others I would aim the slowdown in the projected growth of spending disproportionately at people beyond some minimum level of income.

Mr. RANGEL. Is that in your paper?

Mr. BOSKIN. Only the generic statement that we should be thinking about the outlay side of the budget and the tax side of the budget, both.

Mr. RANGEL. OK.

Thank you, Madam Chairlady.

Mrs. JOHNSON OF CONNECTICUT [presiding]. Thank you, Mr. Rangel.

Mr. Boskin, another way of asking the same question that my colleague from New York was discussing with you, is the following: Do you think the economic impact of an extremely simple system, whether it is U.S.A. tax or a VAT or whatever, is worth sacrificing any use of the Tax Code to encourage any specific activity?

In other words, is it worth eliminating the R&D tax credit, eliminating any mortgage deduction, eliminating any deduction for health premiums, any incentive for pension savings, any encouragement of education?

You know, those are all social policies that we pursue through the Tax Code. And as we talk about simplicity, and in your testimony you specifically said let's broaden the base and lower the rate, so if you are going to really broaden the base, you have to eliminate any incentives or any deductions. And those deductions currently go primarily to research, education, and to a much lesser extent some historic preservation. It is really education, research, home ownership, a few basic activities that we have put a very high value on in our society.

Do you support eliminating absolutely all of those?

Mr. BOSKIN. My own preference would be if we kept an income-type tax, although it wound up allowing an unlimited savings deduction, a la Nunn-Domenici, or the alternative flat tax approach which would exempt capital income and so on. Let me point out that those would provide more incentives for saving and so on than the current system does.

And while—a truly broad-based consumption tax, if you had everything, all consumption in it, would have a tax base that is far larger than the current base of the income tax, even though you are exempting certain things, because we have a tax base of the personal or corporate income tax is only a very modest fraction of personal income in the country.

There are obviously a large number of deductions, any one of which originally was put in for some noble purpose, and some of them may indeed be achieving some of those noble purposes. The two I worry most about, although I would not reject out of hand the prospect of eliminating them, but the two I raised as specific examples, and undoubtedly there are many and everybody has their own list, in my testimony, were if we kept the income-type tax, are the deduction for charities and the mortgage interest deduction.

And the reasons I mentioned those are twofold. One is I think there is a great benefit in a pluralistic society to having many institutions doing good works rather than to having—relying more heavily on the government to provide the services that charities provide. And there is ample evidence that the tax deduction is an efficient—matter of fact, the evidence is my own work with Martin Feldstein for the Filer Commission—that charities get more than the Treasury loses from the deduction.

The mortgage interest deduction is a slightly different story. We do have a tax system that heavily biases investment toward investment in owner-occupied housing, as opposed to other types of savings and investment. And it would be—there is an open issue whether we are getting enough as a society out of that to justify the existing level, whether the cap should be brought down, whether it should be eliminated or kept where it is.

One thing I do know is if we move to eliminate it, that we would—not only would people as they wrote their tax checks have a slight change, but the value of their homes would be reduced because the value of their home capitalizes the value of the mortgage-interest deduction. So I would be concerned to have two-thirds of the families in the country all of a sudden have the value of their largest asset decline. So I would be cautious before I did that in thinking it through.

Mrs. JOHNSON OF CONNECTICUT. And you would make no differentiation among businesses that are capital intensive and businesses that are not capital intensive, and you would be willing to eliminate the current incentives for health benefits and for education?

Mr. BOSKIN. As a general matter, yes. I think the education benefits, most of the cost of education is foregone earnings, unless you are going to somewhere like Stanford which is extremely expensive. And that is treated obviously as if it is immediately expensed.

With respect to health benefits, I think there is an issue but I would deal with this in the context of health reform. I personally believe one of the problems we have is that the price of health is not perceived at the margin by the consumers, and that is one reason we have gotten into the health care cost problems that we have seen in the last decade.

Mrs. JOHNSON OF CONNECTICUT. Thank you.

I am going to move on to another Member, but when you say the problem with education incentives is that it mostly has to do with foregone earnings, that is a big problem. And we have had hearings recently on the tax incentives to help people get the education they need to earn at higher levels. And it is very hard for middle-class working people to move up. Those breaks that we give them are material to their ability to do it. And the cost to the foregone earnings to society is really enormous.

So I just wave a flag of caution, because over the years we have stripped out a lot of the tax expenditures, and those that are left have a fairly high level of social value. And as we move forward, I think we do have to be deliberate about what the consequences are going to be, and if we think savings and investment is the only value, then we have to be up front about that.

Mr. BOSKIN. Well, I think I would just concur with your general description of—my reading of history is the same as yours. As a rough approximation, not item by item, the least bang for the buck so-called tax expenditures are probably the ones——

Mrs. JOHNSON OF CONNECTICUT. We will be talking more with you about this in the future. I have to move on to Mr. Hancock.

Mr. BOSKIN. I take the point and I apologize, but as Chairman Archer mentioned, I stayed over another meeting, so I apologize.

Mr. MCCRERY. Will the Chairwoman yield for a brief question, following up Mr. Rangel's comments?

Dr. Boskin, you rightly answered to Mr. Rangel that we should consider in crafting a tax system what it is we want to finance. But isn't there another question we should consider in crafting a tax system, and that is how much of what our society produces should the government take to finance all services?

Mr. BOSKIN. Yes. The two are interrelated. That is what I meant by using the jargon, "it goes in both directions."

Let me give you a very brief parable I point out in my testimony. For the government to collect a dollar of taxes from the private sector, it is going to wind up distorting some resources, even if it has a very minimal compliance version as would be reduced by some of the reforms we are talking about. So it is going to distort Gary's or mine or yours or other people's incentive to consume versus save or what you are going to consume or how you live, you know, do you own a home or rent, things of that sort.

Economists study the costs of this and at a minimum the cost to the economy of collecting $1 is $1.40 or $1.50. It goes up, the cost goes up with the square of the marginal tax rate, the marginal cost goes up proportionally with the tax rate. So we get $1 into the government's hands, it costs the private economy about $1.40, $1.50, when we take account of all those changes and behaviors that have occurred that have distorted resource allocation. In a well-run program that is desirable, that is efficient, a large fraction of that dol-

lar will be spent on the purpose; on a poorly run program or a poorly targeted program, a small fraction. It will be transferred in a leaky bucket; some will leak out.

So I just think you need a very rigorous benefit-cost standard, and I think you are right, that you have to be very cautious in the actual cost to the economy a lot more than the actual dollars collected by the Federal Government.

Mrs. JOHNSON OF CONNECTICUT. Thank you, Mr. Boskin, and thank you for staying with us a little extra time.

And thank you very much, Mr. Hufbauer, for being with us. The issues that you raise will receive a great deal more attention in the months ahead.

Let us call forward then Charls Walker, Dale Jorgenson and Laurence Kotlikoff, to conclude the second panel. And thereafter we will proceed with the others we have invited to testify.

We will start with Mr. Walker, who is the chairman of the American Council for Capital Formation.

STATEMENT OF CHARLS E. WALKER, PH.D., CHAIRMAN, AMERICAN COUNCIL FOR CAPITAL FORMATION

Mr. WALKER. Thank you very much, Madam Chairman. It is a pleasure to be back before this Committee where I have testified over many, many years. I agree with you that these are historic hearings.

Most of my statement, which grows out of the research and analysis sponsored by the American Council for Capital Formation, over the past 20 years and done by many of the gentlemen you have listened to today, concentrates on the demand side of the saving/investment picture. And as always in economics, we need to look at supply and demand; that is, the supply of savings available for investment, and the demand for that savings from businesses for investment in plant and equipment.

I would like to take just a moment to extract from my statement a point or two on the savings side of the picture, since most of the analysis that we have is on the demand side.

To what extent can public policy promote national saving and thus make more and cheaper funds available for business investment?

First and foremost, and most important of course, is to balance the Federal budget, or preferably get a small surplus over the business cycle. But that is not the end-all and be-all. Other things equal, an elimination of the deficit today would raise our national savings rate up to a level that is still below our past experience and less than half of Western Europe and a third of Japan. So that is not enough in and of itself.

Second, reducing the budget deficit to increase savings—that is one of the results of it, there are a lot of other reasons—ignores the demand side of business incentives to borrow the savings that are generated by Federal surpluses, personal saving, and so on. And at times in the past, we have not had enough of that investment demand. So it is important that we look at both sides of the equation.

The second major point I would like to make, our analysis of the studies by Lawrence Summers, Martin Feldstein, David Wise, James Poterba, a whole host of scholars, leads us to the conclusion

that the IRAs and the 401(k)s have contributed very economically to an increase in the personal savings rate. The U.S. personal savings rate has dropped, but it would have dropped much more, we think, without these incentives.

Because of that, I think we should give very serious consideration to the initiation of a very strong national savings campaign based on patriotism. Such a campaign would be good for the country.

When I was Deputy Secretary of the Treasury in the late sixties, we had a very strong U.S. savings bond program based on patriotism and on self-interest. Read yesterday's Wall Street Journal, lead piece, right side. The baby boomers are saving less than one-third of what they expect to need when they retire. So this program could be sold both on the basis of patriotism and the self-interest side.

Finally, on stimulating business saving, which is a big part of the picture, the lower capital gains tax rates which were voted in this Committee are a positive step. Taxes on capital gains are basically taxes on retained income. The higher the capital gains tax, the much more difficult it is for corporations to retain earnings and increase business saving. So what was done in that respect is a very positive factor to increase business saving.

I will pass over but just mention the point that Mr. Bradford made and with which I fully agree, that actually the taxation of saving can be viewed as very unfair in our system. Typically, the questions you see in the polls, such as in the Wall Street Journal a few weeks ago, where you ask people whether they would rather pay or should they pay higher or lower taxes on their saving investment income versus their wage income, they think of Donald Trump and David Rockefeller and people like that. But if you ask them directly whether if they save out of their income and pay taxes and invest, should they pay taxes again on that return, I think you get much different answers. And most Americans believe that taxation of saving is unfair.

In my conclusion, I state that 1 year ago I would have said this task that the Chairman and others have embarked upon is impossible, as you could never replace the income tax in our system. I have changed that view over the last few months. And I think it is an extremely worthwhile effort because the income tax is not only a bad tax economically, as you have heard here, but also a bad tax politically for two major reasons. It is always an invitation for groups that can benefit from lower tax rates or special preferences to come in and get amendments to that effect. That might be true under its successor, but it still will tend to be less, I think, than under the income tax system.

The second factor is that because rich people save more money than poor people, any efforts to move the tax system in a direction of reducing saving can rise to a demagogic sort of argument of rich versus poor, rich Americans versus working Americans. And that is the worst possible situation we could get into in our capitalistic economy.

Thank you and congratulations for these hearings.

[The prepared statement and attachments follow:]

ACCF

AMERICAN COUNCIL FOR CAPITAL FORMATION

Statement of
Charls E. Walker
Chairman
American Council for Capital Formation
before the House Committee on Ways and Means
June 6, 1995

INTRODUCTION

My name is Charls E. Walker. I am chairman of the American Council for Capital Formation (ACCF). I am accompanied by Mark Bloomfield and Margo Thorning, respectively the president and chief economist of the ACCF. The ACCF represents a broad cross section of the American business community, including the manufacturing and investment sectors, Fortune 500 companies and smaller firms, individuals, and associations. Our board of directors includes cabinet members of prior Republican and Democratic administrations, former members of Congress, prominent business leaders and public finance experts. We appreciate this opportunity to present testimony on the impact of fundamental tax reform on U.S. saving and investment, and economic growth.

We commend the Committee's decision to examine how a shift from an income-based tax system to a consumption-based tax could increase U.S. economic growth by eliminating the bias against saving and investment inherent in the income tax. Almost 10 years after the enactment of the Tax Reform Act of 1986 (TRA), it is clear that U.S. tax policies toward saving and investment must be revised if we are to create better jobs, restore strong growth in living standards, and help the U.S. retain its leading role in world affairs.

Our testimony today will focus on the need to increase saving and investment and how a shift to a consumption-based tax system might achieve that goal. In addition, there could be other likely consequences from such a shift, including reduction in the regulatory burdens and compliance costs associated with the income tax.

SAVING AND INVESTMENT AND ECONOMIC GROWTH

Investment spending in the United States in recent years compares unfavorably with that of other nations as well as with our own past experience. From 1973 to 1992, gross nonresidential investment as a percent of gross domestic product (GDP) was lower for the United States than for any of our major competitors (see Table 1). The U.S. net saving rate during the same period is also low relative to other countries, averaging 4.6 percent compared to 19.0 percent in Japan, 10.6 percent in Germany, and 7.5 percent in Canada.

Even more disturbing is the fact that net business investment in this country has in recent years fallen to only half the level of the 1960s and 1970s. Net private domestic investment averaged 7.4 percent of GDP from 1960 to 1980; since 1991 it has averaged only 3.1 percent (see Table 2). The U.S. net saving rate, a key determinant of U.S. investment, has also fallen sharply, from an average of 7.6 percent in the 1960-1980 period to only 2.0 percent in the 1990s (see Table 2). While larger Federal budget deficits are part of the reason for the saving rate's decline, personal and business saving rates have also fallen.

Reflecting the reduced share of GDP being invested each year, the U.S. capital stock has also grown more slowly. In the three decades prior to 1980, the total capital stock grew an average rate of 4.0 percent per year; in the 1980s and 1990s, the rate fell to 2.7 and 1.9 percent respectively (see Table 3). The stock of equipment, which many experts regard as critical for strong productivity growth, has increased much more slowly since 1980 than in earlier decades. Industrial equipment, which grew at an average rate of 4.3 percent over the 1950-1979 period, increased by just 1.2 percent annually in the 1980s and 0.5 percent since 1990.

The overwhelming importance of investment in plant and equipment for economic growth is emphasized in Harvard Professor Dale Jorgenson's new book, *Productivity: Postwar U.S. Economic Growth*. This study analyzed economic growth between peaks in the business cycle

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over the 1948-1979 period. Allocating increases in output to three sources—growth in the capital stock, labor supply, and multifactor productivity—Professor Jorgenson found that increases in the capital stock had the strongest impact on growth in output.

Studies by Harvard Professors Bradford De Long and Lawrence H. Summers, now on leave at the U.S. Department of Treasury, concluded that investment in equipment is perhaps the single most importance factor in economic growth and development. Their research provided strong evidence that for a broad cross section of nations every 1 percent of GDP invested in equipment is associated with an increase in the GDP growth rate itself of one-third of one percent—a very substantial social rate of return.

Investment's key role in advancing technological progress and productivity growth is also stressed in recent research by New York University Professor Edward N. Wolff. He concluded that U.S. labor productivity growth rates are depressed by the recent slower growth in the capital-to-labor ratio—from a peak of 2.0 percent per year in the 1950s to 1.2 percent per year in the 1972-1992 period. Professor Wolff stressed that the effects of the decline in U.S. capital-labor growth are perhaps even more pernicious than they appear at first glance. First, an increasing capital-labor ratio will increase labor productivity through capital deepening. Second, there appears to be an important and significant interaction effect between capital investment and technological advance. U.S. manufacturing productivity growth lagged behind that of most major industrial countries over the 1973-1993 period. Labor productivity, or output per worker per hour, grew at only 2.4 percent in the 1979-1993 period compared to 4.3 percent in Japan and Belgium, and 4.1 percent in the United Kingdom (see Figure 1). Lagging U.S. labor productivity growth is a concern because of its role in helping to increase real living standards for U.S. workers.

THE SAVING/INVESTMENT EQUATION

Few analyses of business investment levels point out that at the heart of the issue is an old standby of economics—a supply and demand equation. In this instance, supply consists of the national saving available for investment; demand arises from efforts of businesses to earn more in the future by investing in new projects today.

Much of the analysis elsewhere in this testimony concentrates on the demand side of the equation; after all, it is on business incentives to invest that taxes have their most direct and identifiable impact. But national saving as related to tax policy should not be ignored. Without doubt, effective steps to raise the national saving rate reduce interest rates (and therefore capital costs) and foster investment.

The national saving referred to here is not confined to saving by individuals, although they are important participants in the process. Net national saving consists of individual saving, or that part of their income that people do not consume; business saving, defined as annual increases in retained earnings (earnings after taxes not paid out as dividends); and government saving, or the surplus (saving) or deficits (dissaving) realized by Federal, state and local governments.

To what extent can public policy promote national saving and thus make more and cheaper funds available for business investment? Several points should be made.

First and foremost, conversion of the structural Federal deficit into balance or, preferably, a modest surplus over the period of the business cycle would represent the single most important contribution of public policy to generation of more national saving. Such deficits arise when spending exceeds tax revenues; thus determined restraint in Federal spending to bring outlays down to or below revenue levels can properly be viewed as a fiscal policy that adds to saving. The budget plans approved by both House and Senate, if implemented, would therefore mark a significant step toward raising the national saving rate.

One should not conclude, however, that a balanced budget is all that is needed to solve this nation's capital formation problem. Personal and business saving are also historically low and need to be increased. We must also make certain that tax policy is "capital-friendly," so that businesses have adequate incentives to invest any increase in the supply of saving.

Second, turning to enhancement of personal saving, recent experience in the U.S. suggests that lower tax rates on saving do have a positive effect on saving rates. This is an important point; some economists still contest the view that tax policy can influence personal saving to any great degree.

Our most recent experience in this respect is of course the Individual Retirement Account (IRAs) and 401(k)s. We commend the bill approved by this committee, which would liberalize IRAs. Earlier experience with IRAs and 401(k)s convinced many of us that a combination of tax relief (especially in the form of deductions for saving and postponement of taxes on the income generated within the IRA and 401(k)s), well-structured market instruments, and aggressive marketing campaigns by financial institution can raise the personal saving rate. Studies to this effect have been produced by former Council of Economic Advisers Chairman Martin Feldstein, Harvard Professor Lawrence Summers (now on leave as U.S. Treasury Undersecretary for International Affairs), Professors David A. Wise of Harvard University, James M. Poterba of Massachusetts Institute of Technology, Steven F. Venti of Dartmouth College, Jonathan Skinner of the University of Virginia, and Richard A. Thaler of Cornell University. These studies have in part been answered by some analysts, but in our view the rebuttals are far from convincing. We would be glad to provide the Committee with a set of studies on both sides of the issue.

The success of IRAs and 401ks suggests to me that an aggressive National Saving Campaign, based on a combination of patriotism and self-interest, would be a highly worthwhile project that could raise the personal saving rate. Skeptics argue that the U.S. "culture" of high spending and low saving cannot be changed, contrasting this with the high propensity to save among the Japanese. But the fact is that Japanese saving rates were very low before World War II, and it was only through deliberate national policy—mainly through low taxes on individual saving—that Japan became such a high-saving nation. Self-interest can and should play an important role in any such campaign. Professor Douglas Bernheim of Stanford University estimates that "baby-boomers" are now saving only one-third of what they need for comfortable retirement. This can be a powerful selling point.

Third, tax policy can have a very important impact on business saving, which is at a historically low level. Recall that business saving is simply another term for retained earnings and recognize that both public finance experts and Wall Streeters view the capital gains tax as a tax on such earnings. Many purchasers of corporate stock purchase in anticipation of appreciation in its value, preferring such appreciation to dividends. The higher the capital gains tax, the less the incentive to buy stocks for appreciation, and the more difficult it is for corporations which enjoy good investment opportunities to retain the funds to finance them internally. (Such funds might be obtained in the equity or debt markets, but only at higher cost in terms of management time, investment banker fees, etc.)

Finally, with respect to business saving and investment, tax policy that enhances business incentives to invest increases the demand for saving. This higher demand for funds increases the return to savers, and will help increase the amount of savings supplied.

One final point on the saving side of the saving/investment equation: is it fair to tax saving? Or more important, do the American people think it's fair to do so? In answering this question, many peoples' minds immediately turn to high-income Americans, who admittedly save much larger portions of their incomes than do lower-income Americans.

But the fact is that many middle-income Americans do save and invest in various instruments, including mutual funds. Those investments are made out of income already taxed once; is it fair to tax these peoples' saving again? I doubt that many of them would think so. And, for upper-income Americans, only the amounts differ; the principle of unfair, multiple taxation of individual saving is the same.

In the words of the highly respected public finance scholar, Arnold Harberger, a member of the ACCF Center for Policy Research Board of Scholars:

> "As is well-known, the personal income tax is in effect a double tax on savings, taxing the income from which savings are generated and at the same time taxing the proceeds of such savings. In the United States, we add to this double tax on savings a third tax, that on real property, and a fourth, that on the income of corporation...

[T]his treatment is objectionable, particularly in the light of the lip service that is constantly being paid to saving and investment." [Walker and Bloomfield, eds., *New Directions in Federal Tax Policy*, 1983, p. 161.]

Tax Policy and Capital Costs

The user cost of capital is the pretax rate of return on a new investment that is required to cover the purchase price of the asset, the market rate of interest, inflation, risk, economic depreciation, and taxes. This capital cost concept is often called the "hurdle rate" because it measures the return an investment must yield before a firm will be willing to start a new capital project.

Economists are in broad agreement that capital costs are affected by tax policy. For example, John Shoven, Stanford's Dean of Arts & Sciences, estimated that in the U.S. about one-third of the cost of capital is due to taxes. In other words, hurdle rates are 50 percent higher than they otherwise would be due to the tax liability on the income produced by the investment. The higher the tax rate on new investment, the less investment that will take place.

Several measures show that the United States taxes new investment more heavily than most of our competitors. For example, according to a study by the centrist Progressive Foundation, the "think tank" affiliate of the Progressive Policy Institute, the marginal tax rate on domestic U.S. corporate investment is 37.5 percent, exceeding that of every country in the survey except Canada (see Figure 2). The tax rate calculations include the major features of each country's tax code, including individual and corporate income tax rates, depreciation allowances, and whether the corporate and individual tax systems are integrated.

Taxes on machinery and equipment investment, which Professors De Long and Summers concluded are major factors in economic growth, are higher in the United States than in other industrialized countries (see Figure 3). Research by Professor Jorgenson shows that the United States taxes new investment in machinery at 18.5 percent, compared to 8.8 percent in Japan and 8.0 percent in the United Kingdom. Tax rates on machinery investment are *negative* in Italy, France, and Sweden due to generous capital cost recovery allowances.

Prior to TRA, the United States had one of the best capital cost recovery systems in the world. For example, the present value of the deductions for investment in modern and competitive continuous casting equipment for steel production under the strongly pro-investment tax regime in effect from 1981 to 1985 was close to 100 percent, according to a study by Arthur Andersen & Co. In contrast, under current law the present value of capital cost recovery allowance for that same investment today is only 81 percent for a corporation paying the regular income tax. And if a corporation is subject to the corporate AMT, as many major steel companies are, the present value is only 59 percent (see Table 4).

The Arthur Andersen study also showed that the United States lags behind many of our major competitors in capital cost recovery for equipment that is technologically innovative, is crucial to U.S. economic strength, or helps prevent pollution. Capital cost recovery provisions for pollution-control equipment are much less favorable now than prior to TRA's passage. For example, the present value of cost recovery allowances for wastewater treatment facilities used in pulp and paper production was approximately 100 percent prior to TRA. Under regular TRA income tax, the present value for wastewater treatment facilities dropped to 81 percent; for AMT payers the figure became 63 percent. Scrubbers used in the production of electricity fared even worse. Prior to TRA, the present value was only 55 percent; for AMT payers the figure dropped to 42 percent. As is true in the case of productive equipment, loss of the investment tax credit and lengthening of depreciable lives both raise effective tax rates.

According to estimates by Dr. Joel Prakken of Laurence H. Meyer & Associates, the user cost of capital for most types of productive equipment would now be about 15 percent lower had TRA not been enacted (see Figure 4). In effect, therefore, the 1986 legislation sharply raised the hurdle rate for new business investment projects and thus helped significantly to slow the rate of growth of the U.S. capital stock.

CONSUMPTION TAXES AND ECONOMIC GROWTH

Most other industrial countries tax consumption more heavily than does the United States. For example, consumption is taxed at an average rate of 22.1 percent in Germany and 14.6 percent in Canada, compared to only 6.2 percent in the United States (see Figure 5). Other countries also derive a much larger share of their total tax revenue from taxes on consumption. The average for the other G-7 countries is 26 percent, compared to 16.8 percent in the United States, according to OECD data.

Switching to a tax system based on consumption rather than on income would have a significant, positive impact on the U.S. growth rate according to studies by many top flight public finance scholars. A brief survey of some of these studies appears below.

- *Fullerton, Shoven and Whalley.* In "Replacing the U.S. Income Tax with a Progressive Consumption Tax" [*Journal of Public Economics* 2 (1983)]. Professors Don Fullerton of the University of Texas, John Shoven of Stanford University, and John Whalley of the University of Western Ontario, employ a general equilibrium model of the U.S. economy and tax system to measure the short- and long-run consequences of tax restructuring. A general equilibrium model provides "dynamic" estimates of how a change in tax policy will affect factor prices, investment, output and employment after the economy has had time to adjust to the new system. Their study shows that the initial impact of switching to a progressive consumption tax is to increase saving and reduce consumption. Initially, after the switch, consumption falls below the baseline but eventually it will exceed it because of a larger capital stock. The authors conclude that the stream of net gains to the economy has a discounted present value of 1 percent of GDP ($698 billion at 1995 income levels).

- *Jorgenson.* Harvard Professor Dale Jorgenson's study,"The Economic Impact of Fundamental Tax Reform" [prepared for the Hoover Institution, May 1995], employs a general equilibrium model to study the impact of switching to a consumption tax from the income tax. He concludes that switching to a consumption tax system such as those embodied in the Armey Flat Tax and Nunn-Domenici Unlimited Savings Account (USA Tax) would provide for a substantial increase in the U.S. standard of living over time. Professor Jorgenson estimates that this increase has a discounted present value of $2 trillion dollars.

- *Kotlikoff.* Boston University Professor and National Bureau of Economic Research scholar, Laurence J. Kotlikoff, employs a general equilibrium model to show the impact of replacing the income tax with a 17 percent sales tax. His study, also prepared for the Hoover Institution (May, 1995), finds that switching to a sales tax, will by the tenth year of the transition, increase the U.S. saving rate from the current level of about 2.6 percent to 6 percent. The increase in saving produces a concomitant increase in investment. Capital costs and real interest rates decline. Greater investment causes an increase in the per capita stock of capital which raises worker productivity and real wages. In the long run, Kotlikoff concludes per capital output will be 8 percent larger than it would have been without the substitution of a sales tax for the income tax.

- *Hall and Rabushka.* In "The Flat Tax: A Simple Progressive Consumption Tax," Professors Robert Hall and Alvin Rabushka of the Hoover Institution of Stanford University [prepared for the Hoover Institution, May 1995], predict, on the basis of various general equilibrium model analyses of substituting consumption taxes for income taxes, that their flat tax proposal would raise GDP by 4 to 8 percent within seven years (compared to the current law).

- *Prakken.* Joel Prakken of Laurence H. Meyer & Associates, a macroeconomic forecasting group, used a general equilibrium model to analyze the impact of providing improved depreciation for capital equipment (250 percent declining balance over 5 years) by imposing a VAT of 0.5 percent to offset the revenue loss. In "The Macroeconomics of Tax Reform" [Walker and Bloomfield, eds., *The Consumption Tax: A Better Alternative?* Ballenger Publishing Company (1987)], Prakken concludes that "buying" additional investment incentives would increase the capital stock, raise the level of real GDP, and raise real wages by 0.7 per year.

TAX RESTRUCTURING AND THE 104TH CONGRESS

Restructuring the federal tax system to reduce the multiple taxation of saving and investment inherent in the income tax—and thus to promote productivity and higher living standards—appears to be gaining favor among congressional leaders. In addition to Chairman Archer, Speaker of the House Newt Gingrich (R-GA); Majority Leader Richard Armey (R-TX); Ranking Democrat on the Ways and Means Committee Sam Gibbons (D-FL); Senate Finance Committee Chairman Bob Packwood (R-OR); and Senators Pete Domenici (R-NM) and Sam Nunn (D-GA); Arlen Specter (R-PA); and Richard Lugar (R-IN) have also expressed interest in broad tax restructuring. The proposals have more similarities than differences and each has many desirable qualities; all would go a long way toward reducing the bias against saving and investment in our current Federal income tax. Brief summaries of the major proposals follow.

The Flat Tax

House Majority Leader Richard K. Armey (R-TX), introduced the Freedom and Fairness Restoration Act on June 16, 1994. This bill replaces the current individual and corporate federal income tax with a flat tax modeled after the proposal by Stanford economist Robert Hall and Alvin Rabushka of the Hoover Institution. Businesses pay a 17 percent rate on the difference (if positive) between revenue and expenses. The tax covers corporate, partnership, professional, farm, and rental profits and royalties. The base for the tax is gross revenue less purchases of goods and services, capital equipment, structures, land, and wages and pension contributions paid to employees. No deductions are permitted for fringe benefits, interest, or payments to owners.

Personal income is taxed only once at a rate of 17 percent. Personal income is defined as the total of wage, salary, and pensions. thus, the income on savings is exempt from tax. The following personal allowances are permitted: $13,000 for an individual, $17,200 for a single head of household, $26,200 for a married couple, and a dependent deduction of $5,300.

Senator Arlen Specter (R-PA) advocates a modified version of the flat tax which maintains deductions for charitable contributions and a limited home mortgage interest deduction.

USA Tax

Senators Sam Nunn (D-GA) and Pete V. Domenici (R-NM) propose to replace the individual and corporate federal income tax and a portion of the Social Security tax with the Unlimited Savings Account Tax. The USA Tax was introduced as legislation on April 25, 1995. Total revenues from the USA Tax would equal total revenues from individual and corporate income taxes, plus the revenues needed to pay for the Social Security payroll tax credits. To compute its tax base under the USA Tax, a business takes the total value of its business receipts from domestic sales (which, by definition, exclude exports sales, income from overseas operations, and financial income) and subtracts its purchases from other businesses, including regular and pollution control equipment. Purchases of imported goods also are subtracted, assuming that the imports had been taxed at the border.

To compute its tax liability, a business multiplies its tax base by the business tax rate (11.0 percent). The business then takes a tax credit equal to the employer's portion of the payroll tax payments for its employees. The USA Tax does not allow a business to deduct wages, state and local tax payments, or interest and dividend payments.

Most of the other features of the individual-level USA Tax resemble those of the current individual income tax; however, saving is fully deducted from income and money withdrawn from savings and spent is taxable. The USA Tax retains personal exemptions, the standard deduction, the mortgage interest and charitable deduction, and graduated tax rate schedules ranging from 16 to 55 percent. It also has an earned income tax credit for low-income taxpayers.

Value-Added Tax

Congressman Sam M. Gibbons (D-FL) has proposed to replace the current individual and corporate federal income tax, and the Social Security payroll tax with a simplified value-added

tax (VAT). A new personal income tax addresses the regressivity of the VAT. The VAT for business is computed by the subtraction method and uses a uniform tax rate for all goods and services according to the destination principle. The destination principle means that the tax would not be levied on exports but that it would be levied on imports as allowed by the General Agreement on Tariffs and Trade (GATT). Gross receipts from sales of goods and services are the tentative taxable amount. Gross costs for purchases of goods and services from other businesses and for plant and equipment are deducted from that amount. The balance is the business' value-added base, which is multiplied by the tax rate to determine the tax liability.

The tax rate is not specified in Congressman Gibbons' proposal; he states that the rate would be that needed to offset the revenue loss stemming from the repeal of the individual and corporate income tax and payroll taxes. His proposal has not been introduced as legislation.

Sales Tax

Senator Richard Lugar (R-IN) is drafting a proposal for a national sales tax (NST) of about 17 percent on goods and services to replace Federal personal and corporate income taxes. The capital gains and estate taxes would be eliminated as well. The proposal would not revise the current social security tax or FICA systems except that Social Security benefits would not be taxed.

CONCLUSIONS

Mr. Chairman, a year ago I would have strongly argued that the income tax is a permanent, irreplaceable part of the U.S. tax system. In fact, my work over the past quarter-century has been aimed primarily at incrementally moving the tax toward a consumed income tax. Such things as investment tax credits, accelerated depreciation, capital gains tax cuts, IRAs and the like have that effect. This would be, as is most often the case in public policy, a second-best solution to our need for tax policies that are fair and promote good jobs, solid growth, and international competitiveness.

My view a year ago on the "impossibility" of repealing the income tax was not based on any liking for the tax itself. Complete elimination of the Federal income tax—to "tear it out by the roots," in your words—is a consummation devoutly to be wished. As we have shown, the income tax is a very bad tax economically.

It is also very bad politically. Let's look briefly at its major political drawbacks. First, as long as the income tax is on the books, it is a most attractive invitation for individuals and businesses to seek special provisions—some of which may be most worthy—to reduce their tax burdens. Not that such efforts will cease under a successor to the income tax, whatever that might be, but my feeling is that the income tax is especially subject to these legislative forays.

Second, the progressivity in rates that is almost synonymous with the income tax provides a fertile field for those who would try to use the tax for significant income redistribution (an effort that has proved futile in the past) or as the basis of demagogic, "Rich Man versus Working American" politics of envy. Any success in these efforts strikes at the very heart of our capital formation problem because, like it or not, upper-income Americans save more than lower-income Americans. So, to soak the rich is to soak the saver—and that's not good for the world's leading capitalist nation.

Having said that, I think your task is exceedingly difficult. But I will not predict failure as I would have a year ago. This very hearing today is a sign of the great change that has occurred in our political system in recent months. The goal justifies every bit of the effort that you and your associates will have to apply to the task. And, speaking personally, I want to help in your effort.

Thank you very much.

Table 1 Saving and Investment as a Percent of Gross Domestic Product, 1973-1992

	United States	Canada	Japan	France	West Germany	United Kingdom
SAVING						
Net saving[1]	4.6%	7.5%	19.0%	8.7%	10.6%	4.4%
Personal saving[2]	5.8%	7.6%	11.7%	6.3%	8.2%	3.5%
Gross saving (net saving plus consumption of fixed capital)[3]	17.5%	19.1%	32.9%	21.2%	22.9%	15.8%
INVESTMENT						
Gross nonresidential fixed capital formation	13.9%	15.1%	24.2%	15.5%	14.8%	14.2%
Gross fixed capital formation	18.3%	21.5%	30.3%	21.0%	20.7%	17.8%

[1]*The main components of the OECD definition of net saving are: personal saving, business saving (undistributed corporate profits), and government saving (or dissaving). The OECD definition of net saving differs from that used in the National Income and Product Accounts published by the Department of Commerce, primarily because of the treatment of government capital formation.*
[2]*Personal saving is comprised of household saving and private unincorporated enterprise.*
[3]*The main components of the OECD definition of consumption of fixed capital are the capital consumption allowances (depreciation charges) for both the private and the government sector.*

Source: Derived from National Accounts, Vol. II, 1973-1985 and 1980-1992, Organization for Economic Cooperation and Development (OECD), 1987 and 1994 eds. Prepared by the American Council for Capital Formation Center for Policy Research, April 1995.

Table 2 Flow of U.S. Net Saving and Investment (percent of GDP in current $)

	Average 1960-1980	Average 1981-1985	Average 1986-1990	Average 1991-1995[1]
Net private domestic saving	8.2%	7.2%	5.1%	5.2%
State and local government surpluses	0.4%	1.2%	0.9%	0.4%
Subtotal of private and state saving	8.6%	8.4%	5.9%	5.6%
Less: federal budget deficit	-1.0%	-4.1%	-3.2%	-3.6%
Net domestic saving available for private investment	7.6%	4.3%	2.7%	2.0%
Net inflow of foreign saving[2]	-0.4%	1.2%	2.4%	1.1%
Net private domestic investment	7.2%	5.5%	5.1%	3.1%
Personal saving	5.1%	5.6%	3.4%	3.5%
Net business saving[3]	3.1%	1.6%	1.7%	1.8%

[1]*In the 1960-80 period the United States sent more capital abroad than it received; thus net inflow was negative during this period.*
[2]*Net business saving = gross private saving - personal saving - corporate and noncorporate capital consumption allowance.*
[3]*The 1995 figures included in this average reflect only the first quarter.*

Source: Department of Commerce Bureau of Economic Analysis, National Income Accounts. Update prepared by the American Council for Capital Formation Center for Policy Research, May 1995.

Table 3 Growth in the Net Capital Stock by Type
(average annual growth rates in 1987 dollars)

	1950-59	1960-69	1970-79	1980-89	1990-94	1994 level (billions of 1987 $)
Total	3.6	4.5	3.8	2.7	1.9	5144.4
Equipment	4.1	5.0	4.9	2.6	3.3	2511.7
Information processing	8.8	8.9	8.9	9.3	8.8	847.0
Equipment less information processing	3.8	4.7	4.4	1.2	1.0	1664.7
Industrial[1]	5.0	4.3	3.6	1.2	0.5	769.3
Structures	3.3	4.2	2.8	2.8	0.6	2632.7

[1]*Industrial equipment includes fabricated metal products, engines and turbines, metal working machinery, special industry machinery, general industrial (including materials handing, equipment, and electrical transmission), distribution, and industrial apparatus.*

Source: "Fixed Nonresidential Private Capital, by Type of Equipment and Structures," Department of Commerce, Bureau of Economic Analysis, April, 1995. Chart prepared by the American Council for Capital Formation Center for Policy Research, May 1995.

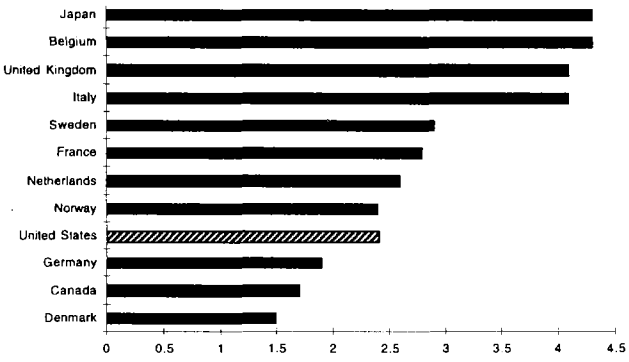
Table 4 International Comparison of the Present Value of Equipment Used to Make Selected Manufacturing Products and Pollution-Control Equipment (as a percent of cost)

	Computer Chips	Telephone Switching Equipment	Factory Robots	Crank-shafts	Continuous Casting for Steel Production	Engine Blocks	Wastewater Treatment for Chemical Production	Wastewater Treatment for Pulp and Paper Equipment	Scrubbers Used in Electricity Plants
United States									
1985 Law	100.1	100.1	100.1	100.1	100.1	100.1	100.1	100.1	89.7
MACRS[1]	85.2	85.2	80.8	80.8	80.8	80.8	85.2	80.8	54.5
AMT[2]	81.1	78.4	68.8	64.6	59.0	60.8	70.0	62.7	41.5
Brazil	75.7	74.8	74.7	74.7	88.3	74.7	74.7	74.7	79.4
Canada	76.9	75.9	74.0	73.8	74.2	73.6	85.3	85.3	85.3
Germany	83.6	83.0	82.7	83.9	82.2	83.9	71.8	69.7	68.9
Japan	87.1	86.2	83.4	83.9	81.4	83.7	84.6	83.7	82.4
Korea (w/3% ITC)	88.7	84.3	82.6	80.1	77.7	79.6	95.2	93.9	92.2
Singapore	91.7	91.7	91.7	91.7	91.7	91.7	91.7	91.7	91.7
Taiwan	83.9	78.0	79.0	64.3	63.5	63.7	147.0	147.0	147.0

Notes: [1]*MACRS* = *Modified Accelerated Cost Recovery System (Current Law for regular taxpayers)*
[2]*AMT* = *Alternative Minimum Tax (Current Law)*

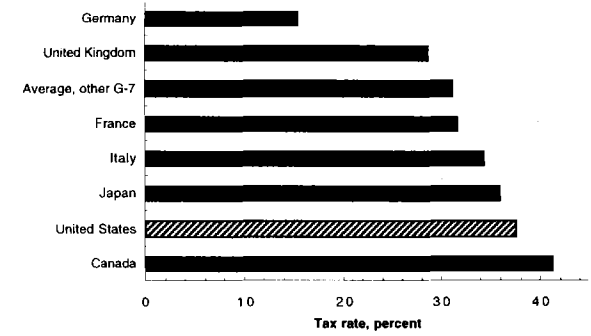
Source: Stephen R. Corrick and Gerald M. Godshaw, "AMT Depreciation: How Bad is Bad," in *Economic Effects of the Corporate Alternative Minimum Tax* (Washington, D.C.: American Council for Capital Formation Center for Policy Research, September 1991); and unpublished data incorporating the AMT provisions of OBRA 1993. Updated by Arthur Andersen LLP, Office of Federal Tax Services, Washington, D.C., January 1995.

Figure 1 International Comparison of Manufacturing Productivity, 1979-1993 (annual percent change)



Source: Monthly Labor Review, February 1995.

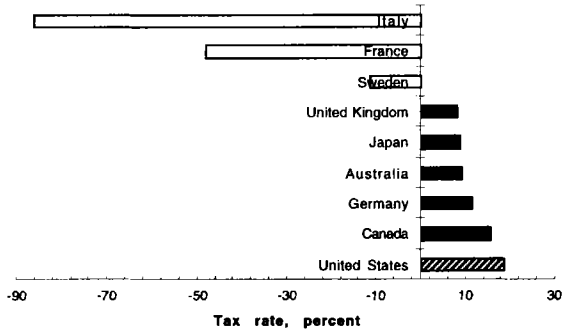
Figure 2 Effective Tax Rates on Domestic Corporate Investment, 1991



Note: Tax rates include both the corporate and personal income tax on investment.

Source: Enterprise Economics and Tax Reform, Progressive Foundation, Progressive Policy Institute, Washington, D.C., October 1994.

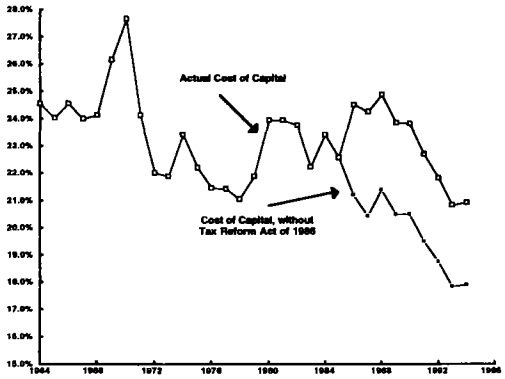
Figure 3 Marginal Effective Corporate Tax Rates on Machinery Assets, 1990



Note: Tax rates are negative in Italy, France, and Sweden due to incentives included in capital cost recovery provisions. Tax rates are based on corporate income taxes and do not include personal income taxes.

Source: Dale Jorgenson, "Tax Reform and the Cost of Capital: An International Comparison," *Tax Notes International*, April 19, 1993.

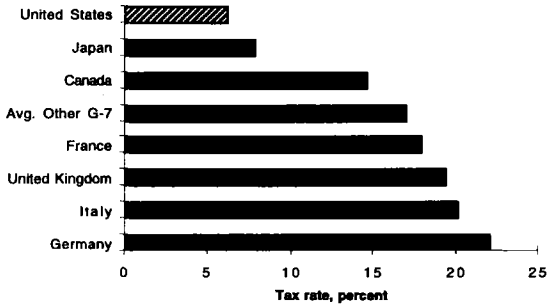
Figure 4 Cost of Capital for Equipment (less computers)



Note: The cost of capital is defined as the user cost of capital; it includes economic depreciation. Personal tax rates are not factored into the calculations.

Source: Joel Prakken, Laurence H. Meyer and Associates, unpublished data, August 1994.

Figure 5 Average Consumption Tax Rates in the G-7 Countries, 1991



Source: OECD, *National Accounts 1993 Vol. II*; and OECD, *Revenue Statistics*

Mrs. JOHNSON OF CONNECTICUT. Thank you, Dr. Walker.
Dr. Jorgenson.

STATEMENT OF DALE W. JORGENSON, PH.D., PROFESSOR, DEPARTMENT OF ECONOMICS, HARVARD UNIVERSITY

Mr. JORGENSON. Thank you very much, Madam Chairman.

I am very pleased to testify on the economic impact of fundamental tax reform. It is important to start out with a definition of fundamental tax reform. And the definition I would like to use is the one that you have heard many times this morning, which is that the tax system would be reformed by moving the base for taxation at the Federal level from income to consumption. So what I am going to concentrate on is the effect of shifting to a consumption-based tax at the Federal level.

At least four different ideas have been discussed today for administering a consumption tax system, and they have advantages and disadvantages. The scheme that is referred to as a value-added tax is used in Europe, and involves taking a credit for taxes paid on business purchases against one's value-added tax liability. Needless to say, adoption of a system like this for the United States would require a new administrative structure for the tax system.

The second approach that has been discussed is the idea of a retail sales tax. That is something that is used by many State governments and some local governments, and that could be collected in much the same manner as a State sales tax. In fact, you might even conceive of a system where the Federal Government would subcontract the collection to State tax agencies.

A third set of ideas is related to the notion of preserving the existing structure of a business tax and an individual tax and using that tax structure to change the tax base to consumption by allowing investment expenditures as a writeoff against business receipts, in much the same way that other business expenses are allowed. This is the basic idea of the Armey flat tax and the Nunn-Domenici U.S.A. tax.

What I have shown in my written testimony is that all of these systems, if they succeed in shifting the tax base to consumption, would have a very major positive impact on the growth of our economy. Just to calibrate the scale, we could start from the last major tax reform enacted by the Congress, which was the Tax Reform Act of 1986. This tax reform eliminated a number of barriers to efficient allocation of capital such as the investment tax credit for investment in equipment.

In my written testimony, I show that this created nearly $1 trillion in new opportunities for U.S. economic growth. What do I mean by growth opportunities? Well, let me be precise. The objective of government policy, which we have discussed a couple times this morning, is to enhance the standard of living of U.S. consumers. And the concept of growth opportunities is a summary measure of the value of all future increases in this standard of living, both of present consumers and of future generations.

What I show in the paper is that the 1986 tax act created nearly $1 trillion in growth opportunities defined in that way, increases in our standard of living. While recognizing the significant achieve-

ments of the 1986 tax act, I show that this legislation fell far short of exploiting the available growth opportunities and that changing the tax base from income to consumption would have generated $2 trillion in opportunities for economic growth.

I conclude, therefore, that adopting consumption as the tax base at the time of the 1986 tax reform would have doubled the benefits.

What is the intuitive basis for these calculations? I have already suggested that the 1986 tax act removed a number of obstacles to efficient allocation. A consumption based tax would remove all the remaining obstacles to efficient allocation of capital, and in addition to that, would eliminate the double taxation of saving. And those two effects account for the impact of a shift toward consumption taxation on our national growth.

So I conclude that changing the Federal tax base from income to consumption is an idea whose time has come. This change will create very important new opportunities for growth in the standard of living of all Americans. The traditional objections to consumption as the base for taxation on the grounds of fairness have been successfully addressed, for example, in the Armey flat tax proposal and the Nunn-Domenici U.S.A. tax.

These proposals or a retail sales tax or a value-added tax would create substantial new growth opportunities and are based on well-established economic ideas. These ideas could serve as the point of departure for tax reform legislation.

Thank you very much.

[The prepared statement follows:]

Prepared for presentation
to the
Ways and Means Committee
U.S. House of Representatives
June 6, 1995

HE ECONOMIC IMPACT OF FUNDAMENTAL TAX REFORM

by

Dale W. Jorgenson

ABSTRACT

Tax policy for saving and investment is critical for stimulating U.S. economic growth, since investment is the most important source of growth. In order to achieve a more satisfactory growth performance the tax burden on investment must be reduced substantially. This could be achieved by fundamental tax reforms that would shift the base for taxation at the federal level from income to consumption.

At least four alternative proposals for shifting the federal tax base to consumption have been developed. The first of these is a value added tax, like that employed in Europe and Japan. A consumption-base value added tax would eliminate investment from the tax base. A second proposal is to tax consumption at the retail level through a sales tax like that employed by many state governments in the U.S. This would also eliminate investment from the tax base.

Two alternative proposals have been developed for shifting the federal tax base from income to consumption, while retaining the existing administrative structure of the income tax. The U.S.A. (Unlimited Savings Allowance) Tax, proposed by Senators Sam Nunn and Pete Domenici, and the Flat Tax, advanced by Congressman Richard Armey, would exclude investment from the tax base by allowing a tax deduction for investment like that for any other business expense. Under these proposals a consumption tax could be made progressive by introducing a system of personal exemptions.

Neutral Cost Recovery, recently passed by the House of Representatives as Title II of the Job Creation and Wage Enhancement Act of 1995, is an important step toward a consumption-based tax system. This system for recovery of capital cost would provide tax deductions with the same present value as investment, thereby excluding investment from the tax base. To complete the shift in the tax base to consumption it would be necessary to eliminate other deductions from income at the same time, including deductions for interest expenses.

Current consumption tax proposals are based on well-tested economic ideas and could serve as an appropriate starting point for fundamental tax reform. In this testimony I compare the economic impact of a consumption tax with the Tax Reform Act of 1986, the most recent fundamental tax reform in the United States. I show that the 1986 Tax Act created nearly one trillion dollars in new opportunities for economic growth, but that adopting consumption as a tax base would have generated more that two trillion dollars in growth opportunities!

1. Introduction

Tax policy for saving and investment is critical for stimulating U.S. economic growth, since investment is the most important source of growth. In order to achieve a more satisfactory growth performance the tax burden on investment must be reduced substantially. This could be achieved by fundamental tax reforms like the Flat Tax, proposed by Congressman Dick Armey, or the U.S.A. (Unlimited Savings Allowance) Tax, proposed by Senators Sam Nunn and Pete Domenici. These tax proposals would have the effect of shifting the base for taxation at the federal level from income to consumption, while preserving the existing administrative structure of the income tax.

An alternative approach for shifting the federal tax base to consumption would be to adopt a value added tax, like that employed in Europe and Japan. A consumption-base value added tax would eliminate investment from the tax base. The system for value added taxation common in

Europe is based on allowing credit for the value added tax already paid on business purchases of goods and services. Adoption of this system for the United States would require a new structure for tax administration, based on auditing of sales and purchases by all businesses.

A third alternative approach to consumption taxation is a retail sales tax like that employed by many state governments and some local governments in the U.S. The existing administrative structure established by state governments could be employed for federal retail sales tax collections, possibly by having these collections done by existing state agencies but financed by the federal government. In order to exclude investment from the federal sales tax base such a tax would have to be levied only on purchases by final consumers -- households and institutions -- and not on purchases by businesses.

Current consumption tax proposals are based on well-tested economic ideas and could serve as an appropriate starting point for fundamental tax reform. An important advantage of the Armey Flat Tax and the Nunn-Domenici U.S. Tax proposals is that the resulting consumption tax systems could would be administered in much the same way as the present income tax system. The traditional objection to a consumption tax is that it would be regressive rather than progressive, falling disproportionately on low income taxpayers. Both the Flat Tax and the U.S.A. Tax would achieve progressivity by means of a system of personal exemptions.

The Tax Reform Act of 1986 is the most recent fundamental tax reform in the United States. This landmark legislation preserved income as the tax base for the federal revenue system. However, the federal income tax was substantially reformed by eliminating special tax provisions for a number of specific types of investment, such as the investment tax credit for investment in equipment. These reforms removed important barriers to the efficient allocation of capital. In this paper I show that the 1986 Tax Act created nearly one trillion dollars in new opportunities for economic growth!

While recognizing the significant achievements of the 1986 Tax Act, I show that this legislation fell far short of exploiting the available opportunities for stimulating U.S. economic growth through tax reform. Changing the tax base from income to consumption would have generated more than two trillion dollars in opportunities for economic growth! I conclude that adopting consumption as the tax base would have *doubled* the benefits from fundamental tax reform. Ironically, a consumption tax was explicitly considered and rejected in the debate that preceded the 1986 tax legislation.

In a 1977 study, *Blueprints for Tax Reform*, the U.S. Treasury had proposed two alternative approaches for shifting the federal tax base from income to consumption. The first of these is a value added tax, like that employed in Europe and Japan. The second would eliminate investment from the tax base by permitting taxpayers to treat investment expenditures as a tax deduction like that for any other business expense. Since investment would be excluded from the tax base, all other deductions from capital income, such as deductions for interest expenses, would be eliminated. However, these approaches to tax reform were considered and rejected by the U.S. Treasury in a 1984 report that initiated the debate leading to the 1986 Tax Act.

Neutral Cost Recovery, recently passed by the House of Representatives as Title II of the Job Creation and Wage Enhancement Act of 1995, is an important step toward revival of the Treasury proposals of 1977. This system for recovery of capital cost would provide depreciation deductions with the same present value as immediate "expensing" of investment. These deductions would be based on the recovery of capital cost over the lifetime of an asset, as under current law. However, the deductions would be increased annually to allow a return on capital of three and a half percent per year and compensate for inflation. At a discount rate of three and a half percent, these deductions would have the same present value as an immediate write-off of capital outlays.

Neutral Cost Recovery, like the Treasury proposal of 1977, would eliminate investment from the tax base. To complete the shift in the tax base to consumption, however, it would be necessary to eliminate other deductions from capital income at the same time, including deductions for interest expenses. Otherwise, the U.S. Treasury would be in the position of providing subsidiesthrough tax deductions for taxpayers who choose to finance investment through debt rather than equity. These subsidies could stimulate a revival of the tax shelter industry that flourished prior to the Tax Reform Act of 1986.

The recovery of capital costs should be regarded as one component of a tax system based on consumption rather than income. Shifting the federal tax base from income to consumption, as recommended in *Blueprints*, would require deductions equivalent to "expensing" of investment. However, other deductions from capital income would have to be eliminated at the same time. Adoption of a consumption tax would create very important new opportunities for U.S. economic growth.

2. The 1986 Tax Reform

I will support my conclusions by first reviewing the achievements of the 1986 tax reform.[1] I have presented simulations of future U.S. economic growth under alternative tax policies in Table 1. These simulations show that the economic impact of the 1986 tax reform was positive and substantial at rates of inflation like those prevailing at the time. As the rate of inflation has declined these benefits have grown very substantially, reflecting the fact that capital cost recovery deductions under the 1986 legislation were not indexed for inflation. These deductions decline in present value as the rate of inflation increases.

Table 1
Growth Opportunities Created by the 1986 Tax Reform
(Billions of 1987 Dollars)

Rate of Inflation	Revenue Adjustment	1985 Tax Law	Treasury Proposal	President's Proposal	1986 Tax Act
	Lump Sum Tax	724.0	1489.6	1691.4	1561.8
0%	Labor Income Tax	478.2	1468.8	1642.4	1565.0
	Sales Tax	400.3	1452.9	1614.6	1558.7
	Individual Income Tax	374.5	1456.1	1619.1	1563.1
	Lump Sum Tax	0.0	1907.6	2452.2	448.4
6%	Labor Income Tax	0.0	1711.4	2170.4	746.9
	Sales Tax	0.0	1600.1	2104.9	901.2
	Individual Income Tax	0.0	1595.8	2007.9	999.4
	Lump Sum Tax	-477.1	2060.4	3015.6	-200.8
10%	Labor Income Tax	-333.7	1791.6	2584.7	267.3
	Sales Tax	-285.2	1623.5	2356.4	517.0
	Individual Income Tax	-221.9	1604.8	2353.1	748.6

Note: In 1987, the national wealth (beginning of the year) was $15,920.2 billion dollars.

More specifically, I have compared growth opportunities available to the U.S. economy under the 1986 Tax Act with the those available under the pre-existing 1985 Tax Law and two tax reform proposals advanced by the Treasury in 1984 and the President in 1985. The benchmark for comparison is the 1985 Tax Law at a six percent inflation rate. Table 1 presents the difference between growth opportunities under alternative tax reforms with those resulting from no change

[1]This review is based on my paper, "Tax Reform and U.S. Economic Growth" with Kun-Young Yun. The paper provides a more detailed appraisal of the Tax Reform Act of 1986.

in tax policy and an unchanged rate of inflation. It is important to be explicit about the role of inflation, since the 1985 Tax Law and the 1986 Tax Act omitted important provisions for indexing the tax structure for inflation included in the Treasury proposal and the President's proposal.

In comparing U.S. economic growth under alternative tax policies I require that all changes tax policy are revenue neutral, that is, revenue and expenditure of the government are the same as in the base case given by the Tax Law of 1985. This requires adjusting tax revenues to maintain the budgetary position of the government. A hypothetical "lump-sum" tax or subsidy does not add to tax induced distortions of private decisions and serves as a standard for comparison among alternative tax policies. I also consider three alternative methods for adjusting government revenues. These involve proportional changes in taxes on labor income, sales taxes on investment and consumption goods, and taxes on income from both capital and labor. Table 1 presents estimates of the growth opportunities created or destroyed by alternative tax reform packages; all estimates are in billions of 1987 dollars. Let me first be precise about the meaning of the term "growth opportunities." The objective of government policy, including tax policy, is to enhance the standard of living of U.S. consumers now and in the future. The concept of growth opportunities is a summary measure of the present value of future increases in the standard of living. It represents the willingness of the present generation of taxpayers to pay for a change in tax policy that will affect their own standard of living and that of future generations of taxpayers.[2]

Turning to the impact of the 1986 Tax Act, we see that this fundamental tax reform produces a sizable gain in opportunities for future U.S. economic growth. For the revenue adjustments based on proportional changes in tax rates these gains range from $746.9 billion 1987 dollars to $999.4 billions, or nearly *one trillion dollars!* There are important differences between results for a hypothetical "lump sum" tax adjustment and adjustments based on changes in tax rates. However, the results do not depend significantly on which of the tax rates is used in maintaining revenue neutrality.

While the Tax Reform Act of 1986 obviously generated very substantial growth opportunities for the U.S. economy, the Treasury and President's proposals would have done substantially more to enhance economic growth. For tax adjustments based on changes in tax rates to maintain revenue neutrality, the Treasury proposal would have produced growth opportunities ranging from $1,595.8 billion 1987 dollars to $1,711.4 billions. The President's proposal would have produced gains ranging from $2,007.9 billion 1987 dollars to $2,170.4 billions or more than *double* the gains from the 1986 Tax Act! Nonetheless, tax policy makers should recognize the 1986 reform as a giant step in the right direction.

The estimates presented in the first column of Table 1 also make it possible to isolate the effects of changes in inflation with no change in tax policy. The 1985 Tax Law, like the Tax Reform Act of 1986, was not completely indexed for inflation, so that the tax burden increases with the inflation rate. By contrast the Treasury proposal and the President's proposal involved indexing the tax structure for inflation. With no change in tax law the results presented in Table 1 show that an increase in the inflation rate from six to ten percent would have imposed a loss on the economy in the range of $221.9-333.7 billion dollars of 1987. Reducing the inflation rate to zero would have produced a gain in the range of $374.5-478.2 billions.

If we compare the Treasury and President's proposals with the 1986 Tax Act at a six percent inflation rate, we find that these proposals would have produced much greater gains in growth opportunities. Gains from the President's proposal would have been more than double those of the 1986 Tax Act and gains from the Treasury proposal would have been fifty percent higher. However, at a zero inflation rate the two proposals and the actual 1986 tax legislation would have had very similar economic impacts, resulting in gains in growth opportunities of one and a half trillions. Under the 1986 Tax Act the gains shrink with increased inflation, but these gains actually grow with increased inflation under the two alternative proposals.

In summary, the Tax Reform Act of 1986 created almost one trillion dollars in growth opportunities for the U.S. economy. This demonstrates the potential contribution to growth from fundamental tax reform. As the inflation rate has gradually subsided, these growth opportunities have steadily increased. At azero rate of inflation the impact of the 1986 Tax Act on U.S. economic growth would have been closely comparable to that of the Treasury proposal or the President's proposal. However, the 1986 Tax Act did not incorporate provisions from these proposals that would have largely insulated the U.S. tax structure from the impact of inflation.

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[2]Further details are given in my paper with Yun, "The Excess Burden of Taxation."

3. Fundamental Tax Reform

In this section I consider the economic impact of a shift in the tax base for the federal revenue system from consumption to income. I also consider a number of alternative tax reforms. As in the previous section, I use the 1985 Tax Law with a six percent inflation rate as a benchmark. These alternative reforms focus on tax distortions induced by differences in the tax treatment of income from corporate, noncorporate, and household sectors, and short-lived and long-lived assets. In the parlance of the 1986 tax debate, these are different ways of "leveling the playing field." As before, I achieve revenue neutrality for each proposal by adjusting tax rates to preserve the balance between revenues and expenditures.

Initially, I will focus attention on the seventh panel in Table 2. This is the consumption tax scheme proposed in the Treasury's 1977 *Blueprints for Tax Reform* and now embodied in the Armey Flat Tax and Nunn-Domenici U.S.A. Tax proposals.Under these proposals the tax base for the federal tax system would be shiftedfrom income to consumption by excluding investment from the tax base. In the business sector this would be achieved through deductions for investment outlays like those for any other business expenses. The eighth panel of Table 2 is a more thorough-going version of this scheme that would eliminate sales taxes on investment as well.

Table 2
Growth Opportunities Created by "Leveling the Playing Field,"
(Billions of 1987 dollars)

		1985 Law
1.	**Within Sector Interasset Distortion**	
	Lump Sum Tax Adjustment	443.9
	Labor Income Tax Adjustment	248.1
	Sales Tax Adjustment	168.7
	Individual Income Tax Adjustment	70.2
2.	**Intersector Distortion: C and NC Sectors**	
	Lump Sum Tax Adjustment	-93.3
	Labor Income Tax Adjustment	-416.7
	Sales Tax Adjustment	-523.8
	Individual Income Tax Adjustment	-715.5
3.	**Intersector Distortion: All Sectors**	
	Lump Sum Tax Adjustment	2262.6
	Labor Income Tax Adjustment	2156.9
	Sales Tax Adjustment	2118.6
	Individual Income Tax Adjustment	2067.7
4.	**No Tax Distortion: C and NC Sectors, All Assets**	
	Lump Sum Tax Adjustment	326.4
	Labor Income Tax Adjustment	69.2
	Sales Tax Adjustment	-29.1
	Individual Income Tax Adjustment	-169.7
5.	**No Tax Distortion: All Sectors, All Assets**	
	Lump Sum Tax Adjustment	2663.7
	Labor Income Tax Adjustment	2603.9
	Sales Tax Adjustment	2572.4
	Individual Income Tax Adjustment	2547.2
6.	**Corporate Tax Integration**	
	Lump Sum Tax Adjustment	1313.1
	Labor Income Tax Adjustment	493.4
	Sales Tax Adjustment	238.1
	Individual Income Tax Adjustment	-274.5
7.	**Consumption Tax Rules (Zero Effective Tax Rates)**	
	Lump Sum Tax Adjustment	3853.9
	Labor Income Tax Adjustment	2045.4
	Sales Tax Adjustment	1749.3
	Individual Income Tax Adjustment	2045.4

8. **Consumption Tax Rules (Zero Effective Tax Rates; No Sales Tax On Investment Goods)**	
Lump Sum Tax Adjustment	4128.1
Labor Income Tax Adjustment	1988.0
Sales Tax Adjustment	1722.1
Individual Income Tax Adjustment	1988.0

The introduction of consumption tax rules for capital cost recovery in 1986 would have generated growth opportunities of more than *two trillion dollars*. This fundamental tax reform would have doubled the gains in U.S. economic growth that resulted from the 1986 Tax Act. This is the consequence of "leveling the playing field" among all economic sectors\-households, noncorporate businesses, and corporations. At the same time income from different types of assets\-plant, equipment, inventories, and land-would be treated symmetrically under the tax law. The tax treatment of income from all assets employed in the U.S. economy would be completely neutral under consumption tax rules like those proposed in *Blueprints*.

The first panel of Table 2 is a hypothetical tax reform that would eliminate differences in the tax treatment of different assets, but would leave the existing tax distortions due to differences in the tax treatment of corporate, noncorporate, and household capital income unaffected. The second panel would removes distortions between corporate and noncorporate business, but would not alter the treatment of income from household assets, such as owner-occupied residential housing. The third panel extends this treatment to the household sector.

The fourth panel would "level the playing field" among assets in corporate and noncorporate sectors, while the fifth would extend this treatment to the household sector as well. The sixth would reduce taxation on corporate assets to those of noncorporate assets through "corporate tax integration," as proposed by the Treasury's 1992 report, *Taxing Business Income Once*. Equalizing the treatment of income from assets in business and household sectors would create the greatest opportunities for U.S. economic growth, as indicated in the simulations summarized in the third and fifth panels of Table 2.

An important advantage of consumption tax rules is that income from capital employed in the household sector, such as owner-occupied residential housing, would be treated symmetrically with income from capital employed by corporate and noncorporate businesses. An alternative approach to equalizing the treatment of all forms of capital income would be to try to include income from owner-occupied residential housing in the federal tax base. However, this would require such politically unpalatable measures as reducing or totally eliminating popular tax deductions for home mortgage interest and state and local property taxes.

As a practical matter, the inclusion of income from the services of owner-occupied residential housing in the tax base for income would be highly problematical. Although owner-occupied residential housing is an investment from the economic point of view, the services of this housing are part of both consumption and income. A possible approach to the taxation of this part of income would be to treat each owner-occupier as a business owning a residence. This approach would involve an "imputation" for the rental value of housing as part of taxable income. European experience[3] shows that this approach is nearly impossible to implement.

A second approach to the taxation of income from owner-occupied housing would be to exclude the value of new residential construction from investment by disallowing a deduction for the purchase of a home along with all other housing-related deductions, such as home mortgage interest and state and local property taxes. In the Armey Flat Tax proposal the appeal of a low flat rate of taxation would help to offset the political consequences of eliminating these popular deductions.

A third approach to taxation of housing, employed in the Nunn-Domenici U.S.A Tax proposal represents a compromise between the existing income tax treatment and a full-scale consumption tax treatment. In this approach the current tax treatment of owner-occupied housing would be retained, while business income would be treated under consumption tax rules. This would nearly equalize the tax burdens on the household sector and the business sector. An important advantage of this compromise between income and consumption taxation would be to avoid complex transition rules for owner-occupied housing already in existence at the time of fundamental tax reform.

In summary, the principal conclusion that emerges from comparison of all eight hypothetical reform proposals is very transparent. The most important opportunities for future growth of the U.S.

[3]This experience is reviewed in my book with Ralph Landau, *Tax Reform and the Cost of Capital: An International Comparison*,

economy would be created by the adoption of consumption-tax rules for capital income. This would make it possible to reduce business taxes at both corporate and individual levels very substantially. If this approach to tax reform had been adopted in 1986 the gains would have been equivalent to almost two trillion dollars or *double* the gains resulting from the 1986 Tax Act.

4. Directions for Future Tax Reform

The purpose of the simulations of U.S. economic growth described in the preceding section is to compare actual tax reform proposals with the Tax Reform Act of 1986. The current tax structure retains many of the features that resulted from the 1986 reform. However, important changes in tax policy were incorporated into the Budget Enforcement Act of 1990 under President Bush and President Clinton's Omnibus Budget Reconciliation Act of 1993. Both of these budget agreements raised tax rates for upper income tax payers, increasing the reliance on capital income taxes relative to those on labor income. These changes have created important new opportunities for generating economic growth through fundamental tax reform.

I next provide a more precise assessment of opportunities to contribute to the future growth of the U.S. economy through tax reform.[4] For this purpose I link tax induced losses in economic efficiency directly to U.S. economic growth. I employ use a nondistorting tax system as a benchmark in measuring the loss in efficiency from taxation. In this tax system all revenue is raised by purely hypothetical "lump sum" taxes that do not distort private decisions and involve no efficiency loss. By focusing on differences in losses among alternative tax programs, I am able to identify promising avenues for future tax reform.

My first conclusion is that the loss in efficiency imposed on the U.S. economy by the current tax system is very large. The efficiency loss is equivalent to eighteen percent of government tax revenue. Each dollar of tax revenue costs the private sector a dollar of foregone investment or consumption and an additional loss in growth opportunities of eighteen cents. I refer to this estimate as the *average excess burden,* defined as the gain in efficiency that would result from replacing the whole U.S. tax system by a nondistorting system. Let me hasten to emphasize that this replacement is purely hypothetical.

The concept of efficiency loss most relevant to tax reform is the *marginal excess burden.* The marginal excess burden of the U.S. tax system is defined in terms of the efficiency loss *per dollar* for the final dollar of revenue raised. The marginal excess burden enables me to quantify one of the most familiar propositions in tax policy analysis. Since efficiency losses rise as tax burdens increase, the marginal cost of raising tax revenue is much greater than the average cost. I estimate that the marginal efficiency loss is 39.1 cents per dollar of revenue, more than double the average loss.

Most important, large differences in marginal excess burdens among different tax programs remain. For example, the marginal cost of raising a dollar through taxes on capital income at the individual level is one dollar and 1.7 cents, while the cost of raising a dollar from labor income taxes is only 37.6 cents. For every dollar of tax revenue transferred from capital income to labor income, the U.S. economy *gains* 64.1 cents in future growth opportunities. This transfer would be revenue neutral, so that it would be in perfect conformity to the Clinton Budget Plan of 1993. This provides a clear indication of important potential gains in future U.S. economic growth through tax reform.

I next describe the efficiency costs of various parts of the U.S. tax system in greater detail. For this purpose, I analyze the growth of the U.S. economy under reductions of tax rates for the following nine components of the U.S. tax system: (1) the corporate income tax; (2) capital income taxes at the individual level, including taxes levied on noncorporate capital income and taxes on individual capital income originating in the corporate sector; (3) property taxes on corporate, noncorporate, and household assets; (4) capital income taxes at both corporate and individual levels; (5) labor income taxes; (6) capital and labor income taxes; (7) the individual income tax; (8) sales taxes on consumption and investment goods; and (9) all taxes.

Table 3 presents the average and marginal efficiency costs of all components of the U.S. tax system under the Tax Reform Act of 1986. The marginal efficiency costs of the whole U.S. tax system in the ninth panel of Table 3 show that the marginal efficiency cost at rates prevailing under the 1986 tax act was .391 so that the loss in efficiency for each dollar of tax revenue raised was 39.1 cents. However, the average efficiency cost for the whole tax system was .180, so that replacing all taxes by a nondistorting tax would have increased opportunities for economic growth by an average of 18 cents per dollar of tax revenue.

The marginal efficiency cost of sales taxes given in the eighth panel of Table 3 was .262 after the reform, while the cost of property taxes given in the third panel was .176. By contrast, the

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[4]Here I draw on a second paper, "The Excess Burden of U.S. Taxation", that I have published with Yun.

marginal efficiency cost of all income taxes given in the sixth panel of Table 3 was .497. The efficiency losses were 49.7 cents per dollar of income tax revenue, only 17.6 cents per dollar of property tax revenue, and only 26.2 cents per dollar of sales tax revenue. A substantial increase in efficiency could have been realized by reducing income tax rates and increasing the rates of sales and property taxes. We conclude that the Tax Reform Act of 1986 did not successfully overcome the excessive reliance of the U.S. tax system on income taxes.

The structure of the income tax itself is completely out of balance with marginal efficiency costs of labor income taxes at .376, individual capital income taxes at 1.017, and corporate income taxes at .448. Very substantial gains in efficiency could have been realized by further reductions in marginal tax rates on individual and corporate taxes on capital income, even at the expense of increases in marginal tax rates on labor income. Considerable gains in growth opportunities for the U.S. economy could have resulted from reduced reliance on individual income taxes on capital income and more reliance on corporate income taxes.

Table 3
Efficiency Costs of US Tax Revenues After the Tax Reform Act of 1986

Tax Bases		Reduction in Tax Rates (5)										
		5	10	20	30	40	50	60	70	80	90	100
1. Corporate Income	MEC	.448	.435	.418	.397	.379	.363	.348	.334	.322	.310	.301
	AEC	.448	.442	.431	.421	.412	.404	.397	.391	.384	.379	.374
2. Individual Capital Income	MEC	1.017	.989	.951	.904	.853	.812	.767	.727	.688	.650	.613
	AEC	1.017	1.003	.977	.953	.928	.906	.884	.863	.842	.822	.803
3. Property Value	MEC	.176	.174	.171	.168	.164	.160	.157	.153	.149	.145	.142
	AEC	.176	.175	.173	.171	.169	.168	.166	.164	.162	.160	.158
4. All Capital Income	MEC	.675	.650	.616	.573	.533	.498	.466	.435	.407	.382	.359
	AEC	.675	.663	.640	.619	.600	.582	.566	.551	.537	.524	.512
5. Labor Income	MEC	.376	.358	.333	.303	.276	.253	.237	.216	.201	.190	.183
	AEC	.376	.367	.350	.334	.320	.307	.296	.285	.275	.266	.259
6. 1 + 2 + 5 = 4 + 5	MEC	.497	.462	.414	.355	.301	.254	.212	.175	.142	.114	.091
	AEC	.497	.480	.448	.418	.391	.366	.343	.323	.304	.287	.271
7. Indiviual Income	MEC	.520	.490	.449	.396	.349	.305	.265	.229	.196	.167	.140
	AEC	.520	.505	.477	.451	.426	.403	.381	.361	.342	.325	.308
8. Sales Value	MEC	.262	.259	.254	.249	.242	.236	.230	.224	.218	.211	.205
	AEC	.262	.261	.257	.254	.251	.248	.245	.242	.239	.236	.232
9. All Tax Bases	MEC	.391	.356	.308	.249	.197	.151	.113	.082	.063	.048	.040
	AEC	.391	.374	.342	.312	.285	.260	.238	.220	.204	.190	.180

Second, within the income tax there is excessive reliance on taxes on capital income at the individual level.

Finally, existing taxes on capital income put excessive burdens on individuals, relative to corporations. Taxes on capital income at both corporate and individual levels are too burdensome, relative to taxes on labor income. Every dollar transferred to labor income taxes from capital income taxes at the individual level costs the U.S. economy 64.1 cents in lost growth opportunities. Reversing the direction of the 1986 reform by raising marginal rates for "high income" taxpayers has greatly increased the tax burden on capital income. This will be enormously costly in terms of opportunities for reviving the growth of the U.S. economy.

In summary, the best way to create new growth opportunities for the U.S. economy would be to reduce the top rates of taxation at the individual level, not to increase these rates. This could be financed by cutting back on tax expenditure programs such as deductions for mortgage interest and state and local property taxes. President Bush's Budget Enforcement Act of 1990 and the Clinton Omnibus Budget Reconciliation Act of 1993 have substantially increased taxes on capital income at the individual level. A growth-oriented tax policy requires reinforcing the basic thrust of the Tax Reform Act of 1986 by reducing differences in the marginal excess burdens imposed by different parts of the U.S. tax system.

5. Conclusion

My first overall conclusion is that increases in tax rates for upper income taxpayers in 1990 and 1993 have nullified many of the growth opportunities for the U.S. economy created by the Tax Reform Act of 1986. It is important to underline this conclusion, since the recent emphasis on "soaking the rich" has increased reliance on capital income taxes relative to those on labor income. This will be enormously costly in terms of future opportunities for growth of the U.S. economy. Future tax reforms should strengthen rather than weaken the basic thrust of the Tax Reform Act of 1986.

Second, Neutral Cost Recovery is an important contribution to the debate over tax reform. This tax proposal would introduce provisions for recovery of capital costs that are equivalent to the expensing of investment expenditures required under consumption tax rules. However, Neutral Cost Recovery must be combined with other tax reforms, such as the elimination of deductions for interest expenses, in order to enhance the neutrality of the federal tax system. Achieving neutrality in the taxation of income from all assets in the U.S. economy is the most important goal for future tax reform.

Finally, changing the federal tax base from income to consumption is an idea whose time has come. This change will create very important new opportunities for growth in the standard of living of all Americans. The traditional objections to consumption as a base for taxation on grounds of fairness have been successfully addressed in the Armey Flat Tax and the Nunn-Domenici U.S.A. Tax proposals. These proposals would create substantial new growth opportunities for the U.S. economy. Both are based on weel established economic ideas and could serve as a point of departure for tax reform legislation.

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Mrs. JOHNSON OF CONNECTICUT. Thank you, Dr. Jorgenson. Professor Kotlikoff.

STATEMENT OF LAURENCE J. KOTLIKOFF, PROFESSOR OF ECONOMICS, BOSTON UNIVERSITY

Mr. KOTLIKOFF. Thank you, Madam Chairman.

Madam Chairman and other Members of the Committee on Ways and Means, I am honored by this opportunity to discuss with you the economic effects of consumption taxation.

My testimony makes five points. First, consumption taxation would be very good for the U.S. economy. It would raise saving, investment, employment, output, and real wages. It would also eliminate a number of major distortions in our current tax structure and thereby significantly raise U.S. economic efficiency.

The second point is that the predicted economic benefits from consumption taxation are substantial. Generic simulations of shifting from income to consumption taxation in the standard, neoclassical economic growth model, the life cycle model, produced long-run increases in living standards ranging from about 10 to 20 percent. These simulations provide some sense of the beneficial economic effects of consumption taxation, although much more detailed simulation studies are needed of particular proposals.

Third, consumption taxation increases saving in large part—and I think this is a point that many of you may not be aware of—consumption taxation increases saving in large part by redistributing from older generations, with high propensities to consume, to younger and future generations with low or zero propensities to consume. In redistributing from the old to the young, and to the unborn, consumption taxation would offset to a small degree the enormous past and ongoing reverse redistribution from the young to the old that has resulted from the expansion of pay-as-you-go entitlement programs, and which is the primary cause for the critically low current rate of U.S. saving.

The fourth point is that consumption taxation, even one levied at a single rate with no exceptions, is much more progressive than is generally believed to be the case. And again here is I think something that is not generally understood by Members of Congress. The reason that consumption taxation is much more progressive than is commonly believed is that consumption taxation represents a tax on wages and a tax on wealth. If you think about how Donald Trump would fare under, for example, a retail sales tax, whenever he went out to spend his money on whatever he buys, Mercedes or vacation trips, diamonds for friends and relatives, he would pay the tax. But under the current income tax, he is paying taxes just on his interest income, his capital income, dividend income and capital gains; he is not being taxed on his principal.

Since a consumption tax combines wage and wealth taxation, it is really taxed principal. And since much of the inequality in living standards across members of each generation represent differences in the amounts of inherited wealth, the wealth tax component of a consumption tax would enhance intragenerational equity.

I think that if the proponents of consumption taxation really understood it, they would be less for it; and if the opponents of it really understood it, they would be more supportive.

The fifth point is that the U.S. economy needs consumption taxation. Whether that consumption taxation should be in the form of a retail sales tax, a flat tax, a personal consumption tax, an electronic consumption tax or a value-added tax, can provide hours of very fascinating debate. But each of the different methods of taxing consumption does tax consumption. Each has its own advantages and disadvantages. But it will be a tragedy if we fail to adopt one of the methods of consumption taxation because we are locked in a debate over which is the best one.

In my view, any of the alternative proposed consumption taxes would be far superior to our current system of taxation.

Thank you.

[The prepared statement and attachments follow:]

TESTIMONY OF LAURENCE J. KOTLIKOFF
BOSTON UNIVERSITY

Chairman Archer and Other Distinguished Members of The Committee on Ways and Means:

I am honored by this opportunity to discuss with you the economics effects of consumption taxation.

My testimony makes five points.

First, consumption taxation would be very good for the U.S. economy. It would raise saving, investment, employment, output, and real wages. It would also eliminate a number of major distortions in our current tax structure and thereby significantly raise U.S. economic efficiency.

Second, the predicted economic benefits from consumption taxation are substantial. Generic simulations of shifting from income to consumption taxation in the standard neoclassical economic growth model -- the life-cycle model -- produce long-run increases in living standards ranging from about 10 to 20 percent. These simulations provide some sense of the beneficial economic effects of consumption taxation, although much more detailed simulation studies are needed of particular proposals.

Third, consumption taxation increases saving, in large part, by redistributing from older generations, with high propensities to consume, to younger and future generations with low or zero propensities to consume. In redistributing from the old to the young and unborn, consumption taxation would offset to a small degree the enormous past and ongoing reverse redistribution that has resulted from the expansion of pay-as-you-go entitlement programs and which is primarily responsible for the critically low level of U.S. saving.

Fourth, a consumption tax, even one levied at a single rate with no exemptions, is much more progressive than is generally believed to be the case. The reason is that consumption taxation represents the combination of wage taxation and wealth taxation. Since much of the inequality in living standards across members of each generation represents differences in the amounts of inherited wealth, the wealth tax component of a consumption tax would enhance intragenerational equity.

Fifth, the U.S. economy needs consumption taxation. Whether consumption taxation should come in the form of a retail sales tax, a flat tax, a personal consumption tax, an Electronic Consumption Tax[1], or a value-added tax is a question that can provide hours of interesting debate. Each of the different

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[1] Under the Electronic Consumption Tax (the ECT), discussed in Kotlikoff (1995), households pass their ECT card through a card reader when they purchase goods and services. Montly purchases (but not the composition of purchases) are tallied and transmitted to the IRS, which withholds taxes. On April 15th, the IRS calculates consumption over the previous calender year, assesses taxes based on a progressive rate structure, and makes tax refunds or witholds additional taxes depending on whether total monthly withholdings in the prior calender year exceeds or falls short of the household's annual tax liability. Since the IRS' withholding of taxes and refunds of overpayments can be made electronically, the ECT entails no use of tax forms.

methods of taxing consumption has it advantages and disadvantages. But it will be a tragedy if we fail to adopt one of these methods of consumption taxation because we are locked in debate over which is the best one. In my view, any of the alternative proposed consumption taxes would be far superior to our current system of taxation.

The Crisis in U.S. Saving

In 1950, the U.S. rate of net national saving was 12.3 percent. In 1994, it was only 3.5 percent. The difference in these saving rates is illustrative of a dramatic long-term decline in U.S. saving. The U.S. saving rate averaged 9.1 percent per year in the 1950s and 1960s, 8.5 percent in the 1970s, 4.7 percent in the 80s, and just 2.7 percent in the first five years of the 1990s.

The decline in U.S. saving has been associated with an equally dramatic decline in U.S. domestic investment. Since 1990, net domestic investment as a share of net national product has averaged 3.6 percent per year, compared with 8.2 percent in the 1950s, 7.9 percent in the 1960s and 1970s, and 6.1 percent in the 1980s.

The low rate of domestic investment has limited growth in labor productivity and, consequently, growth in real wages. Since 1980, labor productivity has grown at less than half the rate observed between 1950 and 1979, and total real compensation (wages plus fringe benefits) per hour has grown at only one-eighth its previously observed rate.

Understanding the Decline In Saving

Table 1 reports average values of the net national saving rate for the 1950s, 1960s, 1970s, and 1980s as well as the first five years of the 1990s. The table also reports rates of government and household consumption out of output. In addition, the table reports my preferred measure of private-sector saving, the *household saving rate*, which equals the share saved of the output left over to the household sector after the government has consumed.

As Table 1 indicates, government spending is not responsible for reducing the rate of national saving. Indeed, government spending in the 1990s has averaged just 21.0 percent of output -- as low a rate as any observed in the five periods. The rate of household consumption spending, on the other hand, rose from 69.9 percent of output in the 1950s to 76.6 percent in the early 1990s. This increased rate of household consumption was associated with a decline in the household saving rate from 11.5 percent in the 1950s to 3.2 percent in the 1990s.

Whose Consumption Has Risen?

If the driving force behind the decline in U.S. saving is an increase in the rate of household consumption, it's natural to ask whose consumption within the household sector has risen so rapidly? The answer is the elderly's. Tables 2 and 3 document this fact.[2] They show a remarkable increase in the relative

[2] These tables come from Gokhale, Kotlikoff, and Sabelhaus (1995).

consumption of the elderly over four periods for which Consumer Expenditure Survey data are available. This increase is more pronounced if medical care is included in the measure of consumption, but the increase in the relative consumption of non medical goods and services is also striking.

As shown in Table 4, the striking increase in the relative consumption of the elderly has coincided with an equally remarkable increase in their relative resources.[3] Indeed, as described in Gokhale, Kotlikoff, and Sabelhaus (1995), the the postwar decline in U.S. saving can be traced to two factors: a) this redistribution of resources toward older generations, with high propensities to consume, from younger ones (including those not yet born), with low or zero propensities to consume and b) increases in the propensity of the elderly to consume.

Much of the redistribution to the elderly reflects the growth in Social Security, Medicare, and Medicaid benefits. The increase in the elderly's consumption propensities may also reflect government policy, namely the fact that government transfers to the elderly come in the form of annuities. In providing these annuities, which are, of course, indexed for inflation, the government has, in effect, told the elderly they needn't worry as much about over-consuming and running out of income.[4]

Implications of the U.S. Saving Decline for Evaluating Consumption Taxation

The fact that the government's past and ongoing intergenerational redistribution appears to be the chief culprit for the decline in U.S. saving is worth bearing in mind in considering switching from income to consumption taxation. Such a switch would partially offset this process of taking from the young and unborn and giving to the old. It would do so by placing a somewhat higher tax burden on the initial elderly and a somewhat lower tax burden on younger and future generations. In switching tax structures (and thus redistributing from the elderly with high propensities to consume to the young and unborn with low or zero propensities to consume), the government can engineer a reduction in aggregate consumption and a concomitant rise in national saving. This redistributional or "income" effect is the key reason that consumption taxation raises national saving.

Alternative Ways to Tax Consumption?

As indicated above, there are a number of different ways of taxing consumption. One way, which you, Mr. Chairman, and Senator Lugar have proposed is through a federal retail sales tax under which the consumption purchases of all Americans are taxed at the same rate. Although a retail sales tax would produce a proportional rather than progressive consumption tax, progressivity vis a vie

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[3] The term "resources" refers to a generation's net worth plus the present values its future labor income, pension income, and Social Security, Medicare, and other transfer payments, less the present value of its future taxes.

[4] In addition, the medical care annuities that the government provides through Medicare and Medicaid come in the form of in-kind consumption of medical goods and services which the elderly cannot help but consume.

consumption could be achieved by combining a retail sales tax with a graduated refundable tax credit or by exempting from sales taxation those commodities on which the poor spend disproportionately more than do the rich.[5]

Another way to tax consumption, proposed by Senators Nunn and Domenici in their USA Tax, is to tax households on their incomes, but allow them a deduction for the amount they save. This personal consumption tax can be assessed at progressive rates since the government receives a tax return specifying each household's total annual consumption.[6]

The Electronic Consumption Tax (ECT) falls between a retail sales tax and a personal consumption tax. Like a retail sales tax, it taxes consumption directly. But like a personal consumption tax, it taxes consumption at progressive rates. Under the ECT, households would be required to run their ATM card through an electronic reader in making their consumption purchases. The amount of the purchase would be recorded by the household's bank. Running the card through the reader will be required regardless of whether the household pays for its purchases with cash or through an electronic withdrawal from its bank. Each month the total amount of households' consumption purchases (but not the composition of these purchases) would be reported to the government, and estimated taxes would be withheld, on a progressive basis, based on the amount reported. Tax witholding would be made electronically either as payroll deductions or as deductions from the household's checking account, so there would be no need for households to file any tax forms. At the end of the year, the government would calculate, on a progressive basis, each household's annual consumption and its annual consumption tax. Households which overpaid taxes during the year would receive an electronic refund, and those who underpaid would experience an electronic withdrawal.

David Bradford, Professor of Economics at Princeton University and former Member of the President's Council of Economic Advisers, has suggested taxing household labor income Y*l* at progressive rates and taxing, at the business level, the difference between capital income and investment (Y*k* - I, business cash flow) at the highest tax rate. This proposal, which he calls "The X Tax," also produces a form of progressive consumption taxation.

Congressman Armey's and Senator Specter's proposed flat taxes also tax Y*l* at the personal level and Y*k*-I at the business level, but they apply a single proportional tax rate.[7] Since these proposed flat taxes include quite high personal exemptions, low income household are exempt from taxation.

A proportional value added tax is another option for taxing consumption. The value added tax, which is used in virtually all other developed countries, taxes Y -

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[5] Differential rates of sales taxation of consumption goods and services would, however, potentially produce significant economic distortions in consumer choice. It would also undermine one of the main advantages of retail sales taxation -- its simplicity and clarity.

[6] David Bradford originally proposed this form of progressive consumption taxation in Blueprints for Basic Tax Reform, U.S. Department of Treasury, Washington, D.C.: U.S. Government Printing Office, 1976.

[7] Armey's Flat Tax proposal is quite similar to that in Hall, Robert E. and Alvin Rabushka, The Flat Tax, Stanford University: Hoover Institution Press, 1986.

I, but does so, for each commodity, by taxing Y - I in each stage of the commodity's production.

Why Tax Consumption?

Given that governments can tax consumption directly or indirectly and that they can do so either with progressive or proportional tax rates, why would they want to tax only output that is consumed and exempt from taxation output that is save (invested)? The answer is that a consumption tax provides more incentive to save (invest) than does an income tax. As the identity Y = C+S, where Y is output, C is consumption, and S is saving, indicates, taxing output can be viewed as taxing saving as well as consumption. Now economists view saving, not as an end in itself, but as a means to finance future consumption. So by taxing consumption and saving, an income tax effectively taxes future consumption twice, once when households save funds for future consumption and once when they engage in that future consumption. Since current consumption is taxed only once (ignoring past taxes on saving because bygones are bygones), in deciding between consuming more now and saving for future consumption, an income tax provides an incentive, at any point in time, to consume more now and save less for the future.

In addition to providing better saving incentives, moving from an income to a consumption tax produces, as previously mentioned, an intergenerational redistribution away from older generations toward younger and future generations that also lowers aggregate consumption and raises national saving. The reason this intergenerational redistribution occurs is that older generations pay a larger share of consumption taxes than they do of income taxes. Under an income tax, elderly retirees pay tax on only their capital income, whereas under a consumption tax, they pay tax on all their consumption purchases. Since elderly retirees finance their consumption by spending not just capital income earned on their net worth, but also their net worth (their principal) as well as private and social security pension benefits, the consumption of the elderly, taken together, exceeds their capital income. Moreover, the consumption of the elderly is a larger share of aggregate consumption than is their capital income as a share of aggregate taxable income. Consequently, a shift from taxing income (including the capital income of the elderly), to taxing consumption (including that of the elderly), places a relatively higher tax burden on the elderly.

Economists refer to the change in economic behavior, such as saving, that arise from a change in one's resource position as *income effects*. They refer to changes in economic behavior due to changes in incentives, holding resources constant, as *substitution effects*. The above discussion indicates that the substitution and income effects of moving from income taxation to consumption taxation reinforce one another. Both work in favor of lowering aggregate consumption and raising national saving.

Why Consumption Taxation Represents a Combination of Wage and Wealth Taxation

The income effects from consumption taxation arise, in large part, because the consumption tax represents a combination of a tax on wages and a tax on

wealth.[8] The reason is that the goods and services that households purchase over time are ultimately financed by the wages they earn plus their initial wealth. Consider, for example, a millionaire who doesn't work, but spends his wealth on consumption. In the case of a retail sales tax or the ECT, the millionaire pays tax as he spends down his wealth; hence, the consumption tax effectively taxes his wealth. Now suppose the millionaire also works. Then when he spends his wage earnings, he also pays consumption taxes, so the consumption tax also effectively taxes wage earnings. If the millionaire chooses not to consume and passes his wealth to his heirs, they will be taxed when they spend their inherited wealth.

The USA tax also includes an implicit wealth tax, albeit a modified one because of its transition rules. Under the USA tax, households that spend more than $50,000 of their assets on consumption must include the excess spending as taxable income.

The flat tax, at least the one originally designed by Hall and Rabushka, also represents an effective tax on real wealth. Under the flat tax, as under our current income tax structure, the sale, by businesses (really, by the owners of businesses), of their real assets (their plant, equipment, and inventories) is included in the calculation of business revenues and is subject to tax. But, unlike the current tax structure, the flat tax permits no deduction of the basis of the asset when it is sold. If the basis of the asset could be deducted, the flat tax, like our current income taxation of businesses, would be taxing simply the capital gains realized by businesses on the sale of their real assets. Why? Because capital gains are calculated as the difference between the sale price of the asset and its depreciated tax basis.

Can owners of real assets avoid the additional tax arising from not being able to deduct basis by simply not selling their asset, but instead, continue to use them to produce business income? The answer is no. The market value of real assets will fall to the point that the owners of the assets will be indifferent between retaining and selling their assets. This decline in the market value of existing real wealth (which will be registered on the stock market) represents an effective tax on real wealth.

To understand why the market value of real business assets must fall, consider an investor, ABC Co., which is considering purchasing a newly produced real asset, say a drill press, for $1000 or buying an existing business, DEF Co., with, for simplicity, a single asset -- an identical drill press which it had purchased prior to the switch to the flat tax and which has a basis of $1000. Assume, for simplicity,

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[8] To see this algebraically, note that at time t, $C_t = Yl_t + Yk_t - S_t$. But, if we let W_t stand for wealth at time t, then $Yk_t = rW_t$, where r_t is the rate of return earned on wealth (i.e., rW_t equals capital income). Also, $S_t = W_{t+1} - W_t$. Hence, $C_t = Yl_t + rW_t - W_{t+1} + W_t$. Write this equation out for time t+1, t+2, etc., and then use the t+1 equation to substitute out for W_{t+1} in the time t equation, to get a new time t equation that will depend on W_{t+2}. Next use the time t+2 equation to substitute out for W_{t+2} in the new time t equation. Proceding in this manner leads to an equation in which the present value of consumption equals the present value of current plus future labor earnings plus initial wealth. Multiplying each side of this present value budget constraint by the tax rate t shows that taxing consumption through time at rate τ is equivalent to taxing earnings through time at rate τ plus taxing initial (time t) wealth at rate τ.

that drill presses do not physically depreciate, so the two machines are physically identical. If ABC purchases the new drill press, it can immediately expense it (deduct its purchase price from its business income). If the flat tax rate is 20 percent, the value of the write off is $200. If ABC purchases DEF, it acquires the same machine, but can't expense it. Consequently, the market value of DEF must fall until ABC and other potential investors are indifferent between purchasing DEF directly and purchasing the same real asset owned by DEF, but expensing it. Hence, the market value of DEF will be $800.

Now, if ABC purchases and then liquidates DEF, it will be able to sell DEF's drill press on the market for $1000, because the new owner can treat the press as a new asset and expense it. But in selling the drill press, ABC will produce $1000 in sales revenues for its subsidiary, DEF, and, thus, a $200 tax liability. Hence, in liquidating DEF, ABC will end up with $800. So whether ABC buys DEF to hold it or to liquidate it, the most it will pay is $800. If it tries to buy DEF for less than $800, the owners of DEF will refuse, because they will be able to find other buyers willing to pay $800. Hence, the market price of DEF will be $800.

Wealth Taxation and National Saving

Since, as just mentioned, the elderly have a disproportionately large share of wealth, a switch from income to consumption taxation places a relatively large share of the tax burden on them. Although the consumption tax also, in effect, taxes wage income, which is also taxed under the income tax, it does so at a lower rate than under the income tax because the consumption tax provides more revenue from its effective wealth taxation. Hence, the young, who are disproportionately larger earners of labor income, benefit from the shift from income to consumption taxation because their effective rate of wage taxation is reduced.

The reduction in the effective rate of wage taxation stimulates labor supply, thereby raising output and further increasing aggregate saving. This stimulus to labor supply will be even greater if the switch in tax structures is from a progressive income tax to a proportional consumption tax. Why? Because the incentive to work depends on the marginal rate of taxation of labor supply, not the average rate. Under progressive income taxation, the marginal effective rate of taxation of labor supply is higher than under a proportional income tax, which is higher still than under a proportional consumption tax.

The Importance of Implicit Wealth Taxation

Note that if initial wealth is effectively exempted from consumption taxation through the design of special transition rules, a switch from income to consumption taxation will really end up as a switch from income to wage taxation. In this case, "consumption" taxation will produce a much smaller reduction in consumption and, consequently, a much small increase in aggregate saving. Why? Because the switch from income to wage taxation redistributes from the young to the old, since the elderly have relatively little wage income, but benefit from the elimination of capital income taxation. Although a wage tax structure provides better incentives to save, its income effects work to reduce saving. Indeed, the net impact, according to simulation studies (see Auerbach and

Kotlikoff, 1987) of a switch from income to wage taxation is a relatively modest increase in aggregate saving, investment, and output.

Efficiency Gains from Consumption Taxation

The current tax system contains a number of distortions which also could be eliminated by switching to consumption taxation. One of these distortions is the differential tax treatment of corporate and noncorporate business that distort business ownership and control decisions. A second is the differential tax treatment of capital gains and dividends that distort firms' decisions about retaining earnings and that lock investors in from selling shares of stock which have accrued capital gains. A third is the implicit subsidy to home ownership, as well as automobiles, and other durable goods that arises from our failure to tax, under the income tax, the rental income we implicitly earn from the services on these durables.[9] A fourth is the subsidization of current relative to future consumption (the tax on saving) associated with the taxation of capital income. A fifth is the differential tax treatment of investment in equipment, structures, and inventories. A sixth is the distortion in corporate financial structure due to the deductibility of interest payments, but the nondeductibility of dividends. And an seventh is the subsidization of health insurance premia and other fringe benefits that are currently exempt from income taxation, but would be treated like wage compensation under most consumption tax proposals.

The distortion of labor supply incentives associated with income taxation would also be eliminated by the proposed tax shift. But a consumption tax would distort this margin of choice as well, so one needs to compare the efficiency gains from eliminating the income tax's distortion of labor supply with the efficiency loss from adding the consumption tax's distortion of labor supply. There is good reason, however, to expect the tax shift to result in a net reduction in the distortion of labor supply. The reason, as mentioned above, is that consumption taxation will extract a larger share of its revenues from older generations, many of whom are retired. As a result, the total tax that needs to be collected from working generations is smaller under a consumption tax than it is under the income tax.

The distortion of labor supply will also be substantially reduced if our progressive income tax rate is replaced by a low, single-rate consumption tax because the low tax rate will leave most workers facing significantly lower total effective marginal tax rates on their labor supply than is currently the case. The size of economic distortions of particular economic activities rises with the square of the total effective marginal tax rate on that activity. In the case of labor supply, most Americans face marginal taxes above 50 percent on their earnings once one adds together the effects of all the different tax and transfer programs at the federal, state, and local government levels. This is an extremely high level of marginal

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[9] To see this, suppose homeowners, owners of automobiles, and owners of other durables were forced to pay rent to themselves for their use of their homes, cars, furniture, etc. At one level, this would be a wash, since the person writing the check would also be the recipient of the check. But this requirement would raise households' taxable income, leading them to pay more income taxes. Does it make sense to think of, say, a home owner as renting her house to herself? The answer is yes since in occupying her house, the home owner is effectively earning the rent on the house and then spending it on herself.

taxation, which is highly distortive. The reduction in this marginal rate of taxation through a retail sales tax or a flat tax, represents a very strong argument for their adoption.

The Auerbach-Kotlikoff Dynamic Life Cycle Simulation Model[10]

The Auerbach-Kotlikoff Model (henceforth, the AK model) can provide some sense of the potential saving, investment, and growth effects of shifting to a consumption tax.[11] The AK model calculates the time-path of all economic variables in its economy over a 150 year period. The model has 55 overlapping generations. Each adult agent in the model lives for 55 years (from age 20 to age 75).

There are three sectors in the model: households, firms, and the government. Households (adult agents) make decisions concerning how much to work and how much to save based on the after-tax wages and after-tax rates of return they can earn in the present and the future on their labor supply and saving, respectively. The work decision involves not only deciding how much to work in those years that one is working, but also when to retire. The AK model's particular form of consumption and leisure preferences that agents use in making their labor supply and saving decisions were chosen in light of evidence on actual labor supply and saving behavior.5

As agents age in the model, they experience a realistic profile of increases in wages. This age-wage profile is separate from the general level of wages, the time-path of which is determined in solving the model. Fiscal policies affect households by altering their after-tax wages, their after-tax rates of return, and, in the case of consumption taxes, their after-tax prices of goods and services. The model is equipped to deal with income taxes, wage taxes, capital income taxes, and consumption taxes. It is also able to handle progressive as well as proportional tax rates.

All agents are assumed to have the same preferences, so differences in behavior across agents arise solely from differences in economic opportunities. Since all agents within an age cohort are assumed to be identical, differences in economic opportunities are present only across cohorts. In this study, the model's population growth rate is set at a constant 1 percent rate, with the population of each new cohort being 1 percent larger than that of the previous cohort.

The AK Model's production sector is characterized by perfectly competitive firms that hire labor and capital to maximize their profits. The production relationships that underlie firms' hiring decisions and production of output are based on

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[10] This section presents the results reported in Kotlikoff (1992) of simulations of a switch from federal income taxation to a retail sales tax. Because a retail sales tax is equivalent to a flat tax of the type originally proposed by Hall and Rabushka, the simulation findings apply to the flat tax as well. The simulations are highly stylized. They do not, for example, take into account proposed exemptions from taxation as well as a number of other features of the flat tax proposals recently advanced by Congressman Armey and Senator Specter.

[11] For a detailed description of the AK Model see Auerbach and Kotlikoff (1987).

empirical findings for the U.S. The government sector consists of a treasury that collects resources from the private sector to finance government consumption and an unfunded, "pay as you go" Social Security system which levies payroll taxes to pay for contemporaneous retiree benefit payments. The model does not distinguish federal from state and local government. Hence, in simulating with the model the elimination of income taxation in favor of consumption taxation, we will, in effect, replace all state and local income taxes, as well as federal income taxes, with a federal consumption tax which can be thought of as a federal retail sales tax, a value added tax, or a flat tax. There is no money in the model, and thus, no monetary policy. There is, however, government debt, and the model can handle deficit-financed tax cuts. It can also handle gradual phase-ins of one tax for the other.

While the model handles a great number of complex processes, its predictions need to be viewed cautiously for several reasons. First, the model does not deal with several of the real world distortions associated with the income tax that were mentioned above. For example, it doesn't distinguish corporate from noncorporate production, housing consumption from non housing consumption, different forms of corporate finance, different types of investment, or differences in capital gains and dividend tax rates. Nor does it permit the kind of tax arbitrage that is available to most tax-paying Americans through tax-subsidized saving accounts. Second, the model's agents are heterogeneous only with respect to their age. There are no welfare recipients or millionaires, whose saving and work behavior might differ dramatically from that of the model's agents. Third, the model does not include saving for purposes other than retirement, such as bequests. Fourth, the model does not incorporate uncertainty either with respect to individual or macroeconomic outcomes. Fifth, the model ignores illegal tax avoidance, an issue that would certainly arise in implementing any and all other form of consumption taxation. While the model abstracts from a significant portion of reality, it can, nonetheless, suggest the degree to which a switch from consumption taxation to income taxation might raise U.S. national saving.

Simulating the Switch from Proportional Income to Proportional Consumption Taxation

In simulating the switch from income taxation to a federal consumption tax, one needs to specify the economy's initial position as well as the way the tax change takes place. To begin, let's assume that the economy has a 15 percent proportional income tax and a 17 percent sales tax. The 15 income tax figure is based on the 1991 ratio of the sum of federal, state, and local personal and corporate income taxes to net national product. The 17 percent sales tax figure is based on the 1991 ratio of the sum of federal, state, and local sales and excise taxes to total personal consumption.6 These taxes are used to finance government consumption spending as well as pay interest on the government debt. The level of government debt is set at 50 percent of output.7 In addition to these features of fiscal policy, the economy is assumed to have a "pay-as-you-go" social security system with a 15 percent payroll tax rates.

Findings

Table 5 shows the transition-path of the economy that results from replacing in year 0 the model's income tax with a proportional consumption tax. I set the new

federal consumption tax rate at the level needed, in conjunction with the pre-existing 17 percent sales tax, to continue to finance the same level of government spending as well as pay interest on the stock of government debt. The first row in the table indicates the economy's initial (year 0) position. With no change in tax policy the economy would remain in this position through time. I measure annual saving rates, annual interest rates, and tax rates in percentage points. In the case of our economy's other variables, the units of measurement are arbitrary, so I describe each of these variables in terms of an index which has an initial (base-year) value of 100.

The initial position of the economy features a 2.6 percent saving rate, a per capita capital stock of 100, a per capita labor supply of 100, a level of per capita output of 100, a real wage rate of 100, a real interest rate of 9.4 percent and, of course, a zero federal consumption tax rate. The 2.6 percent saving rate is close to the current U.S. rate of saving, and the 9.4 percent real interest rate is close to the annual real rate of return that has been earned, on average, on the U.S. capital stock in the postwar period.

The remaining rows in Table 5 show how each of these variables reacts to the introduction at time 0 of the federal consumption tax. As row 1 indicates, the tax change produces an immediate and dramatic increase in the economy's saving rate from 2.6 percent to 9.0 percent. While the saving rate gradually declines after year 1, it remains above 6 percent through the tenth year of the transition. The long-run (year 150) value of the saving rate is 3.2 percent -- 23 percent larger than the year 0 value.

The increased saving produces a concomitant increase in investment. As a result, the capital stock rises. Indeed, the switch in tax regimes leads, eventually (by year 150), to a 34 percent increase in the per capita capital stock. The increase in the capital stock is gradual; only about one quarter of the ultimate increase occurs in the first 10 years of the transition. The increase in the capital stock raises the productivity of workers and thus their real wage. The policy also lowers the return to capital. The real interest rate falls by almost 200 basis points in the course of the transition.

While the real wage ultimately ends up 7 percent higher than it would have been without the tax change, for the first few years of the transition the real wage actually falls. The reason is that agents respond to the prospect of higher real wages and higher short-term real interest rates by increasing their labor supply. In the short run, before the capital stock has had much of a chance to increase, there is an increase in the supply of labor relative to the supply of capital. As a result, labor in the first few years of the transition becomes relatively abundant, meaning that the price it receives in the market -- the real wage -- falls. Eventually, as interest rates fall, the incentive to work more in order to save more and receive higher rates of return on the additional savings diminishes. As a result, labor supply declines. In the long run, the supply of labor is only one percent greater than it is in year 0.

The changes in the supplies of capital and labor alter the per capita level of output. Between year zero and year 1, there is a 4 percent increase in output. In the following 10 or so years the switch in the tax structure raises the economy's growth rate by two tenths of one percent per year. In the long-run, the level of per capita output is 8 percent larger than it is at time 0.

The final variable to discuss is the consumption tax rate. The year 1 value of this tax rate is 23.1 percent. But it declines through time, with its value in the long-run ending up at 16.7 percent. The reason the tax rate can decline is that the growth of the economy permits a higher level of consumption and thus produces a higher consumption tax base. In addition, the reduction in the interest rate lowers required interest payments on the government's debt.

To summarize the findings in Table 5, the simulation of a switch to a federal consumption tax produces a significant increase in saving, capital accumulation, the real wage, and the level of per capita income. While the dynamics are nonlinear (e.g., labor supply first rises and then falls), all of the results make intuitive sense.

Maintaining a Constant Consumption Tax Rate

As an alternative to having the consumption tax rate decline through time, we might want to have a tax rate that is constant through time. I've used the model to simulate such a policy. I've found that if I set the tax rate equal to 19 percent, the model produces deficits in the short-run, since the additional tax revenue raised with the 19 percent tax falls short of the loss in revenue from eliminating the 15 percent income tax. But over time, the growth of output and the consumption tax base associated with the reform raises the amount of revenue collected by the 19 percent tax permitting the full retirement of the additional debt that is issued in the short-run. In this constant tax rate simulation the long-run capital stock and output levels are 32 percent and 7 percent higher than their respective year 0 values. These long-run percentage increases may be compared with the 34 percent and 8 percent increases of Table 5.

Are the Results Reasonable?

Given the size of the model's predicted response to a switch to a consumption tax, one might ask whether the results are really plausible or whether they simply reflect some extreme assumptions about labor supply and saving behavior. The answer is that the labor supply and saving responses assumed in the model are quite conservative. They are certainly well within the range of responses that have been estimated in the empirical economics literature. In addition, the life cycle model being simulated is the basic bread and butter model of neoclassical economics.8

There is, however, one feature of the model which may make the transition occur faster in the model than it would in the real world. This is the model's assumption that new capital can be immediately added to the existing stock of capital without the incursion of installation costs. As discussed in Auerbach and Kotlikoff (1987), the addition of such installation costs would slow down the transition, but would not alter the size of the long-run change of any of the economy's variables.

Another issue, with which I have not yet dealt, is the progressivity of the income tax which is to be replaced. As mentioned, the AK model can handle progressive as well as proportional tax rates. In the case of a progressive income tax, whose degree of progressivity is roughly comparable to that now in the U.S., the year 0

position of the economy from which the transition begins is one featuring a 2.2 percent, rather than a 2.6 percent, saving rate, a per capita capital stock that is 18.1 percent smaller, a per capita labor supply that is 5.2 percent smaller, a per capita output level that is 8.6 percent smaller, a real wage that is 3.5 percent smaller, and an interest rate of 10.4 percent rather than 9.4 percent. Since the switch from this progressive income tax regime to a proportional consumption tax produces the same long-run outcome as indicated in the last row of Table 6, the saving, capital accumulation, and growth effects of the tax change are all magnified by assuming that the initial income tax is progressive. For example, the long-run increase in the per capita capital stock is 63.4 percent, and the long-run increase in per capita output is 18.3 percent.[12]

The Impact on the Initial Elderly

While switching to a consumption tax has a lot to recommend it, this does not include the treatment of the initially elderly who, as mentioned, end up paying much more in consumption taxes than they would have paid in income taxes. For example, in the simulation of Table 5, the oldest elderly in year 1, those who are age 55, suffer a 23 percent decline in their final year's consumption. There are different ways to avoid, or at least mitigate, this redistribution away from those who are old at the time of the switch in tax structures. One is to make additional transfer payments to the initial elderly by, for example, raising social security benefits. The problem with making transfer payments to the initial elderly is that these transfer payments will lead them to consume more and this additional consumption will limit the increase in saving and capital accumulation.

Table 6 points this out. It shows the transition arising from an immediate switch to a retail sale tax, but one in which the government makes transfer payments to all generations alive at the time of the transition to ensure that none of these generations is made worse off from the tax switch. These transfer payments are, of course, largest for the oldest generations alive at the time of the tax switch, since they do not benefit as much from the elimination of income taxes as do younger generations. While the provision of this compensation to initial generations limits the additional saving generated by the consumption tax, there remains, nonetheless, a substantial saving response. According to Table 6, there is a 22 percent increase in the economy's long-run capital stock. While this is less than the 34 percent increase of Table 5, it is still quite substantial. With the compensation scheme in place, the long-run increase in per capita income is 6 percent (compared with 8 percent with no compensation). The fact that one can compensate initial generations in switching to a federal consumption tax and still make future generations significantly better off is reflective of the inefficiency of an income tax structure relative to a consumption tax structure.

Summary and Conclusion

Our nation is facing a grave saving crisis. We are saving at record low levels, and unless we start saving more, we will continue our slide toward second-class

[12] Interestingly, as described in Auerbach and Kotlikoff (1987), almost the same final steady state arises if the switch is to a progressive consumption tax.

economic status. A shift to consumption taxation, be in the form of a retail sales tax, a flat tax, a value-added tax, the Electronic Consumption Tax, the X Tax, or the USA Tax, has the potential for dramatically increasing our saving rate. It would do so by improving incentives to save and by redistributing from the elderly with high propensities to consume to young and future generations with low or zero propensities to consume.

In addition to raising saving and investment, consumption taxation would reduce many of the distortions of the current tax system. Indeed, the distortion of saving behavior alone is so great under our current system of income taxation that it appears we could switch to consumption taxation, fully compensate the initial elderly for their higher tax burden, and still end up with a much higher saving, capital formation, and per capita income.

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Table 1

Saving and Spending Rates

Period	Net National Saving Rate (Y-C-G)/Y	Government Spending Rate G/Y	Household Consumption Rate C/Y	Household Saving Rate (Y-G-C)/(Y-G)
1950-59	.091	.210	.699	.115
1960-69	.091	.221	.688	.117
1970-79	.085	.214	.701	.108
1980-89	.047	.213	.740	.059
1990-94	.027	.207	.766	.031

Y stands for net national product, C stands for household consumption expenditure, and G stands for government purchases of goods and services.

Table 2

Consumption of the Elderly Relative to the Young

Comparison	1960-61	1972-73	1984-86	1987-90
Age 60/Age 20	1.17	1.37	1.58	1.59
Age 70/Age 20	0.97	1.21	1.56	1.64
Age 80/Age 20	0.89	1.16	1.61	1.60
Age 60/Age 30	0.86	0.93	1.09	1.15
Age 70/Age 30	0.71	0.82	1.07	1.18
Age 80/Age 30	0.65	0.79	1.11	1.16
Age 60/Age 40	0.77	0.83	0.87	0.91
Age 70/Age 40	0.64	0.73	0.86	0.94
Age 80/Age 40	0.58	0.70	0.89	0.92

Source: Gokhale, Kotlikoff, and Sabelhaus (1995).

Table 3

Non Medical Consumption of the Elderly Relative to the Young

Comparison	1960-61	1972-73	1984-86	1987-90
Age 60/Age 20	1.11	1.28	1.43	1.42
Age 70/Age 20	0.86	1.04	1.22	1.28
Age 80/Age 20	0.75	0.91	1.16	1.11
Age 60/Age 30	0.81	0.86	0.97	1.02
Age 70/Age 30	0.63	0.70	0.83	0.91
Age 80/Age 30	0.55	0.61	0.78	0.80
Age 60/Age 40	0.73	0.78	0.77	0.80
Age 70/Age 40	0.57	0.63	0.66	0.72
Age 80/Age 40	0.49	0.55	0.62	0.63

Source: Gokhale, Kotlikoff, and Sabelhaus (1995)

Table 4

Resources[a] of the Elderly Relative to the Young

Comparison	1960-61	1972-73	1984-86	1987-90
Age 60/Age 20	1.10	1.41	1.72	1.81
Age 70/Age 20	0.85	1.14	1.49	1.58
Age 80/Age 20	0.63	0.71	0.76	0.83
Age 60/Age 30	0.92	1.07	1.26	1.31
Age 70/Age 30	0.72	0.86	1.09	1.15
Age 80/Age 30	0.53	0.54	0.56	0.60
Age 60/Age 40	0.82	0.95	1.05	1.10
Age 70/Age 40	0.64	0.77	0.91	0.96
Age 80/Age 40	0.47	0.48	0.47	0.51

[a]Resources refers to net worth plus the present values of future labor income, private and government pension benefits, and government transfer payments less the present value of government taxes.
Source: Gokhale, Kotlikoff, and Sabelhaus (1995)

Table 5

Simulating An Immediate Switch From Income Taxation to a Consumption Tax

Year	Saving Rate	Capital[a] Stock Index	Labor[a] Supply Index	Output[a] Index	Wage Index	Interest Rate	Consumption Tax Rate
0	2.6	100	100	100	100	9.4	0.0
1	9.0	100	105	104	99	9.7	23.1
2	8.5	102	105	104	99	9.6	22.5
3	8.1	105	105	105	100	9.4	21.9
4	7.8	107	105	105	100	9.2	21.5
5	7.5	109	104	105	101	9.1	21.1
.							
10	6.2	117	103	106	103	8.5	19.5
20	4.5	127	101	107	106	7.9	17.9
.							
60	3.7	131	101	108	107	7.8	17.3
.							
90	3.2	134	101	108	107	7.5	16.8
.							
150[b]	3.2	134	101	108	107	7.5	16.7

a The capital stock, labor supply, and output are per capita measures.
b Year 150 represents the economy's final steady state.

Table 6

Simulating An Immediate Switch From Income Taxation to a Consumption Tax But Compensating Initial Elderly for their Increased Tax Burden

Year	Saving Rate	Capital[a] Stock Index	Labor[a] Supply Index	Output[a] Index	Wage Index	Interest Rate	Consumption Tax Rate
0	2.6	100	100	100	100	9.4	0.0
1	6.6	100	104	103	99	9.7	22.1
2	6.4	101	104	104	99	9.5	21.8
3	6.3	103	104	104	100	9.4	21.5
4	6.1	104	104	104	100	9.3	21.2
5	5.9	106	104	104	100	9.2	21.0
.							
10	5.1	111	103	105	102	8.8	19.9
.							
20	4.1	118	102	106	104	8.4	18.7
.							
60	3.0	122	101	106	105	8.1	17.8
.							
90	3.0	122	101	106	105	8.1	17.8
.							
150[b]	3.0	122	101	106	105	8.1	17.8

a The capital stock, labor supply, and output are measured per capita.
b Year 150 represents the economy's steady state.

Mr. ZIMMER [presiding]. Thank you very much.

Mr. English will inquire.

Mr. ENGLISH. Thank you.

Again, I appreciate the opportunity to participate with such a distinguished group of panelists. I guess I wanted each of you to comment on an issue which has been raised earlier as it applies to each of these systems. And I notice that one of the earlier participants in the hearing raised the question of tax equity.

Obviously, it is very difficult to measure tax equity, and I am not sure that there has been a very precise standard offered here. I guess what I would like you to do is answer the question, in assessing the tax equity of each of these systems, should we also be taking into account the impact of growth and opportunity that might arise from the tax changes that each of these systems contemplates for middle-class families and for working families?

Dr. Walker, would you care to comment?

Mr. WALKER. Congressman, you put your finger on an extremely important issue. It has become the fashion in recent years, with tax policy and tax changes, to get the Joint Committee on Taxation to draw up burden tables, which is an extremely difficult, if not impossible task, depending on the set of assumptions which many might not agree with. But to bring those into the picture and suggest that any change in the tax system which on paper changes that distribution, is unfair.

That leaves out the most important thing that you mentioned, and that is the creation of good, high-paying, high-quality jobs, restoring growth to our living standards, which are practically not growing at all, and maintaining the economic strength of the United States so that we can remain a world leader.

A second point I would make, some people define fairness of a tax solely in terms of progressivity of rates. The point that I made earlier having to do with the demagoguery of rich versus poor is put frequently in terms of how progressive the rate structure is, as if that is the end-all and be-all of the tax system's fairness to the taxpayer. And it is his or her perception that makes a difference.

Consequently—and I am not coming down for the flat tax per se. Any one of these, as Professor Kotlikoff says, is better than what we have now. But if you say that the flat tax is not fair because you cannot produce the progressivity in rates that you have under systems in the past, and ignore completely the fact that the taxpayer, number one, would love the simplicity, and two, would believe that the simplicity would stop the ripping off that he knows is there because it would be so simple and not so complex, then you need to think a little more carefully about the question of fairness.

Let me close my statement with a quote from the Wall Street Journal which David Bradford put in his excellent book a few years ago. In 1985, a typical taxpayer was queried on, How do you feel about the income tax system? He said, I am mad as hell. When asked, why are you mad?, he said, I am getting ripped off. How are you getting ripped off?, he was asked. He said, I don't understand how I am getting ripped off, but if I understood how I am getting ripped off, I would be even madder than I am right now.

Mr. ENGLISH. Thank you, Dr. Walker.

Dr. Kotlikoff.

Mr. KOTLIKOFF. I am not sure I recall exactly the original question, but the——

Mr. ENGLISH. Had to do with equity.

Mr. KOTLIKOFF. I think equity is an important part of a tax structure. I think that we have to distinguish different aspects of equity. For example, we need to think about intergenerational equity, how we are treating young versus old. The current fiscal system is extremely inequitable from that perspective, because it is leaving an enormous bill for the next generation, as generational accounting.

The other key aspect of equity is intragenerational equity. Unfortunately, we are not producing good measures of intragenerational equity. If we move to consumption taxation, as I was pointing out in my testimony, we will enhance intragenerational equity because we will be really shifting from taxing income to taxing the combination of wages and wealth.

Now, I think that point is extremely important. It is one that I don't think has been raised by other witnesses before you. I think you really need to focus on that. This is a combination of a wage and wealth tax. This is what we teach our graduate students when they come to learn about what happens when you shift from income to consumption taxation; you are really shifting from income taxation to the combination of a wage and a wealth tax. A millionaire who goes and spends his principal, Donald Trump, if he blew all his money today after, let's say, the Archer retail sales tax was put into place, he would pay taxes, perhaps 20 percent of his wealth would go in the form of taxes in terms of retail sales taxes.

So we are really taxing the principal of wealth under a consumption tax, whether it be a sales tax or a flat tax. Each of these taxes has a wealth tax aspect to it.

Again, if the advocates of consumption taxation really understood how equitable it is, how redistributive it is, they would be less for it. And if the opponents really understood it, how it works, they would be more in favor of it. I think it would be very healthy. I think it would improve intragenerational equity, because a lot of the inequity within generations reflects inherited wealth, which is very unevenly distributed.

So I think that consumption taxation wins out on equity grounds as well as efficiency grounds, as well as savings and investment and growth grounds. It is hard to beat it.

Mr. ENGLISH. Thank you for that powerful testimony, and my time has elapsed.

Chairman ARCHER [presiding]. Who is next at this point?

Mr. RANGEL. Mr. Chairman.

Chairman ARCHER. Charlie, you have never been bashful. You are always going to step forward, so I will recognize you.

Mr. RANGEL. Thank you so much for your kindness, Mr. Chairman.

Dr. Walker, it has been a long time since we have had a chance to exchange views on this subject that is very dear to you. In the past you never used such mean-spirited language about people envious of those that have been able to acquire wealth. And to think that they would attempt to manipulate the system in order to redistribute—it would seem like those who have earned it, have

taken the risk, certainly should be given the opportunity to save and invest and, as you pointed out, allow America to continue to provide leadership in the world commerce, and therefore create better jobs for more people, and they too should aspire to be able to save more of what they earn and there should be a constant source of people not trying to take advantage of the earnings of someone else, but to strive to reach that level where they too can earn.

In the previous question, I was trying to find out from the economists just what responsibility would a government have, not only to provide for less consumption, more savings and more investment in plant and machinery, but how do we invest in labor in order to make certain that we are prepared to accept the responsibilities of providing people for these new high-paying jobs?

Clearly, all of us would agree that pumping money into a prison system and an emergency ward system and an aid system and addiction system and a police system is not the way to go. And whether or not the Federal Government should be involved in education and training, that is outside of it.

But you, Dr. Walker, to make certain that we don't have this envy in terms of income, at what level of government, if government should be involved at all, should we depend on the investment in the training of individuals with the same degree of concern as we should for the concern in saving?

Mr. WALKER. Well, it is good to exchange views with you again, Congressman Rangel. It seems to me that what we are talking about here is one of the beauties of our capitalistic system, of the way our economy works.

I was surprised when Mr. English told me some time back what a terrific amount of export and manufacturing activity he has in his particular district. If you create, in my judgment, the proper rules of the game for the system to work, which we do not have particularly in the tax system, it is the worst part of it, at all, business itself will step in and see that the people who work for them get the proper training, provided we attack this fundamental question of the inadequacy of our secondary educational system and the transition from high school into productive work.

Mr. RANGEL. How do we deal with that, Dr. Walker?

Mr. WALKER. I think the basic approach is at the State level. Mr. Archer may have heard this, I have heard it from friends in Texas, my home State, that Texas corporations have despaired at hiring Texas high school graduates, some of whom can't even read their diplomas. And I have friends in Texas that I could name that are eagerly awaiting the chance with the new administration in Texas to attack the K through 12 problem in the educational system.

Mr. RANGEL. Texas traditionally has not really been a major investor in education. Over the years when I was sitting next to Jake Pickle, we have noticed the tables of investment, and taxes, for whatever reason, the reason——

Mr. WALKER. I don't think Texas, though, is churning out any more students than other parts in the country that are spending a lot more money on education.

Mr. RANGEL. No, I didn't mean it in that way. What I meant was that if you and I want to achieve the highest potential of talents with our employers in terms of national interests, whether it is

Texas or New York, and certainly amount of money doesn't guide as to who has the best system available to them, but do you really want to turn over whether or not our country is producing a sufficient quality employee to the private sector, that we should leave that to the States?

Mr. WALKER. Not a question of leaving that to the States. There may be ways to give them incentives to do more. But I know that Texas businessmen and corporate leaders can't wait to get to the reform issue in Texas. And I think this is true of other States also.

Now, look at the other side. When did we establish the Department of Education? I don't remember, but it has been around a long, a very long period of time. And Federal activity has grown and what has happened to the quality of our high school graduates? You give business good high school graduates that can read, write and have good work habits, they will turn them into the people or help turn them into the people to occupy these better, more challenging, high-paying jobs, at least in my opinion.

Mr. RANGEL. Thank you, Doctor.

Chairman ARCHER. Well, this is a very illuminating discussion.

Mr. RANGEL. My time passes by. I just wanted to point out that while you don't always agree, you are beginning to sound more like me, at least in terms of your voice.

Mr. WALKER. I am a little under the weather.

Chairman ARCHER. Very interesting discussion about an issue that is not before the Committee today, but the gentleman's time has expired, and Mr. Christensen may inquire.

Mr. CHRISTENSEN. Thank you, Mr. Chairman.

Dr. Walker, I really appreciate your testimony. You—no offense to my friends from the academic world, but you really seem to have your head screwed on straight with a Ph.D. And I appreciate your perspective.

Mr. WALKER. Thank you, I appreciate your remark.

Mr. CHRISTENSEN. And I know that Dr. Kotlikoff and Dr. Jorgenson have given a lot of thought to this, so I want to get their ideas on a couple questions. The first one would be, Dr. Kotlikoff, you have—and am I pronouncing that name correct?

Mr. KOTLIKOFF. Very good. Better than me.

Mr. CHRISTENSEN. Can you tell me more about this electronic consumption tax? It is the first I have read about it and I see you have a little bit about it in your written testimony. Could you walk that through with us and how that would work?

Mr. KOTLIKOFF. OK. It is an idea I just came up with. It is not that I am advocating electronic consumption tax over the other proposals. I think each has pluses and minuses, but anyway the electronic consumption tax would work like this.

Everyone would have a card, and when you go to the store to buy something, whether you are buying it with cash or a credit card or ATM card, you take your ECT card and just run it through the card reader. And that would send to your bank the information about how much you spent on consumption. At the end of the month, the bank would tally up your total purchases, your total expenditure on consumption, and send that information to the IRS. It wouldn't send the information about the composition of your purchases, just the total.

Then the IRS would withhold taxes and it could do it on progressive rates or proportional rates, depending on what Congress chose to legislate. So it is a way of having a retail sales tax, while having progressive tax rates.

Mr. CHRISTENSEN. In your idea of the ECT card, would this be mainly a tracking system for the tax or would this also be a mode of payment for your goods and services then?

Mr. KOTLIKOFF. Well, you pay—this would track your tax liability, and then the government could electronically withhold the tax payment from your, for example, from your wages or from your checking account. So potentially we could set this tax up in such a way that absolutely no tax forms need being filed. That beats a postcard.

This is one way to have a progressive consumption tax where the actual tax is a little bit more transparent to the individual taxpayer. Because every time he buys a good or service, he'll have to run his card through the card reader.

Mr. CHRISTENSEN. I would like to get your opinion and Dr. Jorgenson's opinion on the flat tax proposal and whether or not in your opinion it would be an advantage to go with a—if we were to go with a flat tax, whether it would be a pure flat tax or whether it would be a modified flat tax with, say, the two exemptions that I continue to hear discussed are the mortgage interest deduction and the charitable deduction.

I know that there is going to be a lot of discussion on this and a lot of debate, but in your own personal opinion, where do you think we would go if we were to follow the flat tax philosophy?

Mr. JORGENSON. Well, I think of the flat tax philosophy which would be applied without any modification would involve the following guiding principle. Everybody who had a home would have a schedule C, and would treat ownership of a home as a business, for which there would be some kind of rental liability.

None of the flat tax proposals that I have seen, the Armey proposal or the Hall-Rabushka proposal, involve anything like that. In fact, owner-occupied housing is carefully excluded from the definition of investment in both of those proposals. So I think that that would be one way to treat the housing, would be to simply leave it out of the tax system and leave out capital gains. And that is the flat tax in the Hall-Rabushka variety.

Another approach which is represented in the U.S.A. tax approach of Senators Nunn and Domenici, involves preserving the current system of having a system of mortgage tax deductions and tax deductions for State and local interest. That has very important advantages, because that would I think put the treatment of investment in housing pretty much on par with business assets, if the rest of the taxation of investment was treated on the basis of a flat tax or consumption tax approach.

So I think either of those approaches are compatible with the basic flat tax. And I certainly would not advocate the extreme form of everybody has a schedule C and treats their home ownership like a business, which would be a perhaps principled version of a flat tax proposal with a consumption tax base.

Mr. CHRISTENSEN. Dr. Kotlikoff.

Mr. KOTLIKOFF. Well, I agree with Professor Jorgenson. I think that we have been oversubsidizing housing, and too much of our capital stock through time, our precious capital stock, has gone into housing relative to plant and equipment, which will raise the productivity of workers and ultimately their real wages.

So I think that if we do adopt a flat tax, that we should do it without special provisions for housing other than deductibility of mortgage interest. I think the Hall-Rabushka proposal deals with housing in a reasonable manner, and the beauty of a flat tax or a retail sales tax is keeping it simple, keeping it pure. Once you start opening the door, you are going to have all kinds of claims to exemptions and deductions and you will get back through time where you started.

In the case of the sales tax, if you start exempting certain kinds of commodities, you will through time end up with a very complicated system, one in which there is great disincentive to purchase certain kinds of goods versus others and a lot of economic distortion. Really, the beauty of these ideas is that they are very simple and pure. They should be kept in that form.

Mr. CHRISTENSEN. Thank you. And I tend to agree. I appreciate your comments.

Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Payne may inquire.

Mr. PAYNE OF VIRGINIA. Thank you very much, Mr. Chairman.

I must say I agree with much of what you said, but I think we have here a responsibility to look more broadly than just at the Tax Code, at the implications of home mortgage interest deductions or charitable deductions or many of these elements of the Tax Code, because there will be some very broad ramifications of what some actions might do and some unintended consequences. Certainly we need to look at those as well.

I just had one question. It had do with the 1986 tax act, and, Dr. Jorgenson, you talked about it in your testimony. I was struck this morning when Mr. Dakin from Mobil Oil was here, he mentioned that since 1986 the amount of resources required for him to complete all the documents that he needs to complete for Mobil Oil, has increased by about 34 percent.

The year 1986 then was an attempt to, among other things, simplify the Tax Code. And if this is any indication of the simplification that occurred as a result of 1986, it must be that from a public policy point of view, we missed the mark at least on that account.

Would you comment on that and what is it that we might learn from that experience as we begin to look once again at reforming the Tax Code?

Mr. JORGENSON. Well, I think that the key decision that was made at the beginning of the debate in 1986, almost before the matter came before this Committee, was to stick with the income tax and not consider seriously the possibility of shifting to a completely new system, as has been proposed by advocates of a consumption tax.

I think that that is the starting point for the kind of complexification of the Tax Code, as opposed to simplification, that actually took place in 1986. As people begin to think about trying to reform the income taxation, they begin to think about things like

being sure that everybody paid some tax. That led to the alternative minimum tax, which accounts for a very large part of this increased administrative burden that you heard about at the opening testimony this morning.

So it seems to me that Chairman Archer has pointed this out on many different occasions, including this morning, that starting with a totally new system, based on a consumption tax or consumption tax base as opposed to an income tax base, offers the only hope it seems to me for simplification.

What we found out in 1986 was that as a result of sticking with the old income tax system, we ended up with a system that was much more complex, although I think from the economic point of view, it certainly had some sizable benefits. If we had shifted to a consumption tax at that time, I think those benefits would have been doubled.

Mr. PAYNE OF VIRGINIA. Are you suggesting then that if we do look at a flat tax there is no way that it would be a simpler system than the system we have in place, that there is no reform of the present income tax system that would result in a simpler system.

Mr. JORGENSON. Yes. The reason is that income is an idea that is much more difficult to define in economic or legal terms than consumption. Consumption is something which is relatively unambiguous in both economic and legal definitions. That being the case, a consumption tax lends itself to simplification.

A good example are the comsumption-based taxes that are actually used in Europe, the so-called value-added taxes, tax systems that involve very complicated administrative systems, with a system of credit for previous tax paid, but from the economic point of view and from the legal point of view, we have to think in terms of legal implementation of these systems.

It is clear that the definition of consumption is something that is intrinsically a good deal simpler than the idea of income, which compares income from labor, income from different forms of capital, different forms of capital income, from equities, from self-employments, from debt; these involve legal complexities that can be done away with by a shift to a consumption-based tax.

Mr. PAYNE. Thank you very much.

Chairman ARCHER. Ms. Dunn.

Ms. DUNN. Thank you, Mr. Chairman.

I want to ask Dr. Walker a question, because your presentation on savings was very interesting to me. During the debate that many of us were involved in during the first few months of this congressional session when we proposed a tax relief bill, there were many on the other side who explained that providing tax cuts to people or companies was simply going to add to the deficit and create problems for us.

I would like to take advantage of your expertise in the area of capital gains to ask you to explain how the capital gains rate cut contributes to our much healthier degree of savings and investment here in the country.

Mr. WALKER. Well, I would approach that by first taking a look at the assistance a cut on capital gains taxes provides to the entrepreneur, which is a great part of the vigor of our capitalistic system. A young man who invents a better mousetrap and it is a good

one and tries to raise the money and needs to market it, produce it and needs to hire some $300,000-a-year engineers from GE and others, and he doesn't have the money but he can promise them stock or stock options. The lower the capital gains tax, the much easier it is for him to do that because they will get a higher rate of return.

Second, if a lower capital gains tax happened tomorrow, all capitalized assets would rise in value, stocks, anything that is subjected to a capital gain. That in turn gives you more vigor in your economy through what economists call the wealth effect, and so forth. These are commonly recognized.

What is not sufficiently recognized even by corporate CEOs themselves—chief financial officers, frequently, yes; chief executive officers, I have been very surprised and somewhat disappointed. What is important, and I have served on several boards, in an investment decision is whether the internal rate of return which you have all these young MBAs figuring out covers your cost of capital.

Several factors go into that cost of capital. Lower capital gains rates will give you a lower cost of capital. People buy stock for one reason. They want a return and they can get that as a dividend or as appreciation of the value of stock. I don't buy for dividends. I don't want any more current income in that sense. I buy for appreciation.

Now, if Uncle Sam lays a 100 percent capital gains tax on that, I am not interested. Fifty percent at least I have more interest. Twenty-five percent I have more interest, and 19.8 percent, I have a dickens of a lot more interest. So it is easier for us directors in corporations that are making investment decisions to retain the earnings and save the stockholders who don't want dividends—no, we retain the earnings because of their capital gains and the good return. This lowers their capital costs actually and increases business investment.

On the saving side, that is just a part of the overall picture of how much of an impact of saving you get from reducing taxes on savings because that is what capital gains are.

Ms. DUNN. Thank you.

Chairman ARCHER. Do any other Members wish to inquire?

Gentlemen, thank you very much. I appreciate your testimony.

The Chair invites our next panel to come to the witness table: Jennie Stathis, Arthur Hall, Charles Adams, James Payne and David Raboy.

We would like you to keep your oral testimony to 5 minutes and you may submit for the record more extensive testimony in writing.

Ms. Stathis, with the GAO, would you proceed, please?

STATEMENT OF JENNIE S. STATHIS, DIRECTOR, TAX POLICY AND ADMINISTRATION ISSUES, GENERAL GOVERNMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE

Ms. STATHIS. Yes, sir. Thank you, Mr. Chairman and Members of the Committee. I am pleased to be here today to participate in your hearing.

I was invited to talk about the tax gap, and that is in fact one of the problems with the current income tax system. One of the

challenges that IRS has is to reduce the amount of income taxes that are owed but not paid.

IRS' current estimate is that the tax gap amounts to more than $100 billion annually. While these types of estimates are necessarily imprecise, they do give you some ballpark ideas of the challenge.

To summarize, I would like to ask Committee Members to turn to page 6 of my statement where I have attached a table which shows the components of IRS' tax gap estimates. You will see there that 74 percent is attributed to individual taxpayers and only about a fourth to corporations.

You will also see that unreported income is considered to be by far the largest problem, overstated deductions accounting for a small percentage. One piece of information that might be of interest to you in considering changes, is that only about 30 percent of individual taxpayers now itemize; so it is not surprising that deductions make up such a small percentage of this gap.

If you turn to the next page, you will see a further breakdown by type of income for individual taxpayers and what IRS calls voluntary reporting rates. In wages and salaries, there is a reporting rate of 97 percent. Where you have interest and dividends which are largely subject to information reporting, the compliance rate drops to 90 and 87 percent. But if you will look down the page, you will get to sole proprietors where there is largely not withholding or information reporting, and the reporting rate is 36 percent. A subcomponent of that is the informal suppliers. They are estimated to report only 11 percent of their income.

Also missing from these estimates is the illegal economy. IRS does not make estimates for the income tax gap from illegal activities anymore, believing that both the data and the methodology are lacking with which to do that.

I have also included in the statement beginning on page 3 some of the factors that we believe are important in influencing the level of compliance in any system that you decide to embark upon. The first is that the simpler the rules, the better. The second is that collecting from fewer sources is easier. The third is that more visible tax information promotes higher compliance. The fourth is that good information is critical to identifying any compliance problems that you have. The tax administrator needs to be on top of that.

Fifth is that you then use that information to focus whatever compliance efforts you might have where they will do the most good. And sixth is dealing with problems quickly. Those are factors that seem to permeate all types of noncompliance that IRS has thus far identified with the income tax.

In closing, let me just say that promoting or encouraging uniform compliance with whatever system we have is important. I know there was some discussion this morning about equity and one subcomponent of equity is trying to ensure that everyone complies to a similar extent. That is why compliance levels are going to be important in whatever system you decide to embark upon.

With that, I will conclude my summary.

[The prepared statement and attachments follow:]

TAXPAYER COMPLIANCE

STATEMENT OF
JENNIE S. STATHIS
DIRECTOR, TAX POLICY AND ADMINISTRATION ISSUES
GENERAL GOVERNMENT DIVISION
U.S. GENERAL ACCOUNTING OFFICE

Mr. Chairman and Members of the Committee:

We are pleased to be invited by the Committee to discuss the income tax gap. One of the biggest challenges facing the Internal Revenue Service (IRS) is finding ways to reduce the gross income tax gap--the difference between income taxes owed and voluntarily paid. IRS has estimated that taxpayers do not voluntarily pay more than $100 billion annually in taxes due on income from legal sources. While such a "tax gap" estimate is necessarily imprecise, it does indicate the size of the challenge confronting tax administration.

My statement covers four points:

-- IRS information, while dated, suggests that U.S. taxpayers voluntarily pay 83 percent of the income taxes they owe--87 percent after IRS audits and other IRS programs. Although this compliance level may be relatively high by world standards, it translates into large sums of "tax gap" dollars because of the size of our economy.

-- Compliance is not uniform across groups of taxpayers. IRS estimates that wage earners report 97 percent of their wages; the self-employed report 36 percent of their income; and "informal suppliers"--self-employed individuals who operate on a cash basis--report just 11 percent of theirs.

-- Significantly, the IRS data show that compliance is highest where there is tax withholding, a little lower where there is information reporting to IRS, and much lower where there is neither. In addition to the relative visibility of the income to tax administrators, the complexity of tax rules, together with a number of other factors, also influence the level of tax compliance.

-- Some of the "tax gap" may not be collectible at an acceptable cost. Collection, in some instances, could require either more recordkeeping or reporting than the public is thought willing to accept or too costly an IRS effort. Thus, it is important that IRS measure compliance with the tax laws and use that information to effectively focus its resources.

I would like to begin with a discussion of the "tax gap" estimates and how they are derived.

TAX GAP ESTIMATES

Tax gap estimates, for the most part, begin with IRS' Taxpayer Compliance Measurement Program (TCMP). In this program, IRS audits a random sample of tax returns, examining every item to identify both under- and over-reporting. These results are then used to estimate compliance levels for the population as a whole. Other sources are used to estimate taxes not paid by large corporations, by those who do not file tax returns, and by those "informal suppliers" who operate cash-based businesses.

Excluded from the estimates are taxes that go uncollected from illegal activities such as drug dealing and prostitution. IRS researchers believe the data and methodology for including such estimates are lacking. Also excluded are other types of taxes--for example, employment and excise taxes.

IRS last estimated the gross tax gap in 1988, for tax years 1973 through 1992. (See table I.1.) The estimates relied on earlier TCMP results, the latest covering tax year 1982. Later TCMP results for tax years 1985 and 1988 (for individuals) and 1987 (for small corporations) have not yet been reflected in tax gap estimates. After making some adjustments for tax law changes and shifts in types of income, IRS estimated that taxpayers have been paying about 83 percent of the taxes they owe. Factoring in estimates of economic growth, IRS derived an income tax gap of as much as $127 billion for tax year 1992. Thus, regardless of the adequacy of IRS enforcement programs, the tax gap could continue to grow in current dollars because of economic growth and changes in tax law that could have the unintended effect of increasing opportunities for noncompliance.

By IRS' estimates, its enforcement programs have, on average, recovered about 4 percent of total income taxes due in any particular tax year. Thus, overall compliance has tended to reach about 87 percent after IRS audits and other IRS programs. But, because of the time consumed by IRS' activities and subsequent appeals and litigation, it may take a number of years to reach the 87-percent compliance level.

COMPONENTS OF THE TAX GAP

Tax administrators from other countries have told us that IRS' data suggest a relatively high level of tax compliance in the United States compared to other countries. Yet, within this overall average level of compliance, are a range of estimates by type of taxpayer or income.

As shown in table I.2, IRS attributes about three-fourths of the tax gap to individuals and one-fourth to corporations. The individual tax gap is due primarily to individuals not fully reporting their income (about $73 billion of the $94 billion estimate). In comparison, smaller estimates were attributed to individuals overstating their deductions ($8 billion) or not making full payment with their returns ($11 billion). The tax gap estimate for corporations is divided between large corporations ($24 billion) and small corporations ($7 billion).

Within these overall tax gap measures, however, compliance across groups of individual taxpayers is not uniform. (See table I.3.)

-- Wage earners whose salaries are subject to tax withholding (the most visible form of income to IRS) are estimated to report 97 percent of their wages.

-- Those with interest and dividends are estimated to report 90 percent of their interest income and 87 percent of dividends--income that for the most part is subject to tax information reporting but not to tax-withholding.

-- In contrast, IRS estimates that the self-employed report about 36 percent of their income--income that is neither subject to withholding nor necessarily covered by information reporting.

-- And finally, among the self-employed who operate informally and thus are even less likely to have income reported to IRS on information returns, compliance is estimated to be about 11 percent.

Similarly, variations in compliance patterns exist in the corporate sector. Small corporations, whose compliance level dropped to 61 percent in IRS' tax year 1987 TCMP, tend to mirror the compliance patterns of sole proprietors. Underreported income is the biggest compliance problem and sufficient documentation is often a problem. Large corporations, in contrast, tend to have issues associated with the ambiguity and

complexity of the tax code. Upon audit, IRS auditors and corporations sometimes interpret tax provisions differently, leading to contested issues. For example, IRS has ultimately collected about 22 cents for each $1 of proposed audit assessments of the nation's 1,700 largest corporations.

Analyzing such tax gap patterns suggests a number of factors which influence the size of the tax gap.

SYSTEMIC FACTORS THAT INFLUENCE TAX COMPLIANCE

Tax administrators around the globe work to promote compliance with whatever tax regime is in place. Some common factors influence their success level.

First: The simpler the rules, the better. This reflects the basic principle that the simpler the tax code and the more certain the results in applying it, the fewer the opportunities for disagreement over the "fine points" of the law. However, very few would argue that the existing U.S. tax system is either simple or certain. For example, some paragraphs in the Internal Revenue Code have generated as much as 250 pages of implementing regulations.

Second: Collecting from fewer sources is easier. Tax withholding allows the tax collector to focus cn the relatively small number of employers, rather than all employees. Congress also followed this reasoning in changing the collection point for diesel fuel taxes to the smaller number of businesses earlier in the production chain. Subsequent to this and other changes in the taxation scheme for diesel fuel, collections have risen significantly.

Third: More visible tax information promotes higher compliance. Tax-withholding and information reporting are two means of making income and some deductions visible to both the taxpayer and the tax administrator, which results in compliance rates that are significantly higher. Good records and other types of paper trails also lead to better results when the tax administrator audits a return or takes some other enforcement action. Other countries have transaction information from administering value-added taxes--information not readily available to IRS.

Fourth: Good information is critical to identifying compliance problems. This factor recognizes the importance of systematically estimating the extent of noncompliance and variations in taxpayer behavior. In this way, the tax administrator can identify areas warranting attention, tax returns to audit, and the results of any efforts to improve compliance.

Fifth: Focus compliance efforts where they will do the most good. Having information on the most significant compliance problems allows IRS to tailor its efforts accordingly. At present, the largest component of the income tax gap is attributable to individuals not fully reporting their income--an estimate that has led IRS to train its auditors to better detect such situations.

Sixth: Deal with problems quickly. Another potential byproduct of assessing problem areas is the ability to deal with them quicker. IRS has found that the longer it takes to reach a taxpayer, the less likely it will achieve a favorable outcome.

THE CHALLENGE FOR IRS

When some taxpayers do not pay all the taxes they owe, the burden of funding government programs shifts to taxpayers who do comply. Thus, maintaining high levels of compliance is important for equity reasons. Yet, it would not be realistic to assume that

all of the tax gap revenues can be recovered. To do so would mean imposing burdens and costs that our society is unlikely to accept. While we do not know how much recovery is realistic, IRS' current plans are to improve compliance from the estimated 87-percent level to 90 percent by the year 2001.

One method by which IRS hopes to achieve such results is by increasing its compliance presence. And there is room for growth. Over the last 30 years, the rates at which IRS has audited income tax returns have declined over 75 percent. And, while alternative mechanisms such as document matching reach certain types of income, IRS has no such substitute for more complex issues.

This year IRS will also undertake another TCMP. This TCMP will be larger than earlier ones because it will cover four types of taxpayers. The most recent TCMP for individual taxpayers was tax year 1988, for small corporations tax year 1987, for partnerships tax year 1981, and for S corporations tax year 1984. The TCMP is very important because it is IRS' only tool for measuring compliance levels and developing formulas for objectively selecting returns to audit. The time and documentation requirements may be of concern to taxpayers selected for a TCMP audit. But TCMP audits will actually reduce the overall long-term burden[1] on taxpayers to the extent that they reduce the number of compliant taxpayers selected for other IRS audits.

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In concluding my testimony this morning, I would like to reiterate how important it is for IRS (or other tax administrators) to invest agency resources to measure noncompliance and use that information to balance efforts among the competing goals of (1) maximizing tax revenues, (2) promoting uniform compliance, and (3) minimizing taxpayer burden. I would welcome any questions you or Members of the Committee may have.

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[1]GAO's prior testimony Tax System Burden: Tax Compliance Burden Faced by Business Taxpayers (GAO/T-GGD-95-42, Dec. 9, 1994) discusses the difficulties of measuring tax system burden. An extract of that testimony is shown at Appendix II.

SELECTIVE TAX GAP SUMMARY STATISTICS

Table I.1: Range of Estimates of the Gross Legal-Sector Income Tax Gap and Voluntary Compliance Rates for Selected Tax Years 1973-1992

Tax year	Gross income tax gap[1] ($ billions)						Voluntary compliance rate[2] (percent)					
	Total		Individual income tax		Corporate income tax		Total		Individual income tax		Corporate income tax	
1973	27.9	32.0	22.0	22.7	5.9	9.3	83.9	82.0	83.0	82.6	86.6	80.3
1976	39.7	45.5	32.6	33.7	7.1	11.8	82.7	80.7	81.2	80.7	87.3	80.6
1979	61.0	69.0	51.5	53.2	9.6	15.9	81.9	80.0	80.3	79.8	87.2	80.4
1982	64.6	70.5	57.5	59.1	7.1	11.4	82.9	81.7	82.2	81.8	87.1	80.8
1984	83.0	91.3	73.5	75.7	9.6	15.6	81.6	80.1	80.4	80.0	87.2	80.6
1986	96.1	105.6	86.0	88.8	10.1	16.8	81.0	79.5	79.7	79.2	87.7	81.1
1988	84.5	96.8	70.3	72.6	14.2	24.3	84.0	82.0	82.7	82.3	88.1	81.2
1992	110.1	127.0	91.0	94.0	19.1	33.1	84.6	82.7	83.6	83.1	88.1	81.1

[1]The higher IRS estimates of the tax gap in the right hand columns are based on the amounts of additional tax recommended by IRS examiners, and the lower estimates of the gap in the left hand columns are based on the amounts of tax ultimately assessed after all appeals and litigation. Since IRS examiners cannot detect all tax deficiencies, IRS believes the actual tax gap lies between these two sets of estimates.

[2]The voluntary compliance rate is what taxpayers voluntarily pay as a percentage of their total tax liability. See note 1 for an explanation of the range of rates.

Source: Income Tax Compliance Research: Net Tax Gap and Remittance Gap Estimates, IRS Publication 1415 (4-90).

Table I.2: Gross Tax Gap Estimates for Tax Years 1992
(Dollars in millions)

Source of tax gap	Tax gap amount	Tax gap distribution (percent)
Individual tax gap	$93,994	73.9%
Unreported income	72,991	57.4
Sole proprietors	33,683	26.5
All other income	39,308	30.9
Overstated deductions[a]	8,081	6.4
Individual remittance gap	11,400	9.0
Math errors	1,521	1.2
Corporate tax gap	33,135	26.1
Small corporations	6,999	5.5
Large corporations	23,716	18.7
Other[b]	420	.3
Corporate remittance gap	2,000	1.6
Total tax gap[c]	$127,129	100.0%

[a]Includes subtractions for erroneous deductions, exemptions, credits, and other adjustments.

[b]Includes unreported income and overstated deductions for exempt organizations' unrelated business income and for fiduciaries.

[c] Totals may not add due to rounding.

Sources: Income Tax Compliance Research, IRS Publication 1415 (7-88); and Income Tax Compliance Research: Net Tax Gap and Remittance Gap Estimates, IRS Publication 1415 (4-90).

Table I.3: 1992 Individual Reporting Rates and Gross Tax Gap Estimates by Source

(Dollars in millions)

Description	Voluntary Reporting Rate[b]	1992 tax gap amount
Wages and salaries	96.6%	$3,667
Interest	90.1	2,680
Dividends	87.3	2,125
State tax refund	87.6	193
Alimony	65.2	279
Capital gains	85.0	10,232
IRS Form 4797	38.2	1,180
Pensions and annuities	84.6	2,809
Taxable unemployment	81.8	539
Farm income	--[c]	6,775
Partnership income	67.5	2,371
Small business corporation	57.0	750
Estates and trusts	95.1	195
Rents and royalties	80.7	2,467
Nonfarm sole proprietors:		
Informal suppliers	36.0	33,683
Other sole proprietors	11.4	10,410
	44.3	23,273
Other income	39.3	3,003
Taxable Social Security	83.2	43
Adjustments to income	106.3	694
Deductions	104.4	3,889
Exemptions	104.1	2,224
Credits	113.0	1,274
Math errors	--[d]	1,521
Nonremittance	--[d]	11,400
Total individual tax gap[a]	--[e]	$93,994

[a]Totals may not add due to rounding.

[b]The voluntary reporting rate is what taxpayers voluntarily report on their tax returns as a percentage of what they should have reported.

[c]Not computable, negative income reported.

[d]Not applicable.

[e]Voluntary compliance rate as computed by IRS is 83.1 percent (see table I.1).

Source: Income Tax Compliance Research, IRS Publication 1415 (7-88).

RELIABLE ESTIMATE OF OVERALL COMPLIANCE COSTS DIFFICULT TO DEVELOP

EXTRACT FROM DECEMBER 9, 1994 STATEMENT OF
LYNDA D. WILLIS
ASSOCIATE DIRECTOR, TAX POLICY AND ADMINISTRATION ISSUES
GENERAL GOVERNMENT DIVISION
U.S. GENERAL ACCOUNTING OFFICE

"As business taxpayers strive to comply with federal, state, and local tax requirements, they expend time, incur costs, and experience frustrations. GAO refers to this time, cost, and frustration as taxpayer compliance burden . . .

"GAO collected information on compliance burden from the management and tax staffs of selected businesses, tax accountants, tax lawyers, representatives of tax associations, and officials of the Internal Revenue Service. In addition, GAO reviewed academic research and other studies on compliance burden and tax simplification . . .

". . . [With respect] to the overall cost to businesses of complying with the tax code, we did not identify a readily available, reliable estimate of such costs. While there was a general consensus that compliance is burdensome and some businesses offered anecdotal examples of their costs, our discussions with businesses and review of available studies indicate that developing a reliable estimate would require that several practical and severe problems be overcome. These problems include working with a broad spectrum of businesses to accurately separate tax costs from other costs and obtaining accurate and consistent responses from businesses on tax burden questions. This would be an expensive and burdensome process in itself.

"In our interviews with business officials and tax experts, we found that business tax compliance strategies usually were not done in isolation from other business operations; few of their activities were done solely or even primarily for tax reasons. More often, tax considerations affected the timing or structure of a business action not whether the action would occur. For example, a business in acquiring equipment would consider tax implications in terms of whether to buy or lease the equipment.

"Few of the businesses we spoke with could readily separate tax compliance costs from other costs of doing business. The integration of the tax compliance activities with other business activities makes it difficult and time-consuming to collect the information necessary from businesses to generate reliable cost estimates. For example, businesses said it would be difficult to take payroll expenditures and isolate those associated with tax compliance.

"Further, business respondents said that they do not routinely need, thus it does not make sense for them to collect, information on compliance costs. And, to separate tax compliance costs from other costs of doing business would be burdensome and of questionable usefulness to them.

"A few business officials provided estimates of some compliance costs, such as legal fees, payroll management fees, and tax software expenditures, but expressed limited confidence in their ability to provide accurate, comprehensive cost data. In addition, those few businesses that said they could isolate some of their tax compliance costs indicated that even in their cases,

it would be difficult to separate federal compliance costs from state and local compliance costs.

"We reviewed seven studies issued since 1980 that provide some estimate of compliance cost associated with the federal and some state tax systems. [We reviewed only those studies that produced original-source estimates and excluded those that made projections from these original studies.] None of these studies attempted to provide an overall compliance cost estimate. Rather, they focused on specific taxpayer populations, such as large corporations, or a limited range of compliance activities, such as record-keeping and filing tax returns. Because of the limited scope, it would not be appropriate to use the estimates from these studies as the basis for estimating the compliance costs for other taxpayer groups, or for different time periods.

"These studies were also subject to the general difficulties inherent in data collection and analysis that limit efforts to obtain reliable cost data. Most used a questionnaire survey approach, sometimes along with group interviews and diary-usage record-keeping, and each has significant limitations. Each of these techniques requires taxpayers to respond accurately, completely, and consistently to compliance burden questions that may be difficult to interpret. The difficulties faced by businesses in answering these types of questions may in part be reflected in the low--less than 50 percent--response rate these studies achieved. The low response rate also affects the reliability of the estimates generated by the studies we reviewed."

RECENT RELATED GAO PRODUCTS

Tax Gap: Many Actions Taken, But a Cohesive Compliance Strategy Needed (GAO/GGD-94-123, May 11, 1994).

Reducing the Tax Gap: Results of a GAO-Sponsored Symposium (GAO/GGD-95-157, June 2, 1995).

Tax Compliance: Status of the Tax Year 1994 Compliance Measurement Program (GAO/GGD-95-39, Dec. 30, 1994).

International Taxation: Transfer Pricing and Information on Nonpayment of Tax (GAO/GGD-95-101, April 13, 1995).

International Taxation: Problems Persist in Determining Tax Effects of Intercompany Prices (GAO/GGD-92-89, June 15, 1992).

Tax Administration: Estimates of the Tax Gap for Service Providers (GAO/GGD-95-59, Dec. 28, 1994).

Tax Administration: IRS Can Better Pursue Noncompliant Sole Proprietors (GAO/GGD-94-175, Aug. 2, 1994).

Tax Administration: Approaches for Improving Independent Contractor Compliance (GAO/GGD-92-108, July 23, 1992).

Tax Administration: Compliance Measures and Audits of Large Corporations Need Improvement (GAO/GGD-94-70, Sep. 1, 1994).

Tax System Burden: Tax Compliance Burden Faced by Business Taxpayers (GAO/T-GGD-95-42, Dec. 9, 1994).

Chairman ARCHER. Thank you.
Dr. Hall.

STATEMENT OF ARTHUR P. HALL II, PH.D., SENIOR ECONOMIST, TAX FOUNDATION

Mr. HALL. Thank you, Mr. Chairman. It is a privilege for me to represent the Tax Foundation at these important hearings.

The Tax Foundation has estimated that complying with the entire Federal tax system costs Americans approximately $200 billion annually. The rules and regulations for the Federal income tax alone accounts for about $140 billion of this cost. Approximately two-thirds of the cost is borne by the business sector.

The cost of compliance, which adds nothing to national output, is tantamount to a tax surcharge on all taxpayers. One way to comprehend the magnitude—and economic waste—of the $140 billion tax surcharge is to imagine putting every vehicle sold by General Motors in 1994 onto ships and dumping them in the ocean.

If Congress were to replace the current Federal income tax with any one of the three predominant alternatives being discussed, whether it is Representative Armey's flat tax, the U.S.A. tax as sponsored by Senators Domenici and Nunn, or a national retail sales tax, it could dramatically reduce America's tax-related burden without necessarily sacrificing a dime of Federal tax revenue.

Using methods that underlie IRS estimates about paperwork burdens and assuming a reasonable transition period for each alternative plan, the Tax Foundation has estimated how much each plan could reduce the current system's $140 billion tax surcharge.

Representative Armey's flat tax could reduce the surcharge by 94 percent to $8.4 billion assuming that the current convention of annual tax filing is retained. However, if he achieves his stated goal of eliminating individual income tax withholding and moving to monthly tax payments, the flat tax would reduce the surcharge by 72 percent to $39 billion.

The U.S.A. tax system could reduce the surcharge by 81 percent to $27 billion. A national retail sales tax could reduce the surcharge by 92 percent to $11.2 billion, assuming that the sales tax plan also included a per person rebate scheme to create a progressive tax system. If no rebate scheme were part of the retail sales tax, it could reduce the surcharge by an estimated 96.5 percent, to $4.9 billion. But the entire burden of that sum would fall on retail businesses.

In considering these estimates, please be mindful that they are based on pure versions of the alternative tax systems. It is reasonable to assume that the effect of molding any of the alternatives into a functioning Tax Code could increase their complexity and therefore their associated compliance costs.

The cost of complying with a tax system is directly related to the complexity of the system. In terms of complexity, it is fair to say that the income tax, the core of the U.S. Government's tax system, ranks among the worst of the tax systems currently in operation around the world.

The give and take of politics, by continually expanding and revising the definition of taxable income, accounts for a substantial measure of the complexity of the current Code. However, in the context of these hearings, it is important to emphasize that the income tax is inherently complex. Ironically, the term "income" itself accounts for the inherent complexity. Income, particularly business income and investment income, is tricky to define and has always added excess complexity to our tax system.

I have discovered complaints about the complexity of the Federal income tax system that date back to 1914, the year immediately following adoption of the 16th amendment to the Constitution which authorized the tax. Indeed, the 1927 report of the Joint Committee on Internal Revenue Taxation states that "it must be recognized that while the degree of simplification is possible, a simple income tax for complex business is not."

The complexity of systems that directly tax people and businesses—like the current income tax, the flat tax and the U.S.A. tax—is almost wholly related to tax-based questions, that is, questions or uncertainty about the timing or definition of taxable transactions. Multiple statutory tax rates alone do not generate much complexity. On the other hand, the complexity of indirect taxes, like the value-added taxes or retail sales taxes, result primarily from the application of multiple tax rates to differentiated products.

The inherent complexity of an income tax base which bears most predominantly on the income taxation of commercial activity results from the difficulty of defining income and determining when to recognize income and expense for tax purposes.

Furthermore, a properly constructed income tax, unlike the current Federal income tax, also must adopt the added complications associated with adjusting for the effect inflation has on these difficult timing issues. The flat tax and U.S.A. tax are direct taxes that should immediately eliminate these timing-related complexities and therefore their attendant compliance costs.

Both plans accomplish this objective by moving to a cash flow tax base rather than accrued income tax base. A cash flow tax, as it applies to business, simply calls for the totaling of business receipts and then subtracting off purchases from other businesses. There is no reason to synchronize timing of income and expenses in such a system. A business cash flow type tax also eliminates any need for the complexities associated with depreciation and depletion allowances, foreign source income rules, inventory capitalization, amortization of intangibles and long-term contracting.

This list of items accounts for the bulk of business compliance costs. For example, based on research sponsored by the Tax Foundation, the current rules pertaining to foreign source income alone account for 45.5 percent of the total Federal income tax compliance costs for the firms of the Fortune 500. In fact, adoption of either the flat tax or the U.S.A. tax would make obsolete almost every Tax Code provision commonly cited as a major source of complexity, and of course the retail sales tax fits into that as well.

Although the flat tax, the U.S.A. tax, or a retail sales tax are inherently far less complex than even the most pure income tax system, misguided political tampering can ruin the integrity of any system. Nevertheless, any one of these plans could be a sound replacement for the current income tax. They can satisfy the current political demand for tax revenue, they stop punishing savings and investment, and by offering the potential for huge reductions in the cost of compliance, they can eliminate hundreds of billions of dollars of pure economic waste.

Thank you, Mr. Chairman.

[The prepared statement follows:]

Testimony of Arthur P. Hall, II
Senior Economist, Tax Foundation
Washington, D.C.

Before the Committee on Ways and Means,
U.S. House of Representatives
on the Subject of
Replacing the Federal Income Tax
June 6, 1995

The Tax Foundation estimates that complying with the entire federal tax system costs Americans $200 billion annually. The rules and regulations for the federal income tax alone account for approximately $140 billion of this cost.

The cost of compliance, which adds nothing to national output, is tantamount to a tax surcharge on all taxpayers. One way to comprehend the magnitude — and economic waste — of the $140 billion federal income tax surcharge is to imagine putting every vehicle sold by General Motors in 1994 onto ships and dumping them into the ocean.

If Congress were to replace the current federal income tax with any one of the three predominant alternatives currently being discussed — Representative Armey's (R-TX) Flat Tax, the USA Tax System sponsored by Senators Domenici (R-NM) and Nunn (D-GA), or a national retail sales tax — it could dramatically reduce America's tax-related burden without necessarily sacrificing a dime of federal tax revenue. The Tax Foundation has estimated how much each plan could reduce the current system's $140 billion tax surcharge, assuming a reasonable transition period had ensued.

Rep. Armey's Flat Tax could reduce the surcharge by 94 percent to $8.4 billion, assuming that the current convention of annual tax filing is retained. However, if Rep. Armey achieves his stated goal of eliminating individual income tax withholding and moving to monthly tax payments, the Flat Tax would reduce the surcharge by 72 percent to $39 billion. The USA Tax System could reduce the surcharge by 81 percent to $27 billion. A national retail sales tax could reduce the surcharge by 92 percent to $11.2, assuming the sales tax plan included a per-person rebate scheme to create a progressive tax system. If no rebate scheme were part of the retail sales tax, it could reduce the surcharge by an estimated 96.5 percent to $4.9 billion, but the entire burden of this sum would fall on retail businesses.

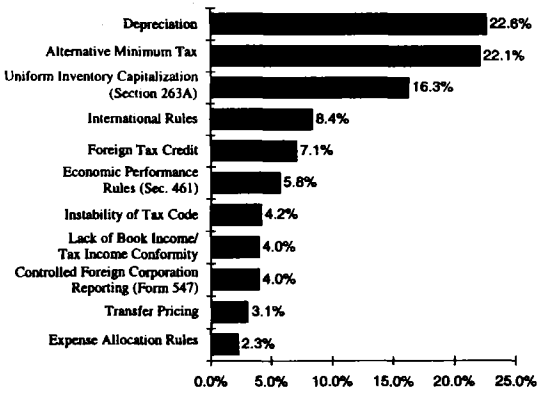
These estimates are based on pure versions of the alternative tax systems. It is reasonable to assume that the effect of molding any of the alternative plans into a functioning tax code could increase the complexity, and therefore their associated compliance costs.

Fundamental Sources of Tax Complexity

The cost of complying with a tax system is directly related to the complexity of the system. In terms of complexity, it is fair to say that an income tax — the core of the U.S. government's tax system — ranks among the top of the tax systems currently in operation around the world. Ironically, the term "income" itself accounts for the inherent complexity. Income, particularly business and investment income, is tricky to define, and has, therefore, always added excess complexity to our tax system.

I have discovered complaints about the complexity of the federal income tax system that date back to 1914, the year immediately following the adoption the 16th Amendment to the Constitution which authorized the income tax. Indeed, the 1927 Report of the Joint Committee on Internal Revenue Taxation (Vol. 1, p. 5) states that: "It must be recognized that while a degree of simplification is possible, a simple income tax for complex business is not."

Figure 1
Where the Tax Code is Most Complex (percent of total survey mentions)



Note: 315 of 365 survey respondents answered this question. Many respondents listed more than one aspect. Only the responses receiving at least 10 mentions were included.

Source: Tax Foundation.

The complexity of systems that directly tax people and businesses — like the current income tax, the Flat Tax, and the USA Tax System — is almost wholly related to tax base questions, that is, questions or uncertainty about the timing or definition of taxable transactions. Multiple statutory tax rates alone do not generate much complexity. On the other hand, the complexity of indirect taxes — like value-added taxes or retail sales taxes — results primarily from the application of multiple tax rates to differentiated products.

The inherent complexity of an income tax base, which bears most predominantly on the income taxation of businesses, results from the difficulty of defining income and determining when to recognize income and expense for tax purposes. Furthermore, a properly constructed income tax (unlike the current federal income tax) also must adopt the added complications associated with adjusting for the effect inflation has on these difficult timing issues.

The Flat Tax and the USA Tax System immediately eliminate these timing-related complexities and, therefore, their attendant compliance costs. Both plans accomplish this objective by moving to a cashflow tax base, rather than an accrued income tax base. A cashflow tax, as it applies to business, simply calls for the totaling of business receipts and then subtracting off purchases from other businesses. There is no reason to synchronize the timing of income and expenses in such a system.

A business cashflow-type tax also eliminates any need for the complexities associated with depreciation and depletion allowances, foreign-source income rules, inventory capitalization, amortization of intangibles, and long-term contracting. This list of items accounts for the bulk of business compliance costs. For example, based on research sponsored by the Tax Foundation, the current rules pertaining to foreign-source income alone account for 45.5 percent of the total federal income tax compliance cost for the firms of the Fortune 500. In fact, adoption of either the Flat Tax or the USA Tax would eliminate virtually every item on Figure 1, which illustrates the findings of a Tax Foundation-sponsored survey of senior corporate tax officers about the sources

Table 1
Comparison of 1954 Code and 1986 Code (as of 1994)

Subchapter of Income Tax Code	Number of Sections in Subchapter 1954	1994	Percent Growth
Determination of Tax Liability	4	44	1000%
Computation of Taxable Income	9	145	1511
Corporate Distributions and Adjustments	14	35	150
Deferred Compensation	2	30	1400
Accounting Periods and Methods	6	33	450
Tax-Exempt Organizations	4	17	325
Corporations Used to Avoid Income Tax on Shareholders	4	27	575
Banking Institutions	3	20	567
Natural Resources	3	10	233
Estates, Trusts, Beneficiaries, Etc.	7	29	314
Partners and Partnerships	7	29	314
Insurance Companies	5	29	480
Regulated Investment Companies, Etc.	1	17	1600
Tax Based on Income from Within or Without the United States	9	78	767
Gain/Loss on Disposition of Property	7	42	500
Capital Gains and Losses	4	52	1200
Readjustment of Tax Between Years and Special Limitations	6	5	-17
Tax Treatment of S Corporations	0	14	NA
Other (a)	8	42	425
Total	103	698	578%

(a) Includes all subchapters not explicitly listed as well as Chapters 2-6 of Subtitle A of the Internal Revenue Code.
Source: Tax Foundation computations from Internal Revenue Code.

of complexity in the current federal income tax code.

Political Sources of Tax Complexity

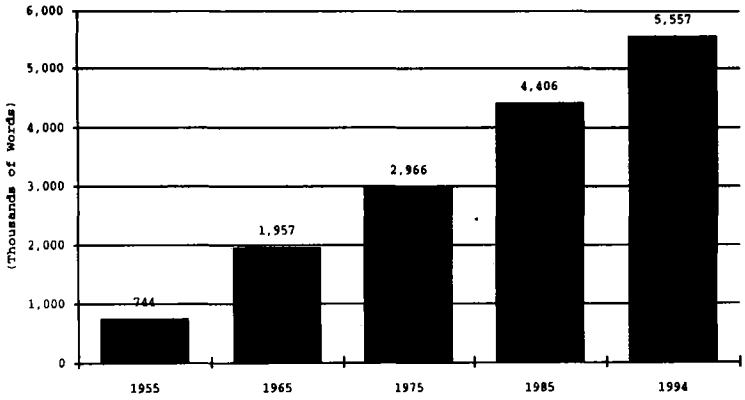
Although the Flat Tax, USA Tax System, or a retail sales tax are inherently far less complex than even the most pure income tax system, misguided political tampering can ruin the integrity of any system. Indeed, over time, the political process of give and take has exacerbated the inherent complexities of the federal income tax system. The definition of taxable income has not only expanded dramatically, but it has undergone chronic revision.

Table 1 reveals the dramatic growth in the income tax code over the past 40 years. In 1954, the federal income tax law comprised 103 code sections. Today, that law comprises 698 code sections, a 578 percent increase. Almost all of the growth relates to tax base questions. Note that since 1954 the number of sections dealing with the "Determination of Tax Liability" has grown 1,000 percent; the number of sections dealing with "Capital Gains and Losses," most of which detail "special rules" for calculating capital gains and losses, has grown 1,200 percent; the number of sections dealing with "Deferred Compensation" (e.g., pension plans) has grown 1,400 percent; and the number of sections dealing with the "Computation of Taxable Income" has grown more than 1,500 percent.

Perhaps a more revealing measure of the growth in tax code complexity is the growth in the number of words that comprise the income tax law and its attendant regulations. Figure 2 charts the growth in the combined number of words that define the body of both the federal income tax laws and their attendant regulations. The Tax Foundation has determined that over the past 40 years the number of words detailing the income tax laws has grown 369 percent. The words detailing income tax regulations, which provide taxpayers with the "guidance" they need to calculate their taxable income, have grown 730 percent. The combined growth is 647 percent.

The growth in the volume of the income tax laws and regulations has resulted piecemeal

Figure 2
Growth of the Income Tax Code (Laws and Regulations)



Source: Tax Foundation.

from the 31 major tax enactments and the more than 400 other public laws that have amended the Internal Revenue Code since the 1954 Act. Based on a sample of one-fifth of the core sections of the income tax code, these enactments have not only increased the volume of the code but have resulted, on average, in the amendment of each code section once every four years. As Figure 3 illustrates, this instability has been much more pronounced in the past 20 years than it was during the 20 years immediately following the 1954 Act.

The complexity generated by the growth and constant change of the tax code creates two general types of economic costs. One is the overhead cost associated with the economically sterile exercise of tax planning, compliance, and litigation. The second cost results from the economic opportunities that are foregone because of taxpayer uncertainty.

Because of complexity and instability, despite substantial cost to fund diligent and expert research, taxpayers may not be able to obtain a reasonably certain conclusion about how taxation will affect a business plan or investment. In many businesses, research and development require longer and longer lead times. If taxpayers cannot accurately predict the tax consequences of a particular economic activity, either because of vagueness, complexity, or instability in the tax code, then tax policy is handicapping the growth and dynamism of the U.S. economy.

Quantifying the Overhead Cost of Tax Compliance

In 1995, according to the Internal Revenue Service and the Office of Management and Budget, taxpayers will spent 5.1 billion hours complying with federal tax laws. An hourly cost of $39.6 can be derived by averaging the average labor cost of both the IRS and the accounting firm of Price-Waterhouse. Applying that hourly cost figure to 5.1 billion hours results in a total compliance cost of $202 billion. Historically, about two-thirds of the compliance burden (or $135.3 billion) is borne by the business sector.

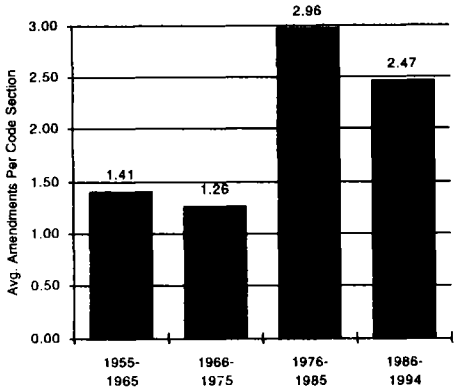
Based on my calculations, at least 70 percent of the total cost of federal tax compliance is due to the income tax, indicating that businesses will pay an estimated $94.7 billion in 1995 to

Table 2
Estimated Cost of Corporate Income Tax Compliance by Amount of Company's Asset Size

Asset Size/1 ($Thousands)	Compliance Cost as % of Assets	Estimated Compliance Cost
$1,000	0.74%	$7,400
$25,000	0.40%	$100,000
$50,000	0.40%	$200,000
$100,000	0.40%	$400,000
$250,000	0.14%	$350,000
$500,000	0.10%	$500,000
$1,000,000	0.09%	$900,000
$2,000,000	0.08%	$1,600,000
$3,000,000	0.08%	$2,400,000
$4,000,000	0.04%	$1,600,000
$5,000,000	0.04%	$2,000,000
$7,500,000	0.05%	$3,750,000
$10,000,000	0.03%	$3,000,000

1. Excludes financial and life insurance firms.
Source: Tax Foundation.

Figure 3
Instability in the Federal Income Tax Code Based on Selected Code Items



Source: Tax Foundation compilation from U.S. Code Annotated (Title 26).

comply with the federal income tax. That figure is up from an estimated $81.2 billion in 1991 (70 percent of $116 billion), the latest year for which complete income tax revenue data is available. The 1991 cost of $81.2 billion amounted to 74 percent of the income tax revenue received from all businesses. This ratio offers solid evidence that the income tax on business, particularly the corporate income tax, is a grossly inefficient revenue system for the federal government.

To date, the Tax Foundation has focused its detailed research on the cost to corporations of complying with the federal income tax. The total cost of compliance differs widely across companies of different size. Based on a 1992 survey of large corporations sponsored by the Tax Foundation, the 1995 cost of complying with the federal corporate income tax for the average Fortune 500

Table 3
Compliance Costs to Businesses of the Value-Added Tax in Great Britain, 1986 and 1987

Size of Business (Annual taxable sales per business in $U.S.)	Compliance Costs as a Percentage of Taxable Sales
0 to 30,000	1.940
30,000 to 75,000	0.780
75,000 to 150,000	0.520
150,000 to 750,000	0.420
750,000 to 1.5 Million	0.260
1.5 Million to 15 Million	0.040
15 Million or More	0.003

Source: Congressional Budget Office, Effects of Adopting a Value-Added Tax, Feberuary 1992, p. 71. Original data from Cedric Sandford, et. al., Administrative and Compliance Costs of Taxation (Bath, England: Fiscal Publications, 1989), p. 116.

firm will amount to an estimated $1.58 million (or $790 million for the entire Fortune 500). For the average small corporation, those with $1 million or less in assets, the minimum cost amounted to an estimated $7,400. But simple averages are quite misleading.

A common research finding clearly demonstrated in Table 2 is that economies of scale exist in tax compliance. That is, relative to asset size, small corporations bear a compliance cost burden at least 24.6 times greater (and, on average, perhaps as much as 177 times greater) than the largest U.S. corporations, those with $10 billion or more in assets. What makes this huge differential more amazing from a public policy standpoint is that only 0.16 percent (5,933, in 1991) of all U.S. corporations paid about three-quarters of all corporate income taxes in 1991.

More than 90 percent of all U.S. corporations have assets of $1 million or less and, therefore, bear tremendous relative compliance burdens. In 1991, as a group, these small corporations had to pay at a minimum $382 in compliance costs for every $100 they paid in income tax. They bore about $14 billion in compliance costs for $3.7 billion in income taxes. (That represents about 4 percent of corporate income taxes paid and about 90 percent of the minimum measure of the corporate income tax compliance cost.)

Because complying with tax laws is a fixed cost for any business, it seems likely that smaller companies will bear a greater compliance burden than larger companies under virtually any type of tax system. For example, Table 3 demonstrates that the value-added tax in Great Britain imposes a compliance burden on that country's smallest companies that is 647 times greater than the burden on the largest firms. Interestingly, however, one measure taken by tax authorities to reduce the compliance burden on small companies in countries that have a value-added tax is to allow these companies to calculate their tax liabilities in a way that is identical to the cashflow method proposed by the Flat Tax and the USA Tax System.

Comparing the Relative Compliance Burden of the Federal Income Tax and the Alternative Replacement Proposals

Tables 4 and 5 form the basis of the Tax Foundation's comparison of the cost of complying with the current federal income tax and the various replacement alternatives. Table 4 compiles a list of the core individual income tax forms along with both the estimated paperwork-burden calculations (in hours of compliance time) generated by the Internal Revenue Service. It also reports IRS projections for 1995 of the number of tax returns by type. Table 5 compiles a similar list for the business sector. These lists are far from exhaustive, and trusts and estates (Form 1041) are not even included. The lists are also incomplete to the degree that adequate tax return informa-

tion could not be obtained or estimated for the many schedules and forms that are common auxiliary components of the core forms.

Tables 4 and 5 combined report a total of 3.2 billion hours of required compliance time for the items reported. This figure is well short of the IRS-estimated 5.1 billion hours of compliance time required for the entire federal tax system. However, the magnitude of the minimal lists compiled provide ample information to make comparisons with the replacement alternatives.

To estimate the paperwork burden associated with the alternative replacement proposals (with the exception of the compliance burden on retail businesses of a national sales tax), the Tax Foundation used the same methods that underlie the IRS estimates. These methods are laid out in Development of Methodology for Estimating the Taxpayer Paperwork Burden, the 1988 report to the IRS delivered by the consulting company of Arthur D. Little, Inc. In brief, these methods estimate taxpayer paperwork burdens using the various characteristics of tax forms and the informational content of the instructions for these forms.

A. The Flat Tax

The postcard-size tax forms advertised by the Flat Tax plan makes the paperwork requirements readily discernible. The average individual taxpayer should take no longer than one hour and eight minutes each year (assuming an annual tax filing) to comply with Rep. Armey's Flat Tax. However, if monthly tax payments become a requirement because of the elimination of withholding, the cost of the "preparation" and "sending" elements listed in Table 4 will have to be repeated each month, adding substantially to the overall compliance costs. The compliance time for the Flat Tax is compared to 11 hours and 36 minutes for the average 1040 Form and two hours and 54 minutes for the average 1040-EZ Form.

Recordkeeping would be simple under the Flat Tax. Both the wage and pension distribution data are supplied on an employer-provided form (Form W-2 and Form 1099). The average compliance time would be somewhat lower, but, because of the current tax treatment of contributions to pension plans, for the foreseeable future many taxpayers reporting pension and individual retirement account distributions would probably have to make extra calculations to determine what part of the distribution is taxable.

The average business taxpayer should take no longer than three hours and 24 minutes each year to comply with the Flat Tax. That compares to an average 21 hours and 54 minutes for a nonfarm sole proprietor under the current income tax system. It compares to 100-plus hours for the average partnership and the 200-plus hours for the average C corporation. The reduction in compliance time comes from a major reduction in every aspect of the overall paperwork burden.

B. The USA Tax System

The USA Tax streamlines the definition of taxable income and would, therefore, substantially reduce the compliance burden associated with the current income tax. However, the USA Tax would require a somewhat greater paperwork burden than a Flat Tax that required only annual filing. The big difference is in the "recordkeeping" and "education" components of the paperwork burden. The USA Tax places a levy on both wage and nonwage income and then allows individuals to deduct an unlimited amount of current-year saving. (It also allows individuals to take a credit for payroll taxes paid.) The Flat Tax by contrast adopts a "prepayment" approach that taxes all of an individual's wages (over the exemption threshold), but never taxes income that results from saving.

As a result of this procedural difference, the USA Tax would retain a tax form similar to the current system's 1040-EZ Form and suggests two new basic tax forms — Schedule S (Net

Table 4
A Comparison of the Compliance Burden on Individuals of the Current Income Tax and Alternative Replacement Plans

Individuals Only	1995 Estimated Number of Returns	Average Time in Hours per Form for 1995 Tax Year: Record-keeping	Education Stage	Form Preparation	Packaging/ Sending	Total	Total Hours
Forms							
1040	57,574,816	3.1	2.9	4.7	0.9	11.6	666,908,285
1040A[a]	18,195,000	2.2	2.8	4.2	2.1	11.2	203,480,750
1040EZ	17,189,000	0.1	0.8	1.3	0.7	2.9	49,848,100
1040ES	38,020,100	1.3	0.3	0.8	0.2	2.6	99,485,928
1040X	1,870,000	1.2	0.4	1.2	0.6	3.4	6,295,667
4868 (Extention of Time)	4,813,000	0.4	0.2	0.3	0.3	1.3	6,016,250
1040 Schedules							
Sch A	43,116,920	2.5	0.4	1.2	0.5	4.6	197,619,218
Sch B	61,595,600	0.6	0.1	0.3	0.3	1.3	80,074,281
Sch D	21,558,460	0.9	0.7	1.0	0.7	3.3	70,064,995
Sch E	26,178,130	2.9	1.1	1.3	0.6	5.8	152,705,759
Sch EIC	7,699,450	0.0	0.0	0.1	0.1	0.2	1,411,566
Sch R	461,967	0.3	0.3	0.4	0.6	1.5	708,349
Individual Totals-Current Income Tax (Forms + Schedules)	298,272,444	NA	NA	NA	NA	NA	1,534,619,148
Flat Tax	92,958,816[c]	0.04	0.4	0.3	0.4	1.14	821,755,933[b]
USA Tax System							
Basic Form	92,958,816[c]	0.1	0.8	1.3	0.7	2.9	269,580,566
Sch S (Net Savings Deduction)	65,071,171	0.03	0.3	0.63	0.4	1.36	88,496,793
Sch S-1 (Savings and Withdrawl Info)	65,071,171	0.14	0.8	1.26	0.4	2.6	169,185,045
Individual Totals - USA Tax (Forms + Schedules)	223,101,158	0.77	0.03	0.28	0.4	1.48	527,262,404
Retail Sales Tax (Assuming a rebate system to create a progressive incidence)	99,528,030[d]	0.77	0.03	0.28	0.4	1.48	147,301,484

[a]Schedules 1-3 are included in the average time.
[b]Assumes that withholding is eliminated and that taxpayers must make monthly payments. If annual filing is maintained the total hours amount to 105,973,050.
[c]Equals sum of nonbusiness 1040, 1040A, and 1040EZ Forms.
[d]Equals estimated number of U.S. households for 1995.

Source: Tax Foundation, using Internal Revenue Service data and estimation methods.

Savings Deduction) and Schedule S-1 (Savings and Withdrawal Information). For the average taxpayer that took advantage of the savings deduction, the USA Tax should require no more than six hours and 52 minutes of compliance time.

The business side of the USA Tax is similar to the Flat Tax in that it is a business cashflow tax. From a compliance perspective, one difference is that the USA Tax would be border adjustable. That is, U.S. businesses could deduct the receipts they generate from the sale of exported goods and services. Border adjustability, therefore, would add to an average business's recordkeeping requirements relative to a Flat Tax. This added recordkeeping accounts for the small difference in business compliance time between the Flat Tax and the USA Tax. In addition, the USA Tax allows for a payroll tax credit. However, the additional compliance costs associated with this credit should be minimal.

C. A National Retail Sales Tax

In 1990, the accounting firm of Price-Waterhouse submitted to the American Retail Education Foundation their final report for the Study to Estimate the Costs of Collecting State and Local

Table 5
A Comparison of the Compliance Burden on Businesses of the Current Income Tax and Alternative Replacement Plans

Businesses	1995 Estimated Number of Returns	Average Time in Hours per Form for 1995 Tax Year: Record-keeping	Education Stage	Form Preparation	Packaging/ Sending	Total	Total Hours
Sole Proprietorships*							
Form 1040	18,394,184	3.1	2.9	4.7	0.9	11.6	213,065,965
Sch C	16,525,451	6.4	1.2	2.1	0.6	10.3	169,661,296
Sch F	1,868,733	4.4	0.4	1.3	0.3	6.5	12,022,184
Partnerships							
Form 1065	1,510,400	38.4	19.8	35.4	4.0	97.6	147,389,867
Partnership Schedules							
Sch D	1,510,400	5.5	1.2	1.3	0.0	8.0	12,133,547
Sch K-1	1,510,400	24.6	8.6	9.4	0.0	42.7	64,468,907
Sch L	1,510,400	15.5	0.1	0.4	0.0	16.0	24,166,400
Sch M-1	1,510,400	3.4	0.2	0.3	0.0	3.8	5,764,693
Sch M-2	1,510,400	1.6	0.2	0.3	0.0	2.1	3,121,493
Corporations							
Forms							
1120	2,116,200	71.3	41.1	72.0	8.0	192.5	407,297,960
1120A	340,300	43.3	23.3	40.8	4.6	111.9	38,073,898
1120S	2,084,200	62.7	20.7	36.6	4.0	124.0	258,475,537
1120X	24,700	12.2	1.1	3.2	0.5	17.1	422,370
1120L	2,748	75.3	23.9	37.3	3.2	139.8	384,142
1120F	20,600	102.4	36.8	64.5	7.0	210.6	4,338,017
1120PC	2,748	106.4	33.3	54.2	5.1	199.0	546,988
1120RIC	6,800	52.4	15.3	29.9	3.8	101.3	688,500
1120REIT	322	55.7	17.3	33.9	4.3	111.2	35,801
7004	2,230,200	5.5	0.8	1.8	0.3	8.4	18,622,170
4626 (AMT)	339,472	18.4	18.2	15.2	0.0	51.9	17,612,913
4562 (Depreciation)	2,456,500	33.7	4.5	5.2	0.0	43.4	106,612,100
1120 Schedules							
Sch D	2,116,200	6.9	3.5	5.7	0.5	16.6	35,199,460
Sch H	211,620	6.0	0.6	0.7	0.0	7.3	1,541,299
Sch PH	105,810	15.3	6.1	8.5	0.5	30.4	3,220,151
1120S Schedules							
Sch D	2,084,200	9.3	4.2	9.2	1.3	24.1	50,229,220
Sch K-1	2,084,200	14.8	10.3	14.7	1.1	41.0	85,347,990
Business Total (Forms + Schedules)	59,621,089	NA	NA	NA	NA	NA	1,680,442,867
Flat Tax	24,445,284	2.3	0.3	0.4	0.4	3.4	83,113,966
USA Tax System	24,445,284	2.5	0.3	0.4	0.4	3.6	88,003,023
Retail Sales Tax (Retail Firms Only)	NA	NA	NA	NA	NA	NA	123,484,848

* No attempt is made to estimate the other schedules of the 1040 Form that a business filer may be required to complete. Such compliance burdens are left in the Individual section (Table 4).

Source: Tax Foundation, using Internal Revenue Service data and estimation methods.

Sales and Use Tax. The study determined that the cost of sales tax compliance for the nation's retailers, on average, amounted to 3.48 percent of total sales tax liability. In dollar terms, this amounted to a 1990 cost of $4.4 billion. The 3.48 percent figure is best viewed as an historic relationship that does not necessarily generalize to future tax collections. Therefore, the 1990 cost is increased by the increase in inflation-adjusted retail sales (12 percent) to yield a $4.9 billion estimated 1995 compliance cost of a national retail sales tax. The total hours reported in Table 5 result from dividing the 1995 cost by the hourly labor cost of $39.6, the labor cost figure used to generate the Tax Foundation's $202 billion total compliance cost estimate.

To offset the regressive incidence commonly attributed to a broad-based sales tax, some proponents of a national sales tax suggest that a rebate scheme be devised to reimburse the tax

paid on a given dollar amount of consumption expenditures made per person in a household. Such a scheme would probably require paperwork of some type for three reasons: (1) to request a rebate, (2) to verify that the designated amount of taxable expenditures were in fact made, and (3) to verify the number of people per household that count toward the requested rebate amount. The estimated time needed to comply with a sales tax rebate scheme is reported in Table 4. The time elements were derived by pooling the time elements of existing tax forms that have similar reporting requirements (namely, Schedules B and EIC of Form 1040 and Schedule 2 of Form 1040A).

Chairman ARCHER. Thank you, Dr. Hall.

Mr. Adams.

STATEMENT OF CHARLES ADAMS, AUTHOR OF "FOR GOOD AND EVIL: THE IMPACT OF TAXES ON THE COURSE OF CIVILIZATION"

Mr. ADAMS. Thank you.

I am here pretty much as a historian. I have written a book of a 20-year study of the impact of taxes and history. If you are determined to tear out the income tax by its roots, I want you to know that you have history on your side. History is your friend. "A page of history," said Oliver Wendell Holmes in one of his great decisions, "is worth a whole volume of logic," and in the few minutes I speak to you I would like to give you a page of history.

I am referring to the first modern energy tax which was invented by the British. All modern income taxes go back to that as the father, or as the mother depending on your gender. That tax was the tax to beat Napoleon. He didn't have a revenue system and the British did, and Waterloo was inevitable at some point.

The British people lived under this tax for 18 years and complied with it, but when Waterloo happened and when the Congress of Vienna settled the political situation, the British Government decided that this was really a great tax, so they then proposed in the House of Commons, in the House of Lords that income tax be continued and they had debate on that.

The leader of the opposition to the tax said that he hoped that the British nation would rise up as one man and object to this monstrosity. He said that this extension of bureaucratic power into everyday life might be the herald of an all-embracing tyranny, and the House of Commons cheered and the House of Lords cheered and then they had a vote and there was a quiet in the House and as the vote was being tallied, the Speaker of the House announced that the income tax had been repealed. And according to historians, there was the loudest exultation ever heard in the British Parliament in 500 years. There were celebrations, church bells rang out, there were bonfires in the countryside. There was more celebration and more joy over abolition of the first income tax than there was over defeat of Napoleon at Waterloo.

Another interesting thing happened. After the debate finally quieted in the House of Lords and the House of Commons, there was then a motion made that all the records of the income tax be destroyed and that motion was carried and they had a huge bonfire and the Chancellor of the Exchequer, and the Chancellor was the key taxman, it is said he stoked the fires as they brought in the tax records—he secretly kept a copy of those tax records hidden in the Exchequer Court which years later were discovered. That was the end of the income tax.

I think they were sending a message that this is a terrible tax system and they destroyed the records. You know why? Dead men tell no tales. Burned tax records tell no tales. It turned out that about 20 years later the Reform Parliament—the parliament that gave us the abolition of slavery ultimately coming to the United States—they brought up the question of an income tax again. The generation of Napoleon was still around. The Chancellor of the Ex-

chequer said, "if ever inquisitorial powers are spoken of, where will you find inquisitorial powers worse than at that time in British history." So the income tax stayed dead.

You might think with that experience, with the page of history being a volume of logic, maybe we should not have adopted an income tax. But history gave a mixed message, because in 1842 Sir Robert Peel put in a flat income tax. And he said, This will only be for 3 years, it is going to be 3 percent and will be collected at the source, and will be nothing like what you lived under during Napoleon's time. And they adopted it.

That income tax continued for 70 years as a simple flat tax. It was held up in the great debates in America over the income tax amendment, it was held up that you could have a good income tax and you don't have to have a bad income tax. What eventually happened is that we got a bad one.

I think from my experience and study as a historian, I would like to add to the four points that the Chairman mentioned about what kind of a tax system we want. I think there are four great lessons that history teaches. The first lesson on adopting a tax is that the tax should be indirect. The Greeks and Romans believed that, the Founding Fathers believed that. The argument was made that an indirect tax is consistent with liberty; a direct tax is consistent with slavery, said Montesquieu.

I think the next main lesson of history is that taxes must not be excessive. That is a hard word to define. When they had some terrible revolts in Britain around 1750, a fellow named Henry Fox spoke about what kind of a tax lesson the British had learned from this. He said that not only is it what people are able to pay, but it is what people are willing to pay.

That is another great point in determining a tax law: Is this what people are willing to pay? During the war with Napoleon, they were willing to pay a lot, but not afterward.

The only other two points I would make is that the taxes should be moderate and they should have a broad base.

I see my time is up. Thank you.

[The prepared statement follows:]

Address
by
CHARLES ADAMS
On Replacing the Income Tax
The Committee on Ways and Means
U.S. House of Representatives
104th Congress
Washington D.C.
June 6, 1995

"Down, Down to hell! & say I sent thee!!"

Mr. Chairman, my name is Charles Adams, author of a 20 year study, entitled, For Good and Evil: The Impact of Taxes on the Course of Civilization. History reveals that most great empires taxed themselves to death, while others became great because of the right kind of taxes--taxes that stimulated growth, peace and commerce. If the Congress decides it is time to replace the income tax, then history provides some wonderful guides on how to do so. Let me begin with the unusual repeal of the first modern income tax, almost two centuries ago.

European cartoonists in the 18th and 19th centuries loved to depict taxes the people hated as a many-headed monster, and the first modern income tax was no exception. Britain's most renown cartoonists, Cruikshank, marked the repeal of the income tax in 1816 with the following cartoon. A battered Britannia on the ground is told, "Rise Britannia! The Monster that so long oppressed and trampled on you is at last Subdued." Members of Parliament wielding their clubs on the monster, shout: "Down, Down to hell! & say I sent thee!!"

No doubt a great percentage of American taxpayers would like to send their Internal Revenue Code, "Down to Hell, and say I sent thee!"

This British income tax with its many schedules and concept of income was the forerunner of modern income taxation today. It was the tax that beat Napoleon. But when the Corsican general was finally put away and the political issues settled at the Congress of Vienna, The British people let their government know they despised the tax, but accepted it for 18 years as a wartime measure only. In the debates over retaining the tax, the leader of the opposition to the tax received a rousing ovation when he proclaimed:

> He hoped that the country would rise up as one man against it...This extension of bureaucratic power into everyday life might be the herald of an all-embracing tyranny.

The Crown followed with a motion to retain the income tax. When the Speaker announced the defeat of the motion, there was "the loudest exultation ever witnessed" within the halls of Parliament. A motion then followed to have all the records of the tax destroyed. It was carried--burned tax records, like dead men, tell no tales. The Crown was a bad loser. The Chancellor of the Exchequer is said to have stoked the fires as the records were being burned, while secretly retaining a duplicate copy of the records hidden away in the basement of the Exchequer Court.

Seventeen years later the famous Reform Parliament (which abolished slavery), considered instituting an income tax. Even the Chancellor opposed the idea with these words:

> If inquisitorial powers are spoken of, where will you find inquisitorial powers greater than those which were then [Napoleonic times] exercised. The tax was--detested by the whole country.

The entire generation of Britons who lived under that first income tax had to pass away before the Crown could pass another income tax law. In 1842, to put the government's finances in shape, Sir Robert Peel pushed through Parliament a simple, 3% flat tax, with stoppage at the source. To allay any fears this tax might become permanent, Peel promised its repeal in a few years once the government's finances were in balance. Of course, that never happened. The tax has continued to this day. But the low rate, flat tax, lasted for almost 70 years, and became a shining example for proponents of income taxation everywhere, and played no small role in the adopted of income taxes in the U.S.

In 1911, Professor Edwin Seligman came forth with a book, The Income Tax, which extolled the virtues of income taxation. He dismissed the experiences under the Napoleonic tax, "Early complaints against the inquisitorial character of the tax have long since well-nigh completely disappeared." That observation looks ludicrous today, but in 1911, with 70 years of tolerable experience under Britain's modest flat tax, how could anyone have predicted otherwise?

But all was not entirely rosy. Germany had instituted an income tax in the late 19th Century which involved extensive audits (like today), which prompted one German legislator to acknowledge, "The country is covered with a perfect system of espionage." But German tax oppression would not happen in America, said Professor Seligman, "Nowhere else are people so

meek in the face of officialdom. In no other country in the world would it be possible to enforce so inquisitorial a procedure as we have learned to be customary in Prussia." And what was the procedure? The audit. The inquisitorial procedure the proponents for the 16th Amendment said would not happen here has become a way of life for all America, and today, most American taxpayers want out, like the British did in 1816.

"A disgrace to the human race"

Our income tax code has been in disrepute for decades. In President Carter's acceptance speech at the Democratic Convention in 1976, he called for major tax reform, labelling the Internal Revenue Code "A disgrace to the human race." No one objected on the Republican side, yet no significant tax reform came about. The whole issue seemed to degenerate into a national debate in our major periodicals over the deductibility of the three martini lunch. Carter's condemnation of the tax code was almost 20 years ago. The Internal Revenue Code and Regulations today are almost twice as thick and certainly twice as complicated and down right unintelligible. One of our most respected income tax scholars, Professor James Eustice, of NYU, when asked about certain new provisions of the tax code, said, "About all I can do is laugh."

Polybius, the great Greek historian of the second century B.C., said that the best preparation for politics was the study of history--in order to avoid the disasters of others. And one of our most revered thinkers in the 20th Century, Oliver Wendall Holmes, echoed the same idea in a 1922 case, "A page of history is worth a volume of logic." However, history gives us a mixed voice when it comes to income taxes. The early British income tax, the German income tax, and our own income tax monster all attest to the dangers inherent in income taxation. On the other hand, the simple flat British tax in the latter half of the 19th Century suggests that, with the utmost care, an income tax can be administered consistent with the spirit of a free nation. But if not controlled, the tax, like fire, can burn down the very civilization we seek to perpetuate. Our income tax is a monster because of our zeal for revenue; we ignored the lessons of history--what Polybius called, "The disasters of others."

Getting rid of our current income tax may seem like an impossibility, considering the huge national debt and deficits, but the seemingly impossible may turn into reality if the American taxpayer, like our cousins in Britain in 1816, has a say. Actually, the Congress and the Treasury have been, unwittingly, digging a grave for the income tax code for over 30 years. President Ulysses S. Grant, said that the best way to get rid of a bad law, is to strictly enforce it, and that has been happening to the income tax law for the past three decades. For the first 50 years, the income tax in America was an honor system. In my first tax audit as a professional, some 30+ years ago, a veteran IRS agent on the eve of retirement, said to me, "You know, our income tax system is an honor system, which is the only way it will work in a free society." Today, the honor part is gone. Does that mean the free society is gone as well? In a sense, yes--although no one wants to accept that painful judgment.

Thirty years ago the ubiquitous information return was almost unknown, and that is why it was an honor system. Today, besides mandatory reporting on just about every aspect of one's financial life, everything going through one's bank account is photographed and held in storage for the tax man to see. Our tax administration is now a spy system, not an honor system. Does that mean there has been a tragic decline in the honor and integrity of our citizens? Or, is there another explanation?

Almost 50 years ago, Supreme Court Justice Jackson, who was formerly chief counsel for the Internal Revenue Bureau, wrote, praising the tax integrity of the American taxpayer:

> The United States has a system of taxation by confession. That a people so numerous, scattered and individualistic annually assess itself with a tax liability often in highly burdensome amounts, is a reassuring sign of the stability and vitality of our system of government.

This praise was repeated by many others at that time. But in 1983, Richard Neely, Chief Justice of the West Virginia Supreme Court, made this disturbing observation:

> Cheating on federal and state income tax is all pervasive in all classes of society; except among the compulsively honest, cheating usually occurs in direct proportion to opportunity.

Justice Jackson spoke of the rare instances of self-serving mistakes and outright evasion--and that was when the income tax was indeed an honor system. Justice Neely, writing almost 40 years later, saw such misdeeds as the norm if people have the opportunity. The government has two choices: cover the nation with even more espionage against taxpayers as the Germans did, or get rid of the monster.

What has gone wrong?

Rather than attack the integrity of the people, what we are experiencing is a broad, non-violent revolt against the tax system. Wealthy citizens are revolting with their shoes--they take flight to more gentler tax climes; others, not so fortunate, resort to just about anything that works: legal, and not-so-legal. To add even more extensive surveillance, more and more penalties, and even worse, more savage punishments, is like adding gasoline to a smoldering fire. The better solution is to bring in a wrecking crew and tear down the whole disreputable edifice. The American people have had a belly-full of a bad tax law; they are fed-up with it and with the many phoney attempts at tax reform. They want out, and their defiance and rebelliousness is a warning to tax policy makers. In fact, politicians who fail to see this sign-of-the-times, had better prepare for a short-lived political career, as George Bush learned. We saw that happen last November. Fortunately, it was a lynching by votes. In other times past, when taxpayer representatives approved taxes the people didn't want, they were lynched by ropes or the headsman.

History has not been kind to governments that taxed too much, or in ways the people disliked. The American Revolution is a reminder we can hardly ignore. In the French Revolution angry, over-taxed Frenchmen hauled every tax man they could find down to the guillotine and cut their heads off. No tears were shed when their heads flopped into the basket. Thomas Jefferson wrote that a government needs a rebellion every 20 years or so, and that the governors should not punish the rebels

severely, for the rebels are pointing out sicknesses to which the government needs to give attention. Looking at Jefferson's historical frame of reference, we discover something other writers who quote Jefferson have ignored. There were about a dozen revolts in Europe and America when he lived--and all of them were over taxes. His was an era of violent tax revolts. Ours is an age of tax revolts by everything but violence. But the revolt is real, and the message the same.

These hearings on replacing the Federal Income tax should be the most important fiscal inquiries since the debates in the nation at the turn of this century over the income tax Amendment. The outcome will determine what kind of civil liberties we will pass on to our children in the next century: i.e., whether or not we pass to them a tax system that is unintelligible, corrupt, and tyrannical; or a system in which all citizens will know that the costs of running the government are apportioned among the people by a standard of fairness they can understand and see. Today, they can neither understand it, nor see it. "Duty, honor and country" have been replaced with beating Uncle Sam out of every penny you can, and this, to a large extent because the tax law is, as President Carter charged, "A disgrace to the human race." How can you expect rational citizens to support a law with such a condemnation?

What should be done?

Nero in one of his fits of madness, said that he wanted to abolish all taxes and "make a beautiful gift tothe human race." Not a bad idea, unless you want civilized life. For taxes are the fuel that makes civilization run. But if you have bad fuel with impediments, or not properly designed for the engine, then civilization will run badly, and that has happened too many times in history to need explaining

Our income tax can be likened to a dirty industrial smelter that polutes the air, poisons the streams, and kills the forests. It will be tolerated so long as nothing else has been invented, and the smelter is essential for society. Like a dirty smelter we pollute the social order with our income tax system. We seek a society in which equality, integrity, and liberty abound, but our current tax system pulls us in the opposite direction. Instead of equality, we have inequality, intentionally and deliberately fostered upon us. Instead of integrity, we have fraud. Instead of liberty we have totalitarian surveillance and inquisitions. In short, our income tax is a dirty tax and the more we demand of it the dirtier it becomes. We are stuck with it because we haven't taken the time to develop something better. Now is the time. We need heroic leadership in matters of taxation and expenditure. Hopefully, that leadership will begin with this Committee.

What guidance can the past give us?

There are both positive and negative lessons. Taxes that wrecked empires, tell us a great deal about human nature, and about taxes that produced the "disasters" Polybius warned us about. And then there were taxes that were compatible with liberty, democracy and respected private property. We need to focus on those taxes as well. Besides these historical examples we have the marvelous wisdom of the great minds of the past; of men who pondered the wreckage bad taxation had wrought, and sought out answers for the best way to tax and spend. We need to look to these great sages of the past, and fortunately, so many of them were prominent in the formation of the United States

200 years ago. They spoke our language. We don't need a translation. All we need to do is listen.

1. Any permanent forms of taxation should be as indirect as possible.

The condemnation of direct forms of taxation as the arch-enemy of liberty, is a truism over 2500 years old. It came from the Greeks and Romans who taught that direct taxation produced tyranny. They came to that conclusion from history--from examining the tax systems of the great empires of their day and their past--Assyria, Babylon, Persia, and Egypt. These were civilizations that were devoid of liberty and respect for private property. The Greeks concluded from history that tyranny was the consequence of the wrong kind of taxes, and liberty came from the right kind of taxes, like sales, imports, or taxes on commerce.

Cicero, the great Roman lawyer, wrote that direct taxes should instituted only if there was no alternative other than complete national collapse.

When Rome declined and fell in A.D. 476, direct taxaes had been in operation for over 175 years, and, at the same time, all forms of liberty had been taken away, starting with the Emperor Diocletian, who enslaved the Roman world to make the tax system work.

The Founders were schooled in classical history, and their greatest sage was from Europe, Baron du Montesquieu. His The Spirit of Laws was quoted more than any other writer by the Founders. He picked up the Greek and Roman theme and said that direct taxation was natural to slavery, but indirect taxes, like those on merchandise, were more compatible to liberty, "because it has not so direct a relation to the person."

I have searched through the debates at the Constitutional Convention and the debates in the state legislatures, and there is not one word of support for direct taxation. Madison and Hamilton wanted the power of direct taxation in the Constitution but only for "extraordinary emergencies." James Wilson, from New York, whom some believe was the primary architect of the Constitution stated that direct taxes were for "all cases of emergency." Luther Martin, a delegate from Maryland, said direct taxes "should not be used but in cases of absolute necessity." In the state debates, a representative, Alexander Hanson, reasoned that direct taxes were to be held in reserve, "nothing but some unforeseen disaster will ever drive them [the federal government] to such ineligible expedients."

It is clear from the writings and thinking of the Founders and of the ancient Greeks and Romans, that a nation bent on preserving liberty should avoid direct taxation and rely on indirect taxes, like sales and import duties, taxes on commerce, not the individual. Add to that historical wisdom the experience of the British under the Napoleonic income tax. They tried to pass on to later generations that the income tax they had experienced over 18 years was a tyranny of the worst kind, and by destroying all the records of this hated tax, they left a message for future generations to come. A message, we might add that never got through to our tax makers a hundred years ago. In this century, we have confirmed, the hard way, that the British in 1816 were right.

2. Taxes, whatever the format, must not be excessive.

The Founders and the men of the Enlightenment, condemned taxes that were "excessive." Unfortunately, they did not define the term, but they did explain the consequences. Montesquieu, who relied on history for his judgments, said excessive taxation resulted in "extraordinary means of oppression." Now, that's worth thinking about. What he seems to be telling us, is that human nature rebels against excessive taxation. It may be a violent revolt; it may be emigration to avoid tax; it may be evasion or fraud of some sort--but it is an iron law of history you cannot legislate against human nature. When a government does, in the tax field, it has to resort to "extraordinary means of oppression." But Montesquieu does not end there; for the inevitable consequence was, "the country is ruined."

The best definition of excessive comes from a leader of the British House of Commons at mid-18th Century, following the excise tax revolts against Sir Robert Walpole. The government had to do a lot of thinking about what had happened, and Henry Fox summed up the wisdom learned with this observation:

> All governments must have a regard not only for what the people are <u>able</u> to pay, but what they are <u>willing</u> to pay, and the manner in which they are willing to pay, without being provoked to a rebellion.

3. Most important, the tax system as a whole, must be moderate.

There is an ancient Asian proverb, "It is not the heavy taxed realm that executes great deeds, but the moderately taxed one." This is consistent with the Greek doctrine of the "golden mean," propounded by Aristotle. Virtue is the middle ground between extremes. Tax policy should follow a moderate course in all respects: tax rates, surveillance, privacy, punishments, even equality. It is, in my opinion, no virtue to exempt any citizen from some tax. In the New Testament, even the widow paid her mite. In the Roman Republic, the taxes of widows and orphans, however small, were set aside for the cavalry. Taxes were paid with pride, and love of one's country.

Tax rates should pass the smell test, and not reek of plunder against any minority class of citizens, like our estate taxes which today confiscate over half the accumulated (and taxed) wealth of the rich. No wonder they take flight and leave, for patriotism, like it or not, is soluble in taxes. Not even a half-starved crow will sit around to be shot at.

Intrusions should show some respect for privacy and due process. Photographing everything in every bank account is looked upon by other Western societies with horror, like something out of Orwell's <u>1984</u>.

Our savage punishment of tax sinners is not only out of step with Western Civilization, it was condemned by the great writers of the Enlightenment. Not only Montesquieu, but William Blackstone in his <u>Commentaries</u>, and Adam Smith in <u>The Wealth of Nations</u>. They all condemned making tax evasion a felony. The tax evader, said Adam Smith, was--

> In every respect, an excellent citizen, had not the laws of his country made a crime which Nature never meant to be so. In those corrupt governments where there is at least a general suspicion of much unnecessary expense, and great misapplication of the public revenue, the laws which guard it are little respected.

Montesquieu and Blackstone in one voice, both said, you must not treat tax offenders as villains.

4. There is no single form of tax Nirvana.

Around 1750, the famous British Poet, Alexander Pope, gave us this wise couplet:

> Whoever hopes a faultless tax to see,
> hopes what ne'er was, is not, and ne'er will be.

Reliance upon any single form of taxation has not worked well in history. Alexander Hamilton saw this and he pushed hard at the Convention to give Congress broad authority to tax in any number of ways. He argued this point in The Federalist to overcome the popular view that the federal government should only be able to tax imports. His argument was sound. He said that if great revenues are needed, as they will be at certain times of emergency, then a single tax will become excessive and this will injure commerce and foster evasion with the high tax rates that will be necessary. Better to have the power to tax all kinds of sources, not just one source, so the rates can be moderate.

Historical examples are easy to find. The Spanish Empire and later the super-Dutch empire both went into decline because of heavy excise taxes that crippled trade. The Netherlands, the superpower of the 17th Century, was unable to compete with lower priced, and lower taxed British goods. An English diplomat in Holland wrote home: "When in a tavern, a certain dish of fish is eaten with the usual sauce, about 30 several excises are paid." Said another English writer, "Should we in England be obliged to pay the taxes that are here imposed, there would be rebellion upon rebellion." As British merchants underpriced Dutch goods, Leiden was a desolate town, its once flourishing cloth industry in a depression. The linen industry of Haarlem had similarly shrunk. As a modern Dutch historian has observed about the decline of the super-Dutch, "Taxation meant the strangling of trade."

The British eclipsed both the Spanish and the Netherlands in world markets, supporting the government with a broad range of taxes on all aspects of commerce and wealth. The tax philosophy of Britain's rise to superpower status was to avoid a single primary tax, which, in the words of one British tax writer 200 years ago, "ought to be most sedulously avoided."

The wisdom of Hamilton has been proven by our reliance on a single, primary tax to carry most of the country's revenue needs: it has fostered evasion and hurt commerce just as he predicted. There is no single tax Nirvana, if history is to be a guide. Such schemes have had disasterous results in the past.

What should be done? Should the present income tax be abolished? Yes--definitely so. It has been misused; the American taxpayers have been abused; they are fed up with it and want a real change. A flat income tax has merit as long as it is moderate, as indirect as possible, and as long as the Orwellian powers of the tax man are rooted out. We may not be able to "Subdue" the tax monster as the British did in 1816, but we must tame the beast before the faith of the people in federal taxation can be restored.

What about a national sales tax? A VAT? A GST like Canada, or some other form of tax on commerce. All these forms of taxation are indirect, and conform to the best tax wisdom of the past 2500 years. The Greeks, Romans, the Enlightenment, the Founders, all would favor such taxes. They have history on their side, as long as they are not too excessive or extensive as was the excise with Spain and The Netherlands.

What else? We need to explore other tax ideas, even novel or ideas that may appear crackpot. We want a tax that conforms to and does not buck the wisdom of the past. This story from Henry Ford's search for a safer car, may have some merit in our search for better ways to tax:

Henry Ford wanted to protect lives and injuries from shattered auto glass. He asked the world's glass experts to make unbreakable glass for his new models. The world's glass experts said it couldn't be done. They knew too many reasons why it couldn't be done. Henry Ford said to his aides, "Bring me eager your fellows who do not know the reasons why unbreakable glass cannot be made. Give the problem to ambitious young fellows who think nothing is impossible." He got the unbreakable glass.

America needs a new tax invention, something that might be possible with our modern technology and be compatible with the temper of a free people. In our search for a new tax system every idea and plan to replace the income tax, must be measured and tested against these four criteria of a bad tax system, given to us by Adam Smith in The Wealth of Nations:

1. The tax must not foster a large bureaucracy.
2. The tax must not discourage enterprise, and thus deprive jobs from the multitude.
3. The tax must not encourage evasion--legal or illegal.
4. The tax must not put taxpayers through odious and vexation examinations by the tax gatherer.

Add to Adam Smith's four signs of a bad tax system, the four positive factors set forth in this treatise:

1. A permanent tax system should be as indirect as possible.

2. The tax must not be excessive; i.e., not only what the people are able to pay, but what they are willing to pay.

3. The system as a whole must be moderate: no savage punishments; no totalitarian intrusions and surveillance; uniform and equal rates.

4. No reliance on a single form of tax--taxes should cover a broad range of the national wealth and commerce.

If we measure our current tax system by the above eight principles, it fails miserably. It might be necessary, if we are to have a good tax system, to give the problem to ambitious young fellows (and gals) who think nothing is impossible.

Chairman ARCHER. Thank you.

You have piqued my interest to read every word in your book. Perhaps every Member of the Committee might be encouraged to do so.

Dr. Payne.

STATEMENT OF JAMES L. PAYNE, PH.D., AUTHOR OF "COSTLY RETURNS; THE BURDENS OF THE U.S. TAX SYSTEM"

Mr. JAMES PAYNE. Thank you, Mr. Chairman.

I agree with what Mr. Hancock said this morning about these being historic hearings that you are having, because down through the years, at least the last 20 or 30 years, there has been surprisingly little attention given by this Committee in particular, and Congress in general, to the real costs and burdens, and problems, and destructiveness of the tax system.

I think we have got to look at these problems before we go too far into tracing out which reform we want to have. One aspect that I will mention is the total overhead cost of running the tax system. Apparently there are some Members of this Committee that still believe it is minuscule. I notice in the questioning of the Mobil representative this morning that there are people that feel this cost is trivial. I don't think anybody that has looked at these numbers can say that anymore.

In the figures I have put together, the compliance cost is only one component—there are costs associated with enforcement, collection and litigation, and disincentive to production. If you add these together in 1985, as I did, they amounted to $363 billion. I have updated this estimate to 1993, the latest year for which the figures are available, and I get $593 billion. That is the figure that Fortune magazine has that was mentioned this morning.

Another way to express the conclusion of this research is to say that the marginal overhead cost of raising $1 through the Federal tax system is 65 cents. If you are going to fund, let's say, a $100 million dam with Federal tax money, the true social cost of that $100 million dam is $165 million because of the overhead cost of collecting the money.

Well, what should we do about it? As I say, I don't think we should rush right away into major reforms. I think there are a large number of simple reforms we can do to test, frankly, Congress' sincerity here in turning around the direction that the tax system has gone. Until now, the premise in Washington has been, really, to get the money from taxpayers, to squeeze taxpayers, and the question of the work that this implied, and all the other types of degradations: This has been left to one side.

For example, one reform that I suggest concerns paid informers. A lot of people don't even know we have paid informers, whereby every American is encouraged with cash rewards to inform on every other American about tax transgressions. This is a system that no other democratic country has. They seem to run their income tax systems without it. It makes us, as far as I can see, unique in the democratic world.

This hasn't been raised; it hasn't been debated. I think eliminating paid informers is one move that this Committee could do to indicate its sincerity to clean up a Tax Code that has gotten Americans so angry over the years.

Thank you.

[The prepared statement follows:]

Statement of James L. Payne prepared for the House Ways and Means Committee hearings on Replacing the Federal Income Tax, June 6, 1995.

The members of this committee are to be congratulated for holding this precedent-setting hearing, looking into what is wrong with the current tax system. Washington has been a city where people concentrate on giving out money, and they have tended to downplay the sacrifices associated with collecting it.

This bias has meant that tax committees have overlooked studies detailing the waste and injury of the income tax system. Instead, they directed their energies into "reforms" to squeeze more money out of taxpayers. This process has resulted in a staggeringly complex tax system, one that imposes great economic, moral, and social costs on the nation.

In my book on the burdens of the income tax system, Costly Returns, I have calculated these costs. As a way of illustrating their magnitude, let me focus on just one, the compliance cost. This is the time spent by businesses and individuals in learning about the tax code, keeping records, making computations, and filling out forms and supporting documents.

The most comprehensive study we have of this cost was undertaken by the Arthur D. Little Company in 1985. This study found that businesses and individuals spent 5.4 billion hours of work complying with federal tax law. This corresponded to 2.9 million people--the entire labor force of Indiana--working full time all year long. The economic cost of this labor came to $159.4 billion.

That was ten years ago. Since that time, the tax law has grown more complex and more taxpaying entities have become subject to it. For 1995, I calculate that the total time businesses and individuals spend on tax compliance work has risen to 10.2 billion hours. This amounts to 5.5 million workers working all year--the equivalent of the entire work forces of Indiana, Iowa, and Maine.

This number is just the compliance burden. The income tax system involves a host of other costs, including those associated with enforcement (audits, demand notices), forced collections (levies, liens, seizures), and tax litigation. In addition, there is the inefficiency caused by the disincentives to production, and the economic waste of tax avoidance and evasion. When all of these costs are added together, I found that in 1985 they amounted to $363 billion. Updated to 1993, the figure is $593 billion. To express this finding another way, the marginal overhead cost of raising one dollar through the federal tax system is 65 cents.

The Road to Reform

These figures reinforce Chairman Archer's contention that the income tax is extremely destructive. However, I believe it is premature to attempt to substitute another tax arrangement for the present one.

The problem is that large numbers of Americans, both citizens and policy makers, are not fully aware of the failings of the current system. They still believe the income tax is working rather well. The main reason for this lack of understanding is the bias I alluded to earlier: Washington's culture of spending has suppressed the unflattering facts about the income tax.

Take the matter of statistics on the overhead costs of the tax system. The number I just gave--that tax system overhead costs are 65 cents on the dollar--is a sober, middle-of-the-road calculation based on respected sources. Nevertheless, most people find it incredible, too large to be believable. Why? Because no one has ever compiled it before. This committee, for example, with all its professional and expert staff members, has never attempted to estimate the overhead cost of the U. S. income tax system. Nor has the GAO. Nor has the Treasury. This, when you stop to think about it, is an astonishing gap: hundreds of Washington experts responsible for the U. S. income tax system who do not know, and have not even bothered to ask, what damage the tax system is doing to the country!

With policy makers ignoring the costs of the tax system, it's not surprising that the general public doesn't know about them either. Reporters, political science professors, and the man in the street accept the IRS's claim that operating the federal income tax system costs "less than one percent" of the tax money collected. No wonder they disbelieve when they hear that the real figure is 65 percent.

This is just one example of how the down side of the income tax system has been obscured, leaving the public seriously misinformed. This lack of information makes it inadvisable to attempt to replace the income tax system. An attempted reform at the present moment would probably result in complex tax

legislation that adds a federal consumption tax without getting rid of the income tax.

To replace the income tax, the first step should be to inform the American people about it, to drag this monster out from under the rock where big spenders have hidden it, and let the daylight shine upon it. The best way to do this, I believe, is to attempt to reform some of its most objectionable features. This is the way to call attention to its underlying flaws.

Among dozens of possibilities, let me suggest three reforms which would bring to public notice some of the grave failings of the current system:

1. Require that IRS demand notices have an accuracy rate of at least 99 percent. The IRS currently sends out 3-6 million computer-generated demand notices each year. They accuse the taxpayer of not paying the right amount of taxes, and threaten forcible collection action if a satisfactory response is not received. These notices generate enormous anxiety among taxpayers, since the IRS is threatening citizens with financial ruin.

Tax practitioners know, and studies confirm, that a high proportion of these demand notices are erroneous. A GAO study found an error rate of 47 percent; a Gallup survey indicated 69 percent. In other words, the coercive power of the state is being brought against citizens in error millions of times each year! Most Americans have no idea about this error rate. Indeed, there are tax committee staff members who are unaware of it.

IRS officials will probably argue that if they concerned themselves with accuracy, this would reduce the number of demand notices they could send out. The "scattergun" approach is necessary, they say, to "provide presence," that is, to maintain the public anxiety on which the income tax depends.

Shouldn't we have a debate on this matter, and openly decide whether we approve of this system of false accusations?

2. Abolish paid informers. Another quietly-hidden feature of the current system is the practice of offering cash rewards to those who inform on possible tax evaders. The reward program encourages children to inform on their parents, husbands to inform against their wives, and so on. In prompting Americans to betray other loyalties, this program has been increasingly successful. In 1961, 4,401 people informed; by 1989, the number had nearly tripled, to 11,754.

Enforcement officials will make the case that encouraging citizens to spy on each other heightens the "fear factor" on which the income tax depends. They have a point: an income tax works best if every person fears that Big Brother is constantly watching him. But the question must be asked: How far are we willing to compromise liberty, privacy, and decency to uphold the income tax? When the Soviet Union had this system of fostering state interests by rewarding citizens to spy on each other, we called it the Evil Empire. I should also note that no other civilized country allows this practice. An American Bar Association survey of 16 other democratic states found that none had statutes corresponding to our section 7623 of the tax code empowering officials to pay cash rewards to tax informers.

3. Abolish the individual estimated tax and quarterly tax payments. The tax code is laden with provisions that place a huge compliance burden on taxpayers in order to obtain a slight revenue gain for the Treasury. The reason these destructive provisions keep getting approved is that, up until now, congressmen and tax officials have not placed any value on taxpayer time and trouble. They only look at the income stream coming into the Treasury.

The individual estimated tax is a typical example. By forcing millions of self-employed workers to try to calculate their income in advance, and then forcing them to make quarterly payments during the year, the Treasury ends up benefitting from the interest on the earlier payments. But this arrangement costs taxpayers dearly in time and frustration. In addition, it forces them to deal with the IRS four times a year instead of just once. Many taxpayers object to this irritating "choke chain," and simply refuse to comply; many others run afoul of some aspect of the regulations. As a result, the estimated tax generates over five million penalties a year--many of which are protested, which leads to still more complications and more frustration.

A Congress that cared about serving taxpayers, instead of simply squeezing them, would long ago have abandoned the individual estimated tax. Raising this issue would be a good way to find out, before we again plunge down the road of major tax reform, whether Congress now has its heart in the right place.

Appendix: Estimate of the Federal tax compliance burden for 1995

For complete citations of sources mentioned, and further details, refer to James L. Payne, Costly Returns; The Burdens of the U. S. Tax System (San Francisco, ICS Press, 1993). (Hereinafter CS)

The starting-point of the estimate is the 1985 finding of the Arthur D. Little study, 5.4 billion hours for business and individual compliance combined (CS, p.21), adapted as follows:

1. The methodology of the Little study--which was financed and supervised by the IRS--was biased toward understating the compliance burden: missing data was entered as zero; seemingly "high" figures were discarded, and so on (See CS pp. 20-23). To control for this bias we can compare the Little results on individual compliance burden with other studies of individual compliance burden, all of which show a higher burden than the Little study:

AD Little, 1985	1.813 billion hours
Slemrod, 1982 (CS, p.23)	2.13 billion hours
Slemrod, 1989 (CS, p. 155)	3.00 billion hours
Collins, 1987 (CS, p. 23)	2.02 billion hours

The average of the Selmrod 1982 and Collins 1987 figures, 2.08 billion hours, gives a fair estimate of the true individual compliance cost in 1985. This means that the Little study figure is .87 of the true value (1.813/2.08).

Therefore, to obtain an unbiased estimate of the entire compliance cost in 1985 (individual and business), one needs to multiply the Little figure (5.427 billion) by 1/.87, giving 6.2 billion hours.

2. The total number of taxpaying units affected by compliance costs is indexed by the total number of tax returns filed. This went from 178 million in 1985 to 207 million in 1993 (IRS Annual Reports). This is a 2% increase per year, or a 20% increase 1985 to 1995.

3. Slemrod's two comparable studies on individual tax compliance burden found that between 1982 and 1989, hours spent per taxpayer increased 26 percent. This figure probably understates the increase in business compliance burdens, but we shall use it to estimate the overall growth of compliance burdens of businesses and individuals. This figure indicates a 3.7 percent increase per year in the compliance burden for a taxpaying unit (26%/7). Hence the estimated increase for the years (1985-1995) is 37% (10 x 3.7).

Hence, to estimate the tax compliance burden in 1995 we multiply the figure for 1985 (corrected) times the increase in the number of taxpaying units, times the increase in burden per taxpaying unit, thus:

1995 compliance burden =

(6.2 billion hours) x (1.20) x (1.37) = 10.2 billion hours

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Chairman ARCHER. Thank you, Dr. Payne.

The last witness is Dr. Raboy.

STATEMENT OF DAVID G. RABOY, PH.D., CHIEF ECONOMIC CONSULTANT, PATTON BOGGS, L.L.P.

Mr. RABOY. Thank you, Mr. Chairman.

As you know, I was originally on the competitiveness panel, and I am a bit out of my element with respect to compliance so I will stick to my original topic, which is to discuss one of the aspects of tax reform that may affect competitiveness, and that is the question of border tax adjustments.

Under the GATT or the successor WTO, there is a system of border tax adjustments which attempts to harmonize the cross-border applications of national tax systems. The GATT includes a destination principle where goods are to be taxed in the country in which they are consumed rather than in the country in which they are produced. The result is that so-called indirect taxes like the VAT can be rebated on exports and levied on imports, whereas so-called direct taxes like income taxes or corporate profits taxes are not eligible for border tax adjustments.

I believe there is no qualitative difference in the incidence of direct and indirect taxes, so to me the GATT distinction is unjustified. Nonetheless, it remains after the Uruguay round and therefore must be a factor in deciding what form tax revision ought to take.

As compared to our trading partners, the United States relies primarily on nonborder adjustable direct taxes. More important, although many of the tax reform proposals before us now have qualitatively similar tax bases, under WTO rules, some would be eligible for border tax adjustments and some wouldn't. The crucial question is whether it matters if we have a border adjustable system.

In the old days many observers believed that our trade problems existed in large part because our exports were subject to double taxation while our competitors' exports escaped taxation, at least partially, both at home and at the U.S. Customs frontier. Then the pendulum swung in the other direction and it was argued, primarily because of floating exchange rates, that border adjustments were irrelevant. I think the truth lies somewhere in between.

First, I think the proper focus for policymakers is not necessarily the nominal trade balance but rather the real costs, the relative costs that determine the individual decisions of consumers, exporting companies, and companies competing with imports. Taxes are real costs just as surely as wages, raw inputs, energy or anything else, and if taxes distort decisions whether to purchase domestic goods or imports, to export or to sell in the U.S. market, or whether investments should flow to the trade sector rather than other sectors, then both the external and internal sectors of the economy suffer.

The tax system should not be an implicit regulator of world trade. Policymakers should strive to create tax systems that are neutral, that don't distort these costs.

Let me bore you with a little economic theory. Economists agree that if you could construct an ideal VAT on an origin basis, then at equilibrium it would be trade neutral. They may not tell you the

real economic effects on trading sectors that may occur on the way to this equilibrium.

These same economists tell you that at equilibrium, an ideal VAT based on a destination principle is also trade neutral, and not surprisingly in this idealized world, a switch from an origin- to a destination-based system would also be neutral. But even in this idealized world, the switch from an origin to a destination system, which we would consider here, can produce some substantial trade flow changes during the adjustment period. Exports will increase and imports will decrease.

Further, since taxes are real costs and not just nominal costs or illusory costs, these trade effects cannot be wiped out solely by nominal exchange rate movements. The magnitude of these effects is indeterminant as is their duration, and as such I would not argue that these effects, themselves, justify a tax overhaul.

But if we are going to consider tax reform for other sound policy reasons, then we ought to adopt the destination principle and enjoy the shortrun trade benefits.

In addition, given our proclivity to run trade deficits, a destination-based tax by definition has a larger tax base and therefore you can have a lower rate and get the same amount of revenue.

I would like to address a fairly thorny political issue within the consumption tax debate: Income distribution and how you remedy it. It is common wisdom that remedial measures may be necessary to address perceived regressivity in a consumption system, and the choices include exemption or zero rating of certain goods.

Many economists have argued that such tax preferences are inefficient ways to achieve progressivity and they would prefer income credits or direct spending outside of a comsumption tax system. But I would argue that there is a compelling international argument to try to find a way, other than exemptions, to deal with regressivity.

Many of the items frequently listed for exemption or zero rating do not enter international trade. These include food, housing, medical services and education. As a result, preferential treatment of these goods drives a tax wedge between trade-intensive and non-trade-intensive sectors.

VAT preferences could conceivably cause investment to flow away from industries that compete with imports or produce exports, and a contraction in our trade sector could result. This, of course, would be opposite of the competitive effect we would like to see from consumption-based tax reform.

Thank you, Mr. Chairman.

[The prepared statement follows:]

TESTIMONY OF DAVID G. RABOY
PATTON BOGGS

My name is David G. Raboy and I am the Chief Economic Consultant to the Washington, D.C. law firm of Patton Boggs, L.L.P. I am pleased to testify today on the international economic implications of a tax reform that would substitute a Value-Added Tax (VAT) for existing business taxes. It is not uncommon for there to be a divergence in views between academic economists and one class of economic actors whose actions economists attempt to study -- business people. It is, of course, somewhat of an irony in our academic era; with its belief that business people act in their own self-interest and basically know what they are doing; that on some issues business people and academic economists can apparently hold radically different views for long periods of time on the effects of policies.

One of the policy issues where it is claimed that business people and those that study their decisions are most at odds is the effect of a VAT (or more correctly the substitution of a VAT for existing business taxes) on "competitiveness." The existence of this issue, of course, can be blamed on the GATT (The General Agreement on Tariffs and Trade), which allows a system of border tax adjustments. Such adjustments are allowed on "indirect taxes" (sales taxes, VATs, excise taxes, and the like), but not on "direct" taxes (income taxes, payroll taxes, and other taxes on income flows). Given a choice of adopting the "origin" principle, where taxes are levied on goods in countries where they are produced, or the "destination" principle, where taxes are levied on goods in the country in which they are consumed; the GATT adopted the destination principle. Indirect taxes like the VAT, which are applied *directly* to goods, are levied on imports and rebated on exports while direct taxes like the corporate income tax, which may *indirectly* enter the price of goods, are not applied to imports and not rebated on exports.

Since the U.S. has relied on origin-based direct taxes with no border adjustments, and the rest of the world is more heavily dependent on indirect taxes with border adjustments, many business people in trade-intensive sectors have argued for transformation of the U.S. tax system, despite the protestations of academic economists, many of whom claim that such a transformation will not affect trade. Mainstream economic theory is based on the foundation that economic actors are "rational", i.e., they behave in predictable ways that represent their self-interest, based on available information. It is, therefore, a bit troubling to face the specter of so many rational, profit-maximizing business people blindly pursuing policies that apparently will not achieve their intended goals. But, maybe, the gulf is not as wide as some economists claim.

My testimony will attempt to reconcile the divergent views on the trade implications of VATs, and to determine what the economic literature actually says about VATs, other taxes, and international "competitiveness." The interaction of several issues will prove crucial: 1) the choice of an origin- or destination- based tax system; 2) the incidence of a VAT as compared to other business taxes; and 3) the effects of the international monetary system.

II. How Should We Judge Competitiveness?

A threshold issue concerns the proper gauge to evaluate the trade implications of tax policy. While many focus on the trade balance, I will argue that a barometer that focuses on real costs is of more use.

Relative Prices and International Trade

The classical theory of trade states that countries trade because they are different. They are endowed with different levels of natural resources, labor of differing qualities and costs, capital, and other factors of production; or there are differences in consumer tastes. Because they are different, countries face different trade-offs in the types and quantities of goods and services they can produce, given their differing resources. In one country a class of goods may be *relatively* less costly than in another country, therefore, "comparative advantages" may exist.

The classical theory holds that by engaging in trade with one another, countries can exploit others' efficiency and better themselves. As they begin to trade the relative prices of the goods entering trade in each country will change, due to increased demand for each country's export, until relative prices are equalized somewhere between the initial pre-trade levels. At this "equilibrium" each country will be economically better off than it was before because there will have been "gains from trade." The faith that is required is that the free market will sort out the

best solution. Therefore countries are best served if prices of goods entering international trade are not distorted by government policies. But not just any prices -- *relative* prices. One of these countries could have higher *absolute* costs for products entering trade and the other still could benefit from trade. The relative prices that are of importance are expressed as opportunity costs -- what must be given up in terms of one thing to produce another thing.

Trade theory has come a long way in the past two decades. Whereas the classical theory held that trade stemmed from differences in countries, the rather embarrassing observation was made that almost identical countries still traded, that countries might export essentially the same good to each other (two-way trade), and that other occurrences could not be explained by the classical theory. Rather than jettisoning classical theory, however, new trade theorists added to it by developing notions of economies of scale in production (in order to be efficient it might not make sense, given the market, to have twenty countries producing wide-body aircraft or super-computers), and imperfect competition. These concepts, when added to the classical concept of comparative advantage, do fairly well in explaining trade in the modern world. Whereas some of the new trade theory questioned the efficacy of free trade, and most economists would grant that interference is warranted under certain situations, the dominant view of the new trade theorists is that, in general, the additional explanations of trade patterns enhance rather than diminish the potential gains from trade. Therefore, it is still appropriate to judge government policy as to its effects on relative prices.

As a general principle, then, policies that artificially distort the *relative* prices of traded goods diminish economic efficiency by lessening the gains from trade. There are both internal and external relative prices to be considered. Economists define the "terms of trade" as the *external* price of exports of a country, divided by the external price of the goods that the country imports. A country is better off when the external price of exports rises relative to imports; that is, when the terms of trade improve; because obviously it can buy more with the same volume of exports -- what it sells in international markets has increased in value.

The terms of trade are not, however, the only relative prices that matter to policymakers. It is well known in the literature, for instance, that there are two countervailing effects of a tariff. There is an efficiency loss from a distortion of the internal prices facing consumers and producers after application of the tariff which disturbs the allocation of resources, and there is an improvement in the terms of trade which benefits the country. For a "small" country, one which has insufficient market share to influence world prices, by definition *no* trade policy can effect the terms of trade. But policies *will* influence internal relative prices and force consumers and producers into decisions they otherwise would not make, thus distorting the allocation of resources and lessening economic efficiency.

Therefore, this testimony will use as its gauge of the effects of policy, changes in both internal relative prices and the terms of trade from those that would prevail under free trade. The relevant question will be whether a VAT, or a VAT/other-tax-substitution, alters the internal or external relative prices of traded goods from those that would have prevailed under free trade.

Why Not the Current Account?

The current account, popularly known as the trade balance, is one component of the international accounts of a country. It is defined as the difference between the value of exports and imports plus other more minor government and nongovernment transactions. The current account is measured in nominal units of a nation's currency.

The second basic account is the capital account which is essentially the net of capital inflows and outflows (both private and public). Capital outflows include government currency reserves and other assets, and private assets such as stocks and bonds issued by foreign companies and governments. Capital inflows are basically official foreign government purchases of home country assets and private purchases of domestic assets by foreigners.

These two accounts comprise the balance of payments, which is simply an accounting identity which reflects all monetary inflows and outflows. By definition this identity must always be in balance; that is, any deficit in the trade balance must be made up by a capital inflow of equal magnitude. The excess of imports over exports must be paid for by borrowing money from foreign entities in one form or another. Since the balance of payments must always balance, it also defines the demand for a nation's currency when exchange rates are free to float.

Because U.S. assets and goods must be purchased with dollars, exports and capital inflows constitute the demand for dollars. Similarly, imports plus capital outflows define the supply.

The best way to illustrate that the current account is not a good gauge for policy is to take an issue that everyone can agree on, and compare the analysis of that issue with respect to the current account or relative prices. Everybody can agree that tariffs distort trade. All economists agree that tariffs artificially distort the internal relative prices facing consumers and producers and therefore change the allocation of resources from what would exist under free trade. All economists also agree that if a country is relatively large, a tariff will change the external terms of trade. Further, there is virtually universal agreement among academic economists that, except in rare situations, tariffs make the world less efficient and less well off, and therefore tariff increases are generally opposed.

So in an era of floating exchange rates, *all else held constant*, what happens to the nominally denominated current account if one country increases its tariffs? *Absolutely nothing. Nothing can change the trade balance* unless it also changes the capital account because the decrease in import demand will cause a dollar appreciation unless capital outflows increase. The trade balance, the current account, is merely an accounting mechanism that measures items in nominal terms. There is no necessary correspondence between it and changes in the real economy, the allocation of resources, or economic efficiency. Tariffs are *real* costs, involving the extraction of real resources. The effects of this extraction cannot be masked by changes in strictly nominal phenomena, such as the movement in nominal exchange rates. For this reason, the effects of tax and trade policies on real relative prices are the preferred analysis route.

Of course, the trade balance will continue to be a politically explosive issue. It is the most publicly accessible image of our trading relationships, and has become politically tied to such issues as the "export of jobs," and some general feelings concerning our standing in the world. Therefore, following an analysis of the effects of VATs on relative prices, the current account will have to be revisited.

III. Origin- Versus Destination-Based Taxes

Much of the debate on the trade effects of a VAT concerns the prospect of substituting a VAT for other "taxes on business," including the corporate income tax and the employer portion of payroll taxes. The first issue that must be considered is whether the choice of an origin- or destination-based system has any trade implications.

The Methodology

The standard methodology used to investigate the effects on relative prices of a VAT involves a general equilibrium model where all results are reported after the world has fully adapted to a tax change, and no mention is made of what happens during the period of adjustment. It makes a crucial assumption that the country being studied is relatively small; that is, its world market share is sufficiently small that it has no power to affect the world prices of traded goods. By definition, therefore, nothing the country does in terms of policy changes can influence the external terms of trade, but tax changes can affect the internal relative prices of traded goods facing domestic producers and consumers. These relative prices are what are tested, at equilibrium, for the effects of VATs or other taxes.

It also assumes that the test country, and the rest of the world, produces three goods. The first good produced by the country is consumed domestically, but also can be exported (exportable). The second domestically produced and consumed good competes with imports from the rest of the world (importables). The final good is produced and consumed domestically and is neither exported nor does it face potential import competition (non-traded).

For equilibrium to occur in these models, three conditions must be satisfied. First, the domestic seller of the exportable good must be receiving the same return, after-tax, in both the home market and the external market. Obviously, if this were not the case, sellers would divert sales to where the after-tax returns were higher, and the positive or negative change in domestic supply in the home market would cause the domestic price to adjust until after-tax prices were equalized in the home and external markets. By definition, the world price is fixed, so that the domestic price of the exportable would be the price that changes to make sellers indifferent between the domestic and external markets. Second, the price of the domestically produced importable good, including tax, cannot be any different than the price of the import, including

tax. Otherwise consumers would shift to the cheaper version until demand changes caused the domestic price to adjust to restore equilibrium. Third, domestic supply of the non-traded good must equal demand for there to be equilibrium.

There is one final assumption that these models make. To isolate the relative price effects of tax changes and allow changes in producer or consumer income to be ignored, it is assumed that all tax revenue is distributed to consumers and/or producers in a non-distorting way that makes them whole for any additional tax liability. Thus, relative price changes, which alter incentives and therefore change economic behavior, are the only subjects of the analysis.

Assume that initially the home (small) country has no tax system. It is irrelevant what the rest of the world has because it is assumed that world prices are given and fixed regardless, but it causes no problem to state that the rest of the world has destination-based VATs. In the initial, free-trade equilibrium, the world price of imports into the home country and, therefore, also of the domestically produced importable is 10. The world price of the good that is exported is 15. If follows that both the internal and external relative price of exportables (exports) to importables (imports) is 1.5.

Origin-Based Taxes

This example will show that there is no change, at equilibrium, in any relative prices when a country with no prior tax system imposes an origin-based tax. An origin-based tax applies to exportables consumed domestically, actual exports, importables produced and consumed domestically, but not to imports. Therefore, in the home country that imposes an origin-based VAT levied at 10 percent, a seller of exportables is constrained in world markets by the world price of 15. Thus at equilibrium, in order to sell into the world market, his return must be reduced to about 13.64 so that after the tax is levied, the seller can meet the world price. Of course, the same price applies to exportables consumed domestically so arbitrage will result in an equilibrium where the return to the seller is also 13.64 and consumers pay an after-tax price of 15. Because there is no tax on imports, they continue to enter the home market at 10, so domestic sellers of importables, at equilibrium, will have reduced their pre-tax price to about 9.09, in order to remain competitive with imports.

There is no change in the relative price facing consumers because exportables still cost 15 and imports and importables still cost 10. Similarly, there is no change in the relative price facing producers because sellers receive 13.64 for exports and 9.09 for importables, leaving the ratio of returns unchanged. For both consumers and producers, the relative price ratio of exports (exportables) to importables remains 1.5 .

Because at equilibrium, none of the relative prices facing consumers or producers have changed after the imposition of the origin-based VAT, the opportunity cost at equilibrium of producing exportables (in terms of foregone importables) is exactly the same as before the imposition of the tax, so there is no incentive to alter the pattern of trade. In other words, the VAT is entirely neutral in its long-run effects on trade.

Destination-Based Taxes

What if the country had imposed, instead, a destination-based tax at the same 10 percent rate? This example shows that, as in the case with the imposition of an origin-based tax, the imposition of a destination-based tax would cause no change in relative prices, compared to the no-tax scenario. Looking strictly at the outcome *at equilibrium* the following would be true. Exporters would be charging and receiving 15 per unit on the world market because the tax would be rebated. Because sellers must make the same return in the home and external markets, the VAT on exportables would be passed forward so that the after-tax price facing consumers would be 16.5 and sellers would receive 15. The world price of imports is still 10, but now the VAT would apply at the border, so consumers would face an after-tax price of 11. Domestic sellers of importables would also receive 10 so that the after-tax price is 11.

What are the relative prices of traded goods at equilibrium under the destination-based tax? For consumers, exportables cost 16.5 and imports (importables) 11. The relative price is still 1.5. Of course, since the sellers of exportables and importables are receiving returns equal to world prices, the sellers' relative price also remains at 1.5. Thus, under both the origin and destination-based VATs, the relative prices of traded goods *at equilibrium* are exactly those that prevail under free trade. Both versions are trade-neutral.

The Switch

What happens if a country decides to substitute a theoretically ideal destination-based VAT for an existing ideal origin-based one? This is the central question relevant to the trade-effects debate. Under the assumptions of the models reported here, it is obvious that the move from a system that is neutral to another that is also neutral results in no long-run trade effects, *at equilibrium.* But simply viewing the equilibrium result does not provide the whole picture. What it does say is that if policy makers decide, for whatever reason, to move to destination-based ideal taxes, they need not concern themselves with a deteriorated trade situation. There are, however, some potentially significant short-run benefits that would accrue to industry sectors that engage in international trade.

The process of moving from the origin-based system to the destination-based one involves some short-run changes in levels of exports and imports. In order to see this, we must look at the "first-order" changes in relative prices; that is, the prices that prevail the instant after the tax change is implemented, before sellers have changed their prices. Then we can predict how behavior will change in the interim period before equilibrium is restored.

Under the origin-based tax, producers of exports (exportables) were charging 15 on the world market but, because of the tax, only receiving 13.64 in private return. The instant after the destination-based tax goes into effect, exporters will receive rebates for the tax, so the private return will increase to 15. In the first order, exportables consumed domestically are still sold to consumers at 15, but sellers are receiving 13.64 because of the tax. Clearly, there is an incentive for sellers to shift from domestic sales to exports. Also, since returns have gone up for the producers of exports (exportables), investment may flow to that sector.

To the producers of importables, *initially* nothing has changed. By definition, they have not changed their price and the tax is still the same. Therefore the first-order relative price of exports to importables for sellers has increased to 1.65. This change in relative prices subsequently provokes changes in behavior which restore equilibrium to the relative price level dictated by world prices over which the country has no influence. One of the changes has already been described. Exports will increase due to the higher returns to exports relative to sales of exportables domestically. As the supply of exportables decreases, the price will be bid up by consumers until the pre-tax price equals the world price and exporters are indifferent between selling domestically or exporting.

Similarly, consumers will find imports more expensive due to the imposition of the border tax that previously only applied to domestically produced importables. Thus the demand for importables produced domestically will increase relative to imports and the pre-tax price of importables will rise. This, of course, increases the short-run profits of importable sellers and encourages the commitment of resources to that sector. The pre-tax price will increase to the world price at which point consumers will be indifferent between imports and importables.

When all the adjustments have been made, the relative price of exports (exportables) to imports (importables) will once again be 1.5 for both sellers and consumers. Trade-neutrality will be restored and there will be no influences on relative prices that deviate from those that would exist under free trade. But along the way several things will have occurred to a greater or lesser extent: profits to exporters and sellers of importables will have increased by some amount, new resources will probably have flowed to the trade sector of the economy, exports will have increased by some amount, imports will have decreased by some amount, and there will have been exchange rate changes. The magnitude of these effects is uncertain, as is their duration, but from the standpoint of a business person involved in a trade-intensive sector, the results are positive.

Of course, the existence of short-run positive trade effects in and of itself is no reason to change a tax system, given the uncertainty of the trade effects and the administrative and compliance costs associated with the tax change. But there are many other reasons to overhaul the existing tax system and replace it with a more economically efficient one. If policy makers engage in tax reform, they ought to base the new system on a destination principle so that, in addition to the economic benefits that justify the change in the first place, some short-run trade effects are enjoyed. Since ultimately both ideal origin and destination based systems are trade neutral, the tax change ought to include the switch to a destination system so as to benefit the traded goods sector in the short-run.

IV. VATs and Other Business Taxes

Incidence

The short-term trade effects that result from shifting from an origin- to a destination-based tax will only occur if the new tax has a similar incidence to the one it is replacing. I have argued previously that the incidence of existing business taxes must be *qualitatively* similar to that of a VAT. The reasoning goes like this. At root, a VAT, regardless of its form (credit, subtraction, addition), is a tax on a company's value added. This in turn is equal to the sum of payments to the factors of production: wages and benefits to labor; and interest, dividends, and capital gains to capital.

Business taxes today include the corporate income tax, payroll taxes, and the individual income tax for non-corporate business. Regardless of the interminable debate on the incidence of the corporate income tax, there are theoretical similarities between its base, and the capital portion of value-added. Most important, the corporate income tax is a tax on the competitive return to equity capital and therefore is a component of variable cost. As such, the corporate income tax is not dissimilar from *ad valorem* taxes which also shift a firm's cost curves. Clearly payroll taxes are also similar to the labor component of a VAT.

Although there are obvious differences; interest is not taxed to corporations but to individuals, non-wage compensation escapes taxation; the aggregate bases of business taxes today add up to a value-added base with a great deal of preferential treatment. A basic tenet of public finance economics is that the initial point of taxation does not determine a tax's incidence. Our general belief is that taxes with identical bases, regardless of the point of taxation, must have the same incidence. Thus it is difficult to rationalize that a VAT, with a *qualitatively* similar tax base to the existing hodgepodge of business taxes, would not also have a qualitatively similar incidence. As long as the incidence is similar, the short-term trade benefits just described will occur.

Other Relative Price Effects

There are other aspects of a VAT/business tax substitution that may affect comparative advantage. In classical trade theory, one explanation of comparative advantage that is frequently cited is relative factor intensity, which in turn can be traced to relative factor cost. Some economists have argued that replacing the corporate income tax with a VAT would significantly lower the cost of capital in the United States.

V. Tax Preferences and Long-Run Trade Effects

In the last sections, the role of non-traded goods was ignored. The economic literature concludes, however, that a VAT will have *adverse* trade effects if preferential tax treatment; such as exemptions, zero-rating, or a lower tax rate; is afforded to non-traded goods. Since many of the goods in existing VAT systems that receive preferential treatment do not enter international trade, the analysis of preferential treatment must include consideration of the trade effects.

The intuition is straight-forward. Consider an example where non-tradeables are zero-rated. If a VAT applies to traded goods but not to non-traded goods, the relative prices of exportables to non-tradeables and importables to non-tradeables would increase. Having the tax apply to tradeable but not to non-tradeables introduces a tax wedge between the two sectors. Either the cost to consumers of importables and exportables relative to non-tradeables has increased and/or the returns to businesses of importables/exportables relative to non-tradeables have decreased. In either case the result is a reduction of consumption of tradeables relative to non-tradeables and/or a relative decrease in investment flowing to the tradeable sector. Strictly because of a tax-induced relative price change, the tradeable-goods sector will contract.

This is a serious issue for policy makers when you think of the types of goods that don't enter international trade. Examples include housing, medical care, education, many types of food sold for home consumption, and other goods. The standard proposals to exempt or zero-rate housing, food, medical care, and welfare activities would apply to non-traded goods.

Preferential treatment for some goods and services as a remedy for perceived regressivity has been criticized on a number of grounds. It is generally agreed that exemption, zero-rating, or lower rates are extremely inefficient and costly ways to redress regressivity; and that it is

preferable to seek remedies outside the VAT system through income tax credits or transfers. It is also apparent that preferential treatment causes economic inefficiency by distorting consumer and producer choices across industries. Now a third and compelling reason has been added to oppose narrowing of the VAT base. The effect will be a *long-term* deterioration of a nation's trading position.

VI. The VAT, The Current Account, and Exchange Rates

Throughout this testimony, the role of economic efficiency and tax policy has been stressed. It has been argued that the proper gauge for tax policy as it effects trade should be the relative prices of traded goods, and that the point of comparison should be the relative prices that would obtain under free trade. Further, these relative prices are *real* prices and the tax effects *real* as well. Taxes represent extractions of real resources just as surely as energy costs or labor costs. Purely nominal phenomena, like exchange rates, cannot mask fundamental real changes in costs.

This would seem fairly obvious in the case of other costs facing businesses. What would be the effect of a discovery by one country of a process to manufacture steel with half the electricity previously required? That country's steel industry would certainly enjoy an enhancement of its competitive position because the cost of producing steel relative to other domestic goods would drop as would the real costs of producing steel domestically relative to foreign produced steel. All else held constant, the comparative advantage (or disadvantage) of steel production would change. It would be a strange conclusion indeed if this innovation was completely nullified by exchange rate changes resulting from an increase in demand for the country's steel.

Taxes on output are no different from a cost stand point than per unit electricity costs. Taxes can only be remitted if steel is sold, and the returns foregone to pay the tax. It is as if a certain level of physical production is transferred to the government. This is not a monetary phenomenon. To argue otherwise is to assume that the entire economy is suffering from money illusion.

Policymakers will continue to focus on the trade balance where exchange rates do matter. And thus the statement that is currently in vogue -- that tax policy cannot affect the current account -- must be investigated. My conclusion is that it would be very difficult to predict the effects on the trade balance from a VAT/other tax substitution. First, the view that such a change would not affect the trade balance is predicated on the belief or assumption that tax changes do not affect international capital flows. Second, this view is also dependent on the notion that exchange rates are primarily a function of traditional trade and capital flows whereas the reality is that exchange rates are more influenced by asset trades than by traditional trade flows. This means that the change in the expectations of currency traders following (or in anticipation of) a tax change will be more influential to exchange rates than currency demand changes associated directly with exports and imports.

"All Else Constant"

First, we must be clear about what is meant by the statement that tax policy cannot affect the current account. It is based on the balance of payments accounting identity that essentially states:

EXPORTS - IMPORTS = CAPITAL OUTFLOWS - CAPITAL INFLOWS

The statement that tax policy (or tariff policy for that matter) can't effect the trade balance is predicated on the assumption of *ceterus paribus* -- all else held constant. In this case, the "all else" that is being held constant is capital flows. Not surprisingly, if the right hand side of the equation, net capital flows, is held constant, then there can be no change in the left hand side. The balance of payments is set in nominal units of currency. So, for example, if a tax change increased the demand for exports, *ceterus paribus*, the dollar must appreciate to restore the left hand side to the same nominal position as previously.

Capital Flows

It is conceivable that the "all else held constant" assumption is of less use here for policy makers than with respect to most other economic issues. It may be very difficult to find things to hold constant because of the complex interactions of taxes and international investment decisions. There is a thriving literature on the effects of tax policy on international capital flows that runs the gamut of "no effects" to "large effects." And the various levels of effects feed through diverse conduits such as deficit reduction or tax-induced changes in savings and investment, all of which would directly affect net capital flows.

The point here is not to argue who is right or who is wrong. It is merely to illustrate that there are several paths by which a VAT can affect capital flows, and therefore the exchange rate. But possibly more important to the determination of exchange rates than actual changes in domestic savings due to tax changes are *perceived* effects ir the eyes of foreign-exchange traders. In fact, the perception of fiscal and monetary policy to currency traders may be the dominant force in exchange rate determination in this regard.

Expectations and Exchange Rates

If exchange rates were primarily influenced by changes in the demand for imports and exports, then a VAT change which affected trading patterns would have a predictable effect on exchange rates. But exchange rate determination is much more complicated, relating primarily to the actions of traders who view foreign exchange as an asset to be traded in its own right. Foreign exchange trading world-wide grew from $200 billion per day in 1986 to $500 billion in 1989. This growth cannot be explained by differences in merchandise trade or capital flows associated with investment in tangible assets. In fact, these latter transactions may account for only 5 to 10 percent of foreign exchange trading.

The overwhelming majority of foreign-exchange transactions are done by investors who view foreign exchange, itself, as an asset. Foreign exchange assets primarily take the form of liquid interest-bearing instruments, and are therefore a component of net capital flows in the balance of payments. Foreign exchange determination is driven by people who hold foreign-exchange as assets, and their transactions are dependent on their expectations. These expectations could easily change in anticipation of a major tax change but it is difficult to predict the net effect on exchange rates. Anybody who feels confident predicting what the expectations of foreign exchange traders would be following the announcement of a major tax reform including a VAT deserves the Nobel Prize in economics (or to be drummed out of the profession, I am not sure which).

Look at all the countervailing items that could affect a trader's perceptions. If the trader perceives that the demand for exports is going to increase and/or the demand for imports is going to drop, he or she may predict a dollar appreciation. But if part of the VAT is used for deficit reduction, he or she may anticipate a dollar depreciation due to decreased U.S. borrowing. Similarly, if he or she anticipates that tax reform is going to lead to greater domestic saving, a dollar depreciation prediction may seem appropriate. But if the expectation is for increased capital inflows due to better investment opportunities, an appreciation may be the better prediction. The sum of all of the fiscal policy ramifications of the VAT/other-tax substitution will determine the expectations of the traders that buy foreign bonds and have more to do with exchange rates than the buyers and sellers of real goods and services. And we haven't even discussed monetary policy!

Monetary Policy

It is well known that domestic monetary policy, not just central bank exchange activity, exerts a primary influence on exchange rate motion. In fact, the *expectation* of monetary changes affects current and forward exchange rates.

What monetary policy might accompany, or be expected to accompany, a major tax reform including the addition of a VAT? The conventional wisdom is that the Fed would accommodate the VAT by increasing the money supply, even when a VAT is used to replace other taxes. Thus, against the expectation of an increased demand for exports (and all the possible countervailing effects involving capital flows) we have an expansion, anticipated or real, of the money supply to accommodate a supply-shock in the amount of *the tax rate times the*

entire domestic economy, many multiplies of any conceivable change in the demand for exports. An anticipated increase in the money supply, of course, exerts downward pressure on the dollar.

The point is that all of the potential effects of fiscal and monetary policy will combine to influence the expectations of foreign exchange investors. In all likelihood, these investors are far more important to exchange rate determination than the buyers of sellers of exports and imports, and their expectations more important than the direct effects on exchange rates from increases in domestic saving, or from reductions in the Federal deficit. Since the expectational effects on exchange rates contain so many countervailing forces, it would probably not be wise to base one's predictions on the effects of a VAT on the current account on an "all else held constant" assumption.

What's the Answer?

Professor Carl Shoup pointed out that the notion that exchange rate changes would wipe out any tax-induced cost effects was not new. He referred to the 1953 Tinbergen Report to the European Community of Coal and Steel. This report, set against a controversy as to whether to adopt a destination or origin based sales tax, presented the "equivalence theorem" which stated the view that tax-induced trade effects would be eliminated by floating exchange rates. Shoup notes that the equivalence theorem was challenged contemporaneously, primarily along the lines noted in this testimony.

Everything that goes around comes around. So if a policymaker views the current account as the proper target to judge tax policy, what is he or she to make of the claim that a VAT-based tax reform cannot affect the current account because of exchange rate adjustments? The last word belongs, appropriately, to Shoup:

> Accordingly, the only tenable position in our present state of knowledge is to assume that the destination and origin principles are neither equivalent nor wholly disequivalent (to coin a word), and that a move from the origin principle to the destination principle will probably increase exports and decrease imports somewhat, but not by as much as the tax rate alone might indicate...This statement may not be of much help in designing tax policy, but it at least avoids the errors inherent in taking either of the extreme positions.

VII. Conclusions

This testimony has considered various aspects of the debate concerning the trade effects of a substitution of a VAT for other business taxes in light of both the economic literature and putative gulf between the beliefs of a wide range of business people and academic economists. I have argued that tax policy should be judged in terms of distortions in the relative prices of traded goods, rather than nominal changes in the trade balance. This is based on the view that undistorted relative prices provide the greatest possibility for gains from trade.

Based on my reading of literature, I believe the following conclusions are warranted: 1) at equilibrium, both an origin and a destination-based VAT are neutral in their effects on the relative prices of traded goods; 2) switching from a pure origin-based VAT to a pure destination-based VAT would cause exports to increase in the short run and imports to decrease. At equilibrium, however, relative prices would return to the neutrality position that existed under free trade; 3) if preferential VAT treatment is afforded classes of goods and services to redress regressivity, the most likely affected goods will be those that do not enter international trade. The results of zero-ratings, exemptions, or preferential tax rates for non-traded goods will be a contraction of the traded goods sector, and a worsening of the U.S. terms of trade (an adverse distortion of relative prices); 4) although a VAT is neutral with respect to relative prices, taxes that may be replaced by the VAT may distort the relative prices of traded goods through artificial distortions of factor costs, and intertemporal distortions. Therefore, at least in the short run, a VAT/other-tax substitution may remove some existing distortions in the relative prices of traded goods; and 5) the effects of the VAT/other-tax substitution on the current account are unpredictable, due to the overwhelming influence on capital flows of foreign-exchange traders, whose expectations will be influenced by countervailing aspects of tax policy as well as by monetary policy. The view that exchange rate appreciations will wipe-out any demand influences on exports or imports is based on a narrow assumption unsustainable in real international financial markets.

Chairman ARCHER. I want to thank each member of this panel for excellent presentations and would like to inquire—Dr. Raboy, we heard from two other witnesses that border adjustability really doesn't affect trade balances and you have taken sort of a middle ground position in saying that it can have an impact on trade balances. I wish I had had time to ask the other witnesses because I honestly cannot understand in a commonsense way how if you can sell your product at a reduced price, that that does not give you an advantage.

If you have lower labor rates than another country and as a result your product is priced below what that product can be manufactured for in another country, does that not have an effect on your trade balance?

Mr. RABOY. Absolutely.

Chairman ARCHER. If you can remove the expense of government, is that not the equivalent of reducing labor expenses that are built into the price of the product?

Mr. RABOY. I think it is.

Chairman ARCHER. Why is it that if you reduce the price of the product by reducing one category of expense, which is the cost of government, that it is different and offset by exchange rates compared to if you had a lower wage rate and thereby had a lower price on your product?

Mr. RABOY. Mr. Chairman, we are in complete agreement. Taxes are real costs, just like having a higher wage rate, a higher electricity cost, or an increase in the cost of steel. To me it is illogical to believe that purely monetary phenomenon like exchange rates can mask real effects on the economy like taxes or wage rates or the cost of electricity.

I think that people focus on an accounting identity in our balance-of-payment system that states that the demand and supply of money have to be equal at all times, and that is true. Then they make another leap that says tax policy may affect the demand for exports and imports but it can't have any effect on the way we invest overseas or here. By definition, if you hold one side of the ledger constant, you can't change the other side.

So their argument is that nothing can change the trade balance unless you affect capital flows. In reality, what happens is exchange rates are extremely complex. There are billions and billions of dollars of exchange trade. Only 5 to 10 percent of that trade is associated with transactions we know as merchandise trade or even long-term investments. What really determines exchange rates is what the guys trading these exchange bonds think.

I certainly would not want to predict how they would react to a major tax overhaul. There are enormous countervailing effects on the policy side, on the capital flow side and on the monetary policy side. I think the best assumption is, since we know that taxes are real effects, they have to affect trading decisions.

Chairman ARCHER. Let me further pursue this question of border adjustability with you. As long as we have an income-based tax, whether it be a flat tax or a very complex one as we have today, how can that possibly be legally border adjustable under the now WTO, for this reason?

I may be in a business that produces widgets and I may have 1 year where I don't pay any taxes because I don't have any income. I have got a break-even business. Do I get to deduct the flat tax percentage from the price of that product when it is shipped overseas? How do I determine what I am able to remove from the price of my product as long as it is in any way income-based from a tax standpoint? Do I have to submit my tax return to the Customs Department and then determine what percentage is going to be removed from the price of that product when it is sold overseas? If my product is in competition with another widget producer in the United States who may have large taxable income and more profits, is the waiver at the border or the adjustment going to be the same? How does that work?

Mr. RABOY. There are two issues. One is economical: Is there an economic difference between two taxes that have identical bases, like an Armey flat tax versus a VAT?

The second is an administrative question. In order for a tax to be border adjustable under the GATT, you have to be able to identify the tax component of the good and take it out of taxable amounts. You can do this with a subtraction method value-added tax. You can do it with a credit invoice value-added tax. You cannot do it with the Hall-Rabushka type of flat tax where income taxes are paid at one level and profits taxes are paid at essentially the other.

Even if we disagreed with the GATT distinctions, nonetheless they constitute the GATT rules that came out of the Uruguay round and we are stuck with it.

Chairman ARCHER. Even if that could be changed by force majeure of the United States of America, you would still have the complexity as to the amount of tax on that item based on what your income happened to be in a particular year, and would you use last year's income tax return, whereas this year you might not have any income at all that is taxable.

To me, it seems like it would not be workable. Yet, there seems to be doubt in the mind of other witnesses as to whether it might be border adjustable.

Let me move on to two other things. Dr. Hall, you mentioned a flat tax and then you mentioned a pure income tax. What is the difference between a flat tax and a pure income tax?

Mr. HALL. Essentially it has to do with the taxation of capital income at the individual level. The flat tax essentially takes investment income and taxes it at the source, unlike the current income tax. Essentially it gets into a tax base itself. How do you calculate your taxes? Is it a cash flow or accrued income? That is the point.

Are you taking your total receipts and subtracting off all purchases or are you trying to in fact match income, what dollar was earned using what dollar of expenses? And therein lies the problem.

Chairman ARCHER. What is a pure income tax, in your mind?

Mr. HALL. I am not sure I can answer that concisely right now.

Chairman ARCHER. You used the term.

Mr. HALL. I think what I was attempting to point out was a properly administered income tax that did not treat differentially any type of capital income and also adjusted for all of the effects

that inflation has on the timing issues associated with an income tax, an accrued income tax base.

Chairman ARCHER. Finally, I want to ask the difference between Dr. Payne's analysis of the cost of compliance and your analysis of the cost of compliance, Dr. Hall, and Fortune's, which gets up to almost $600 billion. He is at $300-and-some-odd billion and you are $136 billion, I believe you said. What are the differences?

Mr. HALL. It is fairly easy to explain. Mine are strictly financial costs, strictly dollar outlays for paperwork burden. As I understand it, Dr. Payne includes a great deal of other types of costs. Mine is simply filling out tax forms, understanding the law, getting legal advice, that type of thing; none of the litigation, none of the opportunity costs, simply financial costs.

For the entire Federal tax system, I estimate $200 billion and for the income tax alone, $140 billion. I think Dr. Payne's analysis is a correct way. We have just concentrated strictly on financial costs because they can be easily demonstrated and are high enough——

Chairman ARCHER. Would you argue with Fortune's estimate?

Mr. HALL. I believe Fortune got their estimate from Dr. Payne.

Chairman ARCHER. Would you argue with that?

Mr. HALL. No.

Chairman ARCHER. So we can assume if you consider all aspects of administration, compliance, litigation, every aspect of maintaining this method of raising revenue, that it is legitimate to say that it is a cost of $592 billion per year?

Dr. PAYNE. Yes. The biggest component there is what the previous panel was talking about, the marginal excess burden. This is the lost production owing to people not working, not investing because they are deterred by the tax system.

Chairman ARCHER. How would you quantify that element?

Dr. PAYNE. I took—this was the figure in the Ballard, Chovin and Wiley study, the 1985 American Economic Review study. The marginal cost for them was 33.2 percent and the average cost was, I think, 23 percent.

Chairman ARCHER. But what dollar amount figure would that be in the $592 billion?

Dr. PAYNE. Just about half of it.

Chairman ARCHER. Thank you very much.

Mr. Gibbons.

Mr. GIBBONS. Mr. Chairman, I was waiting for someone else to be here. I want to thank Dr. Raboy. I am appreciative of his input.

Dr. Hall, I was listening to your testimony. You said there were three principal types of taxes that were being considered here and then you mentioned a business transfer tax. I think you may be calling my value-added tax proposal a business transfer tax. I have a simple subtraction method value-added tax.

Mr. HALL. I did not mean to imply that. I talk about the flat tax, U.S.A. tax and the retail sales tax. I call the flat tax and U.S.A. tax a direct tax and the value-added tax a retail sales tax.

Mr. GIBBONS. You seem to assume that in a value-added tax you have to have different rates.

Mr. HALL. No, sir. I said that is the major source of complexity.

Mr. GIBBONS. I agree with you. That is all the questions I have.

Chairman ARCHER. Mr. Hancock will inquire and also will temporarily preside over the hearing.

Mr. HANCOCK [presiding]. Thank you, Mr. Chairman.

Dr. Adams, I have read your book and in fact I recommended it to a lot of people. I am also glad to point out that I am glad that you believe in the capitalistic system because I tried to buy 200 copies and you wouldn't give me a big enough discount and I couldn't afford it. Maybe if we could get the tax change, I could buy enough copies to send to the Missouri State Legislature.

I didn't realize until I read your book that the scribes that Christ ran out of the temple were the tax collectors. I didn't know that until I read your book. I never had thought about it. I thought they were just keeping records. I didn't realize that those were the tax collectors.

One of my staffers pointed out after he read the book, which I recommended that he do, and your book about the dynasties and the power of the tax collector ruining dynasties, monarchies, he pointed out they have just recently started telling the Queen of England that she has to start paying income taxes now. If they had been doing that all along, we might have had a different situation there.

The present tax law—I kind of like your idea about burning tax records—you know, dead men tell no tales; burn the tax records. If it wasn't for the computer systems that we have now, we couldn't have a tax law like we have. We would be the world's largest bookkeeper if it weren't for computers. There aren't enough man-hours around to keep records if it weren't for computers.

With that, how do you get rid of it? Is it possible to do what the Chairman said, pull it out by the roots and start over?

Mr. ADAMS. I think he is right. In fact, using your reference to ancient Egypt, some people asked me for a comparable tax system; I say go back to Egypt. The scribes even counted the eggs in the pigeon nests and went into the houses of the housewives and tried to check and see if they were using free drippings from their cooking.

I think that while we may think that our computers and our high technology creates a fairly monstrous tax bureau, I think the scribes of Egypt were everywhere, inspecting and snooping and recording.

I am reminded of Adam Smith in "Wealth of Nations." He gave the four signs of a bad tax system. We got all four. The first one he said is a large, cumbersome bureaucracy to administer the tax law. That is bad.

The second thing that he said about a bad tax system is it discourages enterprise and denies jobs to the multitude. It is interesting that he was concerned with jobs.

The third factor of a bad system is it encourages evasion.

And fourth, he said it puts the taxpayer through odious and vexatious examinations by the taxman. Of course, there is the audit.

You can't find many redeeming factors in the tax system that we have in comparing it to the historical past and to the great minds that created our country.

Mr. HANCOCK. You mentioned the Mayan empire went down the tube because they felt they were being overtaxed and disappeared into the jungle.

Mr. ADAMS. One of the great taxmen in America said that, James Eustice, a professor at NYU. That is probably just his guess, but it may be true.

Mr. HANCOCK. Certain people in this country now that are even giving up their citizenship—I don't approve of it and I know we are liable to hear some comments on it—but giving up their citizenship to where they can move their assets out of this country. We have people moving between States now, quite a lot of it in fact, to reduce their tax burdens. Isn't that kind of parallel with what your historical evaluation——

Mr. ADAMS. One point is that many historians believe that more people emigrated to America from Europe to avoid Europe's hated tax system than for any other reason.

One of the things in my book I am proud of, is an old front page of a brochure in 1630 in Amsterdam advertising for passage to New Amsterdam, which is New York, and the title in Dutch is "Freedom." If you read the pamphlet in Dutch, which my Dutch friends have read for me, it was "freedom from taxes."

So there was a great immigration. Now you see it going the other way. One of the points that I have made, remember little sayings, I would say that patriotism is soluble in taxes. Think about that. That might explain why people do leave and why people did come here; because America was a great tax haven. That is what built this country.

Mr. HANCOCK. Thank you.

Mr. Rangel.

Mr. RANGEL. Some would say America still is a great tax haven.

Mr. ADAMS. Say that again?

Mr. RANGEL. Some would say America still is a great tax haven.

Mr. ADAMS. A lot of people say that and there is truth in it.

Mr. RANGEL. Notwithstanding the Chairman's comment that people leave the United States to avoid taxes, that shouldn't influence anybody to change the tax system, do you think?

Mr. ADAMS. It depends on the exodus. If it is the last one to leave, turn out the lights——

Mr. RANGEL. The Chairman referred to a specific number of people—are you familiar with the case the Chairman referred to? Campbell Soup—a dozen people that made several billions of dollars, they have moved to the Bahamas. It is a crummy thing to do, and he certainly doesn't support it, but I don't believe that we should even think about changing our system to accommodate a group of people that think so little of the United States that they would leave.

If the exodus was the kind that you referred to in your book that would cause people to leave their native country, that is different. You haven't seen any exodus from the United States based on the unfairness of this system, have you?

Mr. ADAMS. I think professionally we do from time to time, but not mass exodus.

Mr. RANGEL. Substantial?

Mr. ADAMS. There are a number of people that leave for any reason.

Mr. RANGEL. You have found a number of people sufficient to record that because of the unfairness of the tax system as they see it they would leave the United States?

Mr. ADAMS. I had a little talk with former IRS Commissioner Shirley Peterson, an IRS Commissioner, now in private practice, and I asked her, had the IRS ever made a study on the number of Americans who were leaving to avoid taxes? And she said, No, we have never made a study. But she said, Since I have been in private practice, I sure have got a number of inquiries. I will have to leave you with that.

Mr. RANGEL. Not to worry. I am not going anywhere. Thank you. It is a very good book.

Thank you, Mr. Chairman.

Mr. HANCOCK. Mr. Johnson.

Mr. JOHNSON OF TEXAS. Thank you, Mr. Chairman.

Dr. Hall, you talked about multiple rates concerning sales tax. What do you mean by that?

Mr. HALL. For example, you would have a zero rate on food and a positive rate on golf balls and golf clubs.

Mr. JOHNSON OF TEXAS. You are presuming that a sales tax or any kind of consumption tax would have variable rates or——

Mr. HALL. No. I am not assuming that at all. I meant to point out that for any indirect tax, of which a retail sales tax or VAT taxes are, multiple rates are the key source of complexity to those systems.

Mr. JOHNSON. But if you had a single rate on everything——

Mr. HALL. Then the complexity part would be diminished.

Mr. JOHNSON. And that is uniformity, and I think Mr. Adams talks about uniformity in his book, too, to some degree.

How would you view the continuation of various Federal excise taxes in the context of a flat tax proposal, since both are essentially a consumption tax?

Mr. HALL. I think a good case could be made that if in fact the flat tax is administratively simpler, that all Federal taxes should be rolled into one tax system. That would dramatically simplify——

Mr. JOHNSON OF TEXAS. You are saying if a flat tax were imposed, you would do away with all other taxes?

Mr. HALL. Yes.

Mr. JOHNSON OF TEXAS. All of them?

Mr. HALL. Yes.

Mr. JOHNSON OF TEXAS. Mr. Adams, you did talk about uniformity in your book. You know, this morning we heard some comments about a police state, the Gestapo-like tactics of our IRS, which makes it I guess one of the reasons it falls into those four bad categories you spoke about, a tax to evade, so to speak.

What do you mean by uniformity?

Mr. ADAMS. I remember when Mr. Rabushka and I guess Mr. Hall wrote the article in the Wall Street Journal about 12 or 13 years ago. I think the first article that they wrote they didn't use the word flat tax but used the word uniform rate tax. I always thought that was the correct name. I don't like the name flat be-

cause it is a dead word. I like the word uniform because the Constitution says taxes are supposed to be uniform.

When that case came up before the Supreme Court, it was considered to be the leading case of the year and the Supreme Court dismissed it as a one liner. The major law reviews and the major leading tax scholars in America thought that the real issue of graduated rates was whether or not they violate the uniformity command in the Constitution. I think they do.

I think the Supreme Court has the last word on it, but I think they made a mistake there like they made a mistake on segregation because they made uniformity the same for everybody. If you go back to the Convention that was drafting the Constitution, the first draft said the taxes would be common to all, and then they said "uniform and equal." They ended up with "uniform."

What they were trying to do was to prevent America from having a tax system that was then existing in France when there were all kinds of exemptions and immunities and privileges. They wanted this to be a country in which the rates were uniform and common to all.

We have breached that only because the Court let us do it. I think the Court let us do it because at the turn of the century, we were seduced by the philosophy of socialism. Nobody was ever seduced by communism. That came by rape. But socialism has been a seductive idea and it is dead now. We spent a whole century proving it was a dumb idea.

Mr. JOHNSON OF TEXAS. Kind of like a flat tax? I think you are right when you say that the income tax is the mother of all taxes, and I appreciate that comment.

Thank you, Mr. Chairman.

Mr. HANCOCK [presiding]. Ms. Dunn.

Ms. DUNN. Thank you, Mr. Chairman.

Dr. Raboy, is that proper pronunciation? Would you pronounce it for me?

Mr. RABOY. Raboy. Actually, three different family members pronounce it different ways.

Ms. DUNN. Do they? I don't feel so bad. Thank you.

I wanted to ask you a couple questions having to do with trade. I am on the Trade Subcommittee, and I would like to know your impression of how well our current tax system is suited to the goals that we have in trade and economic policy for the United States.

Mr. RABOY. Well, I don't think it is very well suited at all for a large variety of reasons. I think there is an inherent bias in our Tax Code against capital investment, productive investment, and that by definition has to hurt our trading situation.

I think it is unfortunate that the rest of the world has adopted border adjustable consumption taxes as their primary form of revenue, and the United States hasn't. Now, that is not to say that the imposition of a consumption tax on a border adjustable basis is a panacea for trade. But simply, it harmonizes our system. It means that the rules are fair, they are predictable, and trade thrives in that type of a situation.

Ms. DUNN. What sorts of changes in tax policy would you see our adopting that would encourage greater exports?

Mr. RABOY. I think that any of the tax proposals before this Committee that eliminate the double taxation of savings and investment income will by definition increase the productivity of our export sector and lead to greater competitiveness on the part of the export sector.

I also believe that we should adopt the destination principle. We should not forgo that opportunity. The switch from an origin-based system to a destination-based system will cause exports to increase somewhat in the short run.

One final cautionary note is that when we are considering adopting a consumption-based system, there are many who believe that there should be various exemptions for food, housing and education and those sorts of things, to address perceived or real regressivity. And I think it is important that regressivity be addressed.

I would simply encourage that it be done outside of the VAT system. Because otherwise you will create a privileged sector that doesn't enter into international trade, primarily housing, education, and medical care. They will become tax-preferred entities. As a result, investment will flow into those sectors, rather than into the export sector or the sector that competes directly with exports. That could do us some damage.

Ms. DUNN. OK, great. Thank you.

I would like to ask the panel to answer a couple of questions I encountered when I was talking with constituents from my district. One is that the consumption-based tax would unfairly hit senior citizens who had been through their income-producing years, paid their income taxes, had planned for their future and now they are on mixed incomes, then they are faced with a large, 15 or 17 percent, whatever it is, sales tax on products they buy.

What would we do under this tax system or what should we do under this tax system to protect people like that? Anybody who cares to answer.

Mr. HALL. Well, it is essentially a tradeoff between—essentially what you are talking about are key transitional issues, and no matter what system we adopt, you are going have these transitional issues. And they are going to, at least in the short term, create complexities.

Under the flat tax, just as an example, though, the couple you described may or may not have any tax liability at all. The retail sales tax would affect them, and if you choose to exempt them in some fashion, then you are going to just simply create more complexity. However, you know, this is an equity-complexity tradeoff.

The U.S.A. tax system has essentially addressed this question in its preliminary transition rules, and once again it is an equity versus complexity tradeoff.

Ms. DUNN. OK. Anybody else care to answer that one?

And then, Dr. Hall, could you please explain to me, I have been in and out of this hearing all day, how you handle—once again, please explain how you handle mortgage interest on home ownership so that we could continue some policy of encouraging home ownership?

Mr. HALL. Well, I think part of the problem is that we are in fact encouraging home ownership over and above other types of invest-

ment. And that may be an interesting policy matter, but it is in fact a tax distortion.

The question, the real question is once again a transition question. People have bought their homes with the knowledge that they will have this interest deduction, and if you are taking it away from them or you remove it from the tax system entirely, then that will have an immediate impact on the net worth of their home. And that could cause problems.

As a simple matter, simply the financial aspect of losing the home interest deduction, if you lower the tax rate enough, you simply buy them out. Their tax bill is lower, even without the home interest deduction.

Ms. DUNN. Anybody else care to comment on any of those questions?

Thank you.

Mr. HANCOCK. Mr. English.

Mr. ENGLISH. Thank you, Mr. Chairman.

Dr. Raboy, I wonder if you could comment on something that Dr. Hufbauer touched on in his testimony. And I think he had one viewpoint on this. If we fail to adopt a border tax, what impact would you anticipate that will have on exchange rates?

Mr. RABOY. If we fail to?

Mr. ENGLISH. Yes.

Mr. RABOY. Again, I think that the effect on exchange rates is indeterminative. It would be almost impossible to predict it, because in order to answer that question, I have to put myself in the mind of an exchange trader. What is important is not what happens to the actual amounts of goods and services crossing the border, but what is going to go on in his mind. Because what goes on in his mind affects 80 to 90 percent of the foreign exchange trade.

So if we do nothing, then what the exchange trader is going to look at is the other components of the tax system, and he is going to ask himself, How is that going to affect investment in this country versus overseas? How is that going to affect what the Fed decides to do to the money supply? So I hate to punt on that one, but I am not sure I could give you a prediction.

Mr. ENGLISH. No, I appreciate it.

Dr. Hufbauer also testified—and I would like to read a portion of his testimony and get your comment—the fundamental reason for border tax adjustments is neither to alter the Nation's trade balance, nor to find a substitute for exchange rate adjustments. The fundamental reason for border tax adjustments is to deal with the burden on sectors that are more heavily taxed under the new system than the old.

Any TBA system will impose higher taxes on many business firms than the current corporate income tax, both because some firms pay little or no tax under the current present complicated system and because under some TBA systems, a larger portion of wage taxes will be paid at the corporate level.

I wonder if you would either concur or dissent from that and comment on it. And what sectors do you think would be adversely impacted under the new tax system?

Mr. RABOY. OK. Well, as a general rule, if you go to a consumption-based tax system, then companies that are more capital intensive clearly benefit relative to the situation they were in before.

Mr. ENGLISH. That would include steel, energy?

Mr. RABOY. Yes.

Mr. ENGLISH. Heavy manufacturing?

Mr. RABOY. Petrochemicals, all those industries.

Now, having said that, though, I believe that these countries are currently in a situation of bias. In other words, the Tax Code is biased against capital-intensive industries. So by going to a border adjustable or even a nonborder adjustable consumption tax, essentially what you are establishing is neutrality, so that firms are neither benefited nor harmed if they choose to use labor or use capital.

Mr. ENGLISH. Thank you.

Dr. Hall, Dr. Boskin in his testimony spoke to the complexity issue as it applied to the U.S.A. tax, indicating that it would be a more complex tax than some other alternatives because of the need to track assets. Would you care to comment on that?

Mr. HALL. Yes. Well, that is in fact true. Under the—essentially what, if I could contrast the flat tax with the U.S.A. tax——

Mr. ENGLISH. Please do.

Mr. HALL. The reason the flat tax is administratively simpler is because it goes under what is called a prepayment approach. It taxes all income immediately, and then—at the individual level. It taxes all wage and income immediately, and then never taxes any income earned on savings and investment. So capital gains, interest income, dividends are never taxed at the individual level. So there is no reason to have to track all those assets because you have prepaid.

Under the U.S.A. tax system, you tax wages and nonwage income, and by so doing—and also, and the key feature of what U.S.A. stands for, you have the unlimited savings allowance.

So because of the unlimited savings allowance, you in fact have to document what you have saved—you in effect have to prove your net saving for the year, and by undertaking that exercise, there is a greater complexity.

Mr. ENGLISH. Dr. Hall, one thing that leapt out about your testimony as I reviewed it is where you talk about the compliance costs to small U.S. corporations with assets of $1 million or less. And that as a group, these small corporations have had to pay a minimum of $382 in compliance costs for every $100 they paid in the income tax.

Could you get a little bit into the methodology for calculating that, and how solid an estimate is that? It is a stunning figure.

Mr. HALL. Yes, it is. Essentially it is very simple. It is an IRS figure that—and all I simply did was apply a labor cost figure to what the IRS calculates, which is an hourly burden. If you take essentially the hour—the time cost burden of complying with form 1120, which is the corporate income tax form, and you multiply it by a labor cost of $39 a hour, roughly speaking, or I guess for 1991 it was somewhat less than that, and you simply multiply that figure by the number of corporations that have $1 million in assets or less, you come up with a figure of roughly $15 billion.

Well, you can also track through IRS records what those companies paid in income tax and it was roughly $4 billion. So we have a compliance cost to tax paid ratio of roughly 382 percent.

Mr. ENGLISH. Thank you.

And I would like to thank all of the panelists. This has been very enlightening.

Thank you, Mr. Chairman.

Mr. HANCOCK. Mr. Gibbons, would you like to inquire?

Let me express my appreciation to the panel. It has been very informative. We appreciate the conciseness of your remarks and the directness in answering the questions that the Committee has asked.

The Committee stands in recess until 10 o'clock tomorrow.

[Whereupon, at 3:11 p.m., the hearing was adjourned, to reconvene at 10 a.m., Wednesday, June 7, 1995.]

REPLACING THE FEDERAL INCOME TAX

WEDNESDAY, JUNE 7, 1995

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, D.C.

The Committee met, pursuant to call, at 10 a.m., in room 1100, Longworth House Office Building, Hon. Bill Archer (Chairman of the Committee) presiding.

Chairman ARCHER. The Committee will come to order. I would like to ask our guests and staff and press to please take seats so we may commence.

This morning we are continuing the second day of hearings on replacements for the current income tax system, and we of course will have another full day of hearings tomorrow.

[The opening statements follow:]

OPENING STATEMENT OF HON. BILL ARCHER

Today we hold the second of 3 days of hearings on replacing completely our current tax system. Yesterday we heard from several witnesses about the problems of our current system and some broad guidelines for framing a replacement. Today we will hear from the administration its position on fundamental tax reform. We will also have presented two of the major replacement alternatives, the value-added tax, which will be advocated by the distinguished Ranking Democrat on the Committee, Sam Gibbons, and the U.S.A. tax which is advocated by Senators Domenici and Nunn.

OPENING STATEMENT OF HON. JIM RAMSTAD

Mr. Chairman, thank you for calling this series of hearings on one of the most critical economic policy issues facing our Nation.

The current Federal income tax imposes huge costs on the American people. The time and money spent complying with Federal tax requirements is staggering. An IRS-commissioned study completed in 1985 concluded that the 5.4 billion hours of work expended by taxpayers for filing business and individual returns amounted to 24.4 percent of income tax revenues—a sum of $159 billion.

More recently, economists Robert Hall—who we'll hear from tomorrow—and Alvin Rabushka have estimated that direct compliance costs—both in filing and in buying expert advice—exceed $100 billion. Direct planning costs exceed $35 billion and revenue lost to the Treasury because of tax evasion exceeds $100 billion.

Economists widely believe that there are five desirable characteristics of any tax system: Economic efficiency, administrative simplicity, flexibility, political responsibility and fairness. Our current system scores low marks in each of these areas.

While today's witnesses support different ways to reform our Tax Code, it is important that we recognize the great degree of agreement—near unanimity—on the need to fundamentally overhaul the current system.

Again, Mr. Chairman, thank you for calling this series of hearings. I look forward to hearing from our distinguished guests and to moving forward to improve the system for all taxpayers.

Chairman ARCHER. We commence this morning with a representative from the Treasury, Assistant Secretary for Tax Policy, Les Samuels, who will be our first witness.

Les, if you would like to proceed. We are not going to strictly hold you to it, but as you know, if you can keep your oral presentation to within 5 minutes, we would appreciate it; and you of course can submit your entire written statement for the record. If you feel constrained that you have to go beyond 5 minutes, then certainly we will be pleased to accommodate that. You may proceed.

STATEMENT OF HON. LESLIE B. SAMUELS, ASSISTANT SECRETARY FOR TAX POLICY, U.S. DEPARTMENT OF THE TREASURY, ACCOMPANIED BY ERIC TODER, DEPUTY ASSISTANT SECRETARY

Mr. SAMUELS. Mr. Chairman, I would first like to introduce Deputy Assistant Secretary Eric Toder, who is accompanying me today, and I do have a longer written statement for the record, and I would like to summarize it.

Chairman ARCHER. Welcome, Mr. Toder.

Mr. TODER. Thank you.

Mr. SAMUELS. Mr. Chairman, at the outset I want to congratulate you for calling this very important hearing. Frustration with our tax system is unacceptably high. We are committed to working with Congress to address this serious problem. An excellent way to improve our tax system is to consider alternatives. Thus, I am pleased to discuss today proposals for fundamental tax reform.

Several plans have been introduced that would replace all or part of the income tax and payroll taxes with a tax on consumption. These reform proposals originate in part from frustration with the complexity of our existing system and concerns about our national savings rate.

The most important reason to consider replacing the income tax with a consumption tax is the change could increase savings and capital formation, and thereby raise our standard of living in the long run. Depending on how it is designed, a consumption tax could also improve economic efficiency and simplify the tax system.

Regardless of how they are collected, consumption taxes have one element in common—they tax income only when it is spent on consumer goods and services, or in other words, they exempt income from new saving from tax.

The proposals that are currently under discussion include Representative Armey's and Senator Specter's plans to adopt a two-part rate consumption tax in place of the current corporate and personal income taxes. Representative Gibbons has proposed a subtraction method VAT in place of the corporate income tax, the payroll tax, and most of the individual income tax. Senators Nunn and Domenici propose to replace the individual and corporate income taxes with two consumption taxes: A flat rate tax on businesses and a progressive rate individual consumed income tax. In addition, Mr. Chairman, you have indicated that you would replace the present income tax with a national retail sales tax or a VAT.

As with all tax proposals, these reform ideas should be carefully evaluated according to their ability to achieve fundamental tax policy objectives—fairness, efficiency, and simplicity.

Reforms should also include rules to reduce windfall gains and unexpected losses during the period of transition to a new system. Consumption tax proposals, in particular, may require special transition rules to prevent taxing consumption from previously taxed income, which could impose severe tax burdens on elderly Americans. In this regard, I would note that when many economists talk about an ideal consumption tax, they postulate that in order to obtain maximum efficiency, all existing wealth would be taxed as part of a transition to a new system.

Also, it is widely acknowledged that consumption tax proposals will need special rules for certain sectors, such as financial services businesses. Another issue is coordination with State and local governments which depend heavily on retail sales taxes for revenues.

The current Federal income tax promotes widely held social and economic goals, such as home ownership, private charitable giving, and provision of medical insurance by employers. We expect that a new consumption tax would still promote social and economic goals. But continued use of the tax system for these purposes would greatly lessen the possibilities for simplification and tax rate reduction from replacing our current system with a broad-based consumption tax.

Moving from one system to another would be complex and costly and would create both intended and unintended winners and losers. It would also change asset values, and the levels of prices and wages.

Mr. Chairman, we recognize that the current U.S. income tax system has many defects, and we welcome discussion on how to reform it. But radical changes to the tax system involve major costs and risks. Replacing the entire income tax system with a consumption tax would be a grand experiment of applying theory to a practical application that no other country in the world has chosen to undertake. Proponents of these plans must, therefore, overcome a significant hurdle—they must show that it is worthwhile to conduct this experiment on the world's largest and most complex economy.

I will briefly comment on four issues: Distributional effects, effects on saving, costs of compliance, and the treatment of existing wealth.

A consumption tax would typically place a higher burden on low- and middle-income families than an income tax with the same rate structure. In this regard, eliminating the tax on income from new capital benefits high-income families because they receive the bulk of capital income.

Chart 1 we have up on the board shows the distributional effect of replacing the revenue of corporate and personal income taxes, including the earned income tax, with a broad-based consumption tax with no exemptions and a revenue neutral flat rate of 14.5 percent. This baseline proposal is the simplest and most regressive form of consumption tax. It would increase Federal taxes for families in the first four income quintiles and cut taxes for families in the highest income quintile.

There are, of course, a number of ways to make consumption taxes less regressive or even progressive. European countries reduce the regressivity of value-added taxes by exempting specific goods and services or taxing them at lower rates. This approach does not make the VAT much less regressive, however, because the tax relief from exempting specific goods and services is not directly targeted to low-income families.

Consumption taxes that are collected wholly or in part from individuals can be more easily made progressive than those collected solely from businesses. This can be achieved by providing standard deductions for low-income families or graduated rates.

Chart 2, that we are just putting on the board now, illustrates the effect of including a standard deduction and personal exemption in a general consumption tax. It shows the distributional effect of replacing the individual and corporate income tax with a modified flat tax. This has a standard deduction of $24,700 for joint returns and a $5,000 personal exemption. The revenue neutral flat rate is 22.9 percent.

Under this version of the flat tax, the aggregate aftertax income for the top quintile would still be 1.6 percent higher than under current law, a net tax cut, and the aggregate aftertax income for the group of families in the first four income quintiles would still be 1 to 2.2 percent lower than under current law, a net tax increase.

Chart 3 compares the progressivity of the current Federal system with the modified flat tax I just described. It shows that current law is progressive—effective rates rise with each income quintile. The modified flat tax is progressive through the fourth income quintile. Compared to present law, the effective tax rate decreases from 24.5 to 16.4 percent for families in the top 1 percent of the income distribution. This decrease in tax burden occurs because under the flat tax proposal, income from new savings and investment is not taxed.

Addressing regressivity is a key challenge in designing a consumption tax that will not add burdens to low- and middle-income families. Thus, in analyzing any of the proposals, the first question to be asked—is it fair? Compared to the current system, who will be the winners and the losers?

Consumption taxes will not tax the return to new savings and investment. An income tax does tax this return and thereby discourages savings and investment to some degree. Consequently, one might expect that replacing the income tax with a consumption tax would encourage domestic saving and capital formation.

The national savings rate in the United States has declined in the eighties compared to the previous three decades, due to a decline in private saving and increases in the Federal budget deficit. We consider the low rate of U.S. savings to be a very serious concern. But we must ask ourselves how much the proposals under public discussion would help. The decline in savings does not appear directly related to changes in tax policy. Marginal tax rates were lowered substantially during the eighties and new saving incentives were introduced, but the overall private savings still fell.

How much would substituting a consumption tax for the income tax boost total private savings? If the aftertax rate of return on

savings goes up, individuals may increase saving for future consumption. Most statistical research by economists, however, finds that the effect of increasing the rate of return on savings is small or negligible.

Our current income tax includes incentives for employers to provide retirement savings plans for all of their employees—including low-income employees. The incentives for employers to establish retirement plans would be weakened under a consumption tax.

Simplification of the tax system is a very important goal of many tax reform proposals. We strongly support this goal. A simpler tax system would lower compliance costs for taxpayers and administration costs for the government.

One source of complexity in our current income tax, the measurement of capital income, would be largely absent under a consumption tax. Three other important sources of complexity—provisions to distribute the tax burden equitably, rules to measure the consumption component of business income properly, and the provisions that use the tax system to advance certain social and economic policies—would continue under any consumption tax.

For example, suppose it is desirable to have a consumption tax that continues to promote home ownership. Because consumption taxes, unlike income tax, would exempt interest income from tax, continuing to allow a deduction for mortgage interest paid would encourage homeowners to incur additional borrowings beyond their financing needs. Rules to prevent this type of tax arbitrage would be complex and difficult to enforce.

Some commentators have suggested that a switch from the present income tax to a simpler consumption tax would promote compliance from the underground economy. This benefit may be easily overstated. The reporting of income and sales from illegal activities is unlikely to be affected by changes in the tax system. Incentives for not reporting income or sales from informal activities would also remain under a consumption tax.

A very significant issue in converting to a consumption tax system is deciding how to treat the return to wealth that was accumulated out of aftertax income under the income tax. For example, without a transition rule for past savings, a retiree who accumulated $100,000 in savings out of aftertax income before the imposition of a consumption tax would be taxed on withdrawals from that account that are for consumption.

An exemption for existing wealth may be desirable to relieve the tax burden on individuals with accumulated savings, many of whom are elderly. However, it would also require higher tax rates on wage income and reduce much of the gain in economic efficiency that are predicted from a consumption tax. In this respect, transition rules are not merely an inconsequential technical issue. How existing wealth is treated during the transition could have material economic effects.

We are not at this time convinced that the case for completely replacing the income tax with a consumption tax is compelling. The most frequently cited economic benefit of such a change, an increase in private savings, is uncertain and could be small. Savings incentives within the existing income tax can increase savings without replacing the entire system.

The fairness of replacing the income tax with a consumption tax is also a concern. Moving to a flat rate consumption tax would increase the tax burden on low-income and lower the tax burden on high-income families. Efforts to improve the progressivity of consumption tax proposals would result in complexity. In addition, the effects of switching to a consumption tax on wage and price levels, interest rates, and the value of existing assets, including homes, is uncertain.

In examining consumption tax proposals, it is inappropriate to compare a theoretically ideal consumption tax and the income tax system in place today. Instead, we should analyze a consumption tax that is likely to emerge from the political process. Exclusions would be made under a consumption tax, and those exclusions would reduce the economic benefits of the proposals and increase complexity.

We commend efforts to develop consumption tax proposals that are progressive and revenue neutral. We are concerned, however, that such a consumption tax could be excessively complex.

Mr. Chairman, we look forward to working with the Congress on improving our system. We believe that greater weight should be given to simplification in evaluating tax reform proposals than has been given in the past. A simpler tax system would lower compliance costs for taxpayers and administration costs for the government. We will give serious consideration to proposals that would meet the tax policy objectives set forth in my testimony—proposals that would simplify the tax system and improve economic incentives without sacrificing revenue or fairness.

While the debate is in process, simplification should also be given greater weight in evaluating changes to our existing tax system. Last year, the House of Representatives passed the Simplification and Technical Corrections Act. We ask the Committee to consider this legislation.

Mr. Chairman, that concludes my remarks and I would be pleased to answer any questions you or Members of the Committee may have.

[The prepared statement follows:]

Mr. Chairman and Members of the Committee:

Introduction

I am pleased to discuss today proposals for fundamental reform of the tax system. During the last two years, several proposals have been made that would replace all or part of the income tax and payroll taxes with a tax on consumption. The conceptual proposals under current discussion include Representative Armey's and Senator Specter's plans to adopt a two-part flat consumption tax in place of the current corporate and personal income taxes, Representative Gibbons' plan to adopt a subtraction method value-added tax (VAT) in place of the corporate income tax, the payroll tax, and most of the individual income tax, and a plan by Senators Nunn and Domenici to replace the individual and corporate income taxes with two consumption taxes: a flat-rate tax on businesses and a progressive-rate individual consumed income tax. In addition, Chairman Archer would replace the present income tax system with a national retail sales tax or a VAT. Some of these proposals have been introduced as bills, but we understand that some of them are not yet in final form.

The interest in consumption taxes apparently arises for several reasons. The most frequently cited benefit of moving from a system that taxes income toward one that taxes consumption is that a consumption tax will improve saving rates and capital formation, and our standard of living in the long run. Proponents of consumption taxes also argue that a consumption tax would improve economic efficiency -- and thereby increase national output -- and simplify the tax system. Some supporters of consumption taxes point out that most of our major trading partners rely more heavily on consumption taxes, particularly VATs, and that adoption of a VAT in the United States would be more compatible with international practices.

Mr. Chairman, we recognize that the current U.S. income tax system has many defects, and we welcome the discussion on how to reform it. Since radical changes to the tax system -- especially changes that would completely replace the existing system -- involve costs and risks, they should be carefully evaluated according to their ability to achieve the fundamental objectives of a tax system -- fairness, efficiency, and simplicity. We believe a tax system should:

- raise sufficient revenue,
- distribute the burden of taxes equitably,
- avoid excessive intrusion of tax considerations into private economic decisions,
- promote economic prosperity and growth,
- and limit the costs to families and businesses of complying with the tax and the costs to the government of administering it.

Reforms should also include rules to reduce windfall gains and losses during the period of transition to a new system. Consumption tax proposals, in particular, should address the effect of the transition on the tax burden of the elderly, should include rules for the treatment of certain hard-to-tax economic sectors, such as financial institutions, and should address the coordination of a Federal consumption tax with State and local retail sales taxes.

In addition to these general tax policy objectives, the Federal income tax has, over the years, been used to promote widely-held social and economic goals, such as home ownership, private charitable giving, and provision of medical insurance by employers. It is likely that these goals would continue to be seen as pursuits worthy of preference under a reformed tax system. To the extent that a reformed system is to be used to promote social and economic goals, possibilities for simplification and tax rate reduction would be materially reduced.

The strongest argument for a consumption tax is that it will probably increase saving and investment, but the amount of any increase is highly uncertain and could be small. Other ways of increasing national saving -- such as further deficit reduction or expanding saving incentives within the income tax -- can be used to further this objective either more surely or with less overall disruption than a wholesale replacement of the existing income tax.

Replacing the income tax with a consumption tax also raises concerns about fairness, because many consumption tax alternatives would increase the tax burden on low- and middle-income families. Efforts to improve the progressivity of consumption taxes would require significant increases in costs of compliance and administration. Moving from one tax system to another would also be complex and costly and would create both intended and unintended winners and losers. It also would change asset values, and the level of prices and wages.

Replacing the entire income tax with a consumption tax would be a grand experiment of applying theory to a practical application that no other country in the world has chosen to undertake. Proponents of these plans must, therefore, overcome a significant hurdle -- they must show that it is worthwhile to conduct this experiment on the world's largest and most complex economy.

The remainder of my testimony will describe (i) various types of consumption taxes, (ii) the distributional and economic effects of replacing the income tax with a consumption tax (including the international aspects of the proposals), (iii) some issues related to specific economic sectors that would have to be addressed in implementing a consumption tax, (iv) observations about simplifying the tax system, (v) the effect of some consumption tax proposals on the underground economy, (vi) coordination of proposals with State and local retail sales taxes, and (vii) transition issues.

Background

Imposing taxes on the basis of income (whether from labor or the return to savings and investment) arises from the principle that an equitable tax system should take into consideration the variation among individuals' ability to pay taxes. The "ability-to-pay" principle is often understood to mean that a tax should be progressive with respect to income; that is, the portion of income that is paid in taxes should rise as income rises. A broad-based income tax with graduated tax rates, as in the United States and other advanced economies, satisfies that criterion. An income tax need not have graduated rates, however. A flat-rate income tax applied beyond some base level of income would be progressive, but not to the same degree as a graduated-rate tax.

What is a consumption tax?

As an alternative to income-based taxes, consumption taxes are levied only on income that is spent on consumer goods and services; or, in other words, income that is saved is exempt from tax. Within this definition, broad-based consumption taxes can be administered in a number of ways. They can be collected wholly from businesses, either on final sales to consumers or on the value-added by all businesses at each stage of production. They can be collected in part from businesses and in part from wage-earners by allowing businesses to deduct wages and taxing them at the individual level. They can be collected wholly from individuals by modifying the current individual income tax to allow taxpayers to claim a deduction for all net saving. Furthermore, the statutory rates under a consumption tax can be flat, or they can differ across individuals or across different types of consumption. And a consumption tax that is collected from businesses can be broad-based, or it can exempt certain goods and services or businesses from tax.

Consumption taxes that are collected from individuals exempt income that is saved from tax in one of two ways: (1) by allowing a deduction from an income base for income that is saved and adding to the tax base the amount dissaved, or (2) by including compensation in the tax base and exempting the return to savings (interest, dividends, and capital gains). To see how exempting income that is saved is equivalent to exempting the return to savings, consider the effect of each approach on a taxpayer who begins a year with $100 of wage income and wishes to postpone all consumption for five years. The taxpayer saves all of his after-tax wage income in the first year and earns a five percent annual return on his savings. At the end of five years, he withdraws his principal and accumulated interest and spends it. In each year, the tax rate is 28 percent.

In the first case, the taxpayer is allowed a deduction for net saving, but is taxed on net withdrawals from savings. The taxpayer deposits his $100 of wages in a savings account. He deducts $100 from his taxable income, leaving him with zero taxable income and zero tax liability. His after-tax consumption in the first year is also zero. Because the taxpayer reinvests the interest income on his savings, he owes no tax on the interest income during the next five years. In the fifth year he withdraws $127.63: his original savings of $100 plus interest of $27.63. At a tax rate of 28 percent, his tax due on $127.63 of taxable income is $35.74. His after-tax consumption is $91.89.

In the second case, the taxpayer must pay tax on his wage income and receives no savings deduction. He pays $28 of tax on his $100 of wage income and deposits the remaining $72 of after-tax income in the bank. He has zero after-tax consumption in the first year. Over the next five years, his interest income is exempt from tax. In the fifth year he withdraws $91.89, his original savings of $72 plus interest of $19.89. His taxable income is zero, and his after-tax consumption is $91.89. Assuming that the taxpayer is in the same tax bracket during the five-year period, exempting the return to saving results in the same pattern of after-tax consumption as allowing a deduction for income that is saved, leaving the taxpayer indifferent between the two approaches.

Consumption taxes that are collected from businesses grant an immediate deduction for purchases of new capital stocks (including machinery, buildings, land, and inventory). This immediate deduction -- or "expensing" -- effectively eliminates the tax on the return from new investment. A consumption tax that is collected in part from individuals and in part from businesses would allow businesses to expense capital purchases and, under the individual tax, either exempt income that is saved or exempt the return to savings. The combination of these mechanisms ensures that income from capital -- the return to saving and investment -- is untaxed at any level.

Relieving new saving and new investment from tax is seen as the primary benefit of taxing consumption instead of income. Because the after-tax return to savers will increase, families will have an incentive to save more. But exempting the return to new saving reduces the tax base, requiring higher tax burdens on wage income. Moreover, because low-and middle-income households typically do not save as large a percentage of their incomes as higher-income households, flat rate consumption taxes are regressive -- effective tax rates decline as family incomes rise. Addressing the regressivity problem is a key challenge in designing a consumption tax that will not add to tax burdens of lower- and middle-income families.

While the key feature of a consumption tax is that it exempts income from new saving and investment, it should also be noted that many forms of consumption tax would reduce the number and types of deductions allowed to businesses. In general, a business-level consumption tax will allow deductions only for payments made to other businesses. Therefore, wage payments and the cost of non-pension employee fringe benefits -- such as employer-provided health insurance -- State and local taxes, and payroll taxes would generally not be deductible to businesses. The disallowance of deductions for fringe benefits and for the employer portion of the payroll tax under some proposals represents a "hidden" tax on employees, since most economists believe that these taxes would be shifted by employers to their employees.

Options for taxing consumption

There are a number of ways to administer a consumption tax, although the various forms would all not tax the return from new saving. The distributional effects and administrative costs would depend on the details of each proposal.

The theoretical model for each general option is described below. Applying theory to practice, however, will inevitably involve some compromises with the pure models. The degree of the deviations will be important in assessing both the possible viability and the overall economic effects of any particular proposal.

1. Retail sales tax (RST). Businesses are the sole collection agents for retail sales taxes -- like those used by most States -- and VATs. A RST is applied to sales of goods and services to households. In order to tax only sales to consumers, the RST must exempt sales between businesses. It is necessary to distinguish between taxable and exempt sales of capital goods. If the RST is levied on a broad base, it is a tax on total consumption. Because a RST is collected only on retail sales to domestic consumers, it automatically taxes imports and exempts exports. State sales taxes in the United States are not broad-based for two main reasons. First, certain purchases, including purchases of housing and necessities like food and medical care, are tax-exempt for social policy reasons. Second, many services are exempt for administrative reasons.

2. Value-added tax. Most countries that have a national consumption tax administer it as a credit-invoice VAT. Under this system, businesses are liable for VAT on their sales, but

receive a credit against their tax liabilities for VAT paid on inputs purchased from other businesses. Credit-invoice VATs in effect in other countries tax imports and exempt exports. They achieve this result by not taxing export sales, while allowing exporters a credit for all purchased inputs, and effectively imposing tax on goods purchased from other countries by not allowing their costs to be creditable.

Under a subtraction method VAT (also called a "business transfer tax" or BTT), a business is liable for tax on the difference between its sales and its purchases from other businesses, including purchases of buildings and equipment (but, as stated above, excluding other costs such as taxes paid and labor compensation). If the tax is applied to all goods and services at the same rate, a credit-invoice method VAT is economically equivalent to a similarly broad-based subtraction method VAT or national RST. Under Representative Gibbons' proposal, businesses would be subject to a subtraction method VAT.

3. Two-part individual/business consumption tax. Another form of consumption tax is collected in part from individuals and in part from businesses. The tax could be administered in the same way as a subtraction method VAT, except that it would allow wages to be deducted from the business tax base and would tax them at the individual level. If wages are subject to the same, single tax rate that is applied to businesses, the tax is "flat."

The proposals by Representative Armey and Senator Specter are consumption taxes of this form. In their proposals, wages are subject to a flat tax rate equal to the business tax rate, but wage earners are allowed to claim personal exemptions. These plans are economically equivalent to a VAT with a credit for wages up to the personal exemption amount. Alternatively, the individual portion of the tax could be levied at graduated rates. With no exemptions or deductions, the base of this two-part tax is the same as that of a broad-based VAT or national RST -- total consumption.

4. Consumed income tax. A consumption tax collected solely from individuals would be levied directly on their reported income, just like the current income tax, but would allow a deduction for net saving. The base of this tax is equal to consumption, because consumption is the difference between income and net saving. In order to measure income properly, proceeds from all forms of borrowing would need to be included in the tax base, and all forms of saving would be deductible.

The USA Tax System proposed by Senators Nunn and Domenici is comprised of both a flat-rate tax on businesses that is similar to a subtraction method VAT and a progressive-rate individual consumed income tax. The Nunn-Domenici proposal would not allow a deduction for labor costs under the business tax and would include labor income under the individual tax. This means that wages and salaries and non-pension fringe benefits would be taxed twice: once at the business level and again at the individual level. However, the tax burden on wages would be reduced through tax credits to both employers and employees for payroll taxes paid.

Distributional effects of replacing the income tax with a consumption tax

Replacing the income tax with a flat-rate consumption tax

The effect on the distribution of the tax burden of replacing the income tax with a consumption tax depends on the details of the tax that is adopted and on which taxes are replaced. Generally, however, taxing consumption places a higher burden on low- and middle-income families -- who typically do not save much of their income -- relative to an income tax. Because capital income is concentrated among high-income families, eliminating the tax on income from new capital will disproportionately benefit high-income families.[1] The change will, therefore, shift the tax burden away from high-income families to middle-and low-income families.

[1] For example, about 40 percent of all taxable interest and dividend income reported on 1991 individual tax returns was received by the 6 percent of taxpayers with adjusted gross income over $75,000. See U.S. Internal Revenue Service, Statistics of Income Division, *Individual Income Tax Returns--1991*, U.S. Government Printing Office, 1994, pp. 28-30.

Table 1 shows the distributional effect of replacing the revenue of the corporate and personal income taxes (including the earned income tax credit) with a general consumption tax with no exemptions (such as a broad-based VAT or national RST).[2] The revenue-neutral rate of 14.5 percent used for these calculations assumes that the tax is imposed on all consumption in the economy, including consumption services supplied by the government and non-profit sectors, which would probably be exempt from a VAT or RST. In practice, therefore, the rate that would be required under a broad-based VAT or RST would probably be much higher.[3]

At the 14.5 percent tax rate, the aggregate after-tax income for the group of families in the first through fourth income quintiles would be lower under the flat tax (i.e., a net tax increase), while the aggregate after-tax income for the group of families in the highest income quintile would be higher under the flat tax (a net tax cut). Expressed as a percentage of after-tax income under current law, the proposal would cause a reduction in aggregate after-tax income of between 3.9 percent and 11.1 percent for the groups of families in the first through fourth income quintiles and a 5.4 percent increase in after-tax income for the groups of families in the highest income quintile.[4] This amounts to aggregate increases in Federal taxes ranging from 15.5 percent to 134.1 percent for the group of families in the first through fourth income quintiles, and a 18.6 percent reduction in taxes for the group of families in the highest income quintile.[5,6]

In this analysis, the burden of the consumption tax is distributed to taxpayers according to components of current income. But individuals may base current expenditures on their expectation of future income as well as on current income. For example, college students who earn very little while they are in school might, nevertheless, have high current consumption expenditures if they are able to borrow against the expectation that they will have high incomes in the future. In such cases, annual income understates economic well-being. Annual income may overstate economic well-being in a year when a family receives income from a transitory source, such as a large bonus. For these reasons, some economists argue that lifetime income is a better measure of an individual's long-term economic well-being than annual income. Our analyses, however, do not distribute tax burdens according to lifetime income because future earnings are uncertain, and even if future earnings were known, lifetime income would be difficult to measure with accuracy. In addition, lifetime income is an inappropriate measure of current well-being if individuals are unable to smooth their consumption over their lifetime by borrowing and saving. For example, if the college students mentioned above are not able to borrow against their uncertain future earnings, it may be inappropriate for the tax system to view

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[2]For an explanation of how to design a consumed income tax that is distributionally neutral across income quintiles, see U.S. Congressional Budget Office, *Estimates for a Prototype Saving-Exempt Income Tax*, Congressional Budget Office, 1994, pp. 19-28.

[3]The 14.5 percent tax rate would be applied on a tax-inclusive basis, in a manner similar to the income tax. The equivalent rate calculated on a tax-exclusive basis, as would be relevant under a VAT, is 17.0 percent.

[4]These results are illustrated in Chart 1.

[5]The distributional estimates shown in the Table 1 are based on the assumption that the consumption tax is borne by taxpayers in proportion to their earnings and income from existing capital. Alternative assumptions could be made about who bears the burden of the tax. A traditional assumption is that a consumption tax is borne by consumers in proportion to their consumption. We have not followed this approach, because it overstates the tax cut for high-income families and the tax increases for low- and middle-income families by failing to adjust for temporary income fluctuations and normal life-cycle patterns of consumption and income. In addition, lack of reliable data on consumption by families with very high and very low incomes make distributional estimates based on the traditional approach less reliable than those shown in Table 1. Following this approach would lead to a more regressive distribution of the tax than that shown in Table 1.

[6]The finding that replacing the income tax with a flat-rate consumption tax would redistribute tax burdens from low-income to high-income families is consistent with previous analyses. For example, CBO and JCT find that, under a broad-based VAT, low-income families would pay a higher fraction of their income in tax compared to high-income families. See U.S. Congressional Budget Office, *Effects of Adopting a Value-Added Tax*, U.S. Congressional Budget Office, 1992, pp. 32-7, and Joint Committee on Taxation, *Methodology and Issues in Measuring Changes in the Distribution of Tax Burdens*, U.S. Government Printing Office, 1993, p. 54-5.

Table 1
Replace Current Individual and Corporate Income Taxes (including the EITC) with a 14.5% Flat Rate Consumption Tax with No Exemptions(1)

(1996 Income Levels)

Family Economic Income Quintile (2)	After-Tax (3) Income Under Current Law ($B)	Change in After-Tax Income from Proposal (4): Repeal Income Tax ($B)	Flat Rate Consumption Tax with No Exemptions ($B)	Total Change: Amount ($B)	Total Change: Percentage Change (%)	Percentage Change in Total Federal Taxes (%)
Lowest (5)	171.1	-4.5	-14.5	-19.0	-11.1	134.1
Second	431.0	9.9	-53.1	-43.2	-10.0	70.5
Third	697.9	59.6	-100.6	-40.9	-5.9	27.9
Fourth	1,091.9	126.6	-168.8	-42.2	-3.9	15.5
Highest	2,693.1	536.7	-391.4	145.4	5.4	-18.6
Total (5)	5,054.7	729.4	-729.4	0.0	0.0	0.0
Top 10%	1,899.8	427.7	-264.9	162.8	8.6	-28.8
Top 5%	1,371.5	341.2	-180.5	160.7	11.7	-38.7
Top 1%	683.5	202.7	-81.5	121.2	17.7	-54.6

Department of the Treasury
Office of Tax Analysis

March 7, 1995

(1) This table distributes the estimated change in after-tax income due to the proposal with a revenue-neutral rate of 14.5 percent.

(2) Family Economic Income (FEI) is a broad-based income concept. FEI is constructed by adding to AGI unreported and underreported income; IRA and Keogh deductions; nontaxable transfer payments, such as Social Security and AFDC; employer-provided fringe benefits; inside build-up on pensions, IRAs, Keoghs, and life insurance; tax-exempt interest; and imputed rent on owner-occupied housing. Capital gains are computed on an accrual basis, adjusted for inflation to the extent reliable data allow. Inflationary losses of lenders are subtracted and of borrowers are added. There is also an adjustment for accelerated depreciation of noncorporate businesses. FEI is shown on a family, rather than on a tax return basis. The economic incomes of all members of a family unit are added to arrive at the family's economic income used in the distributions.

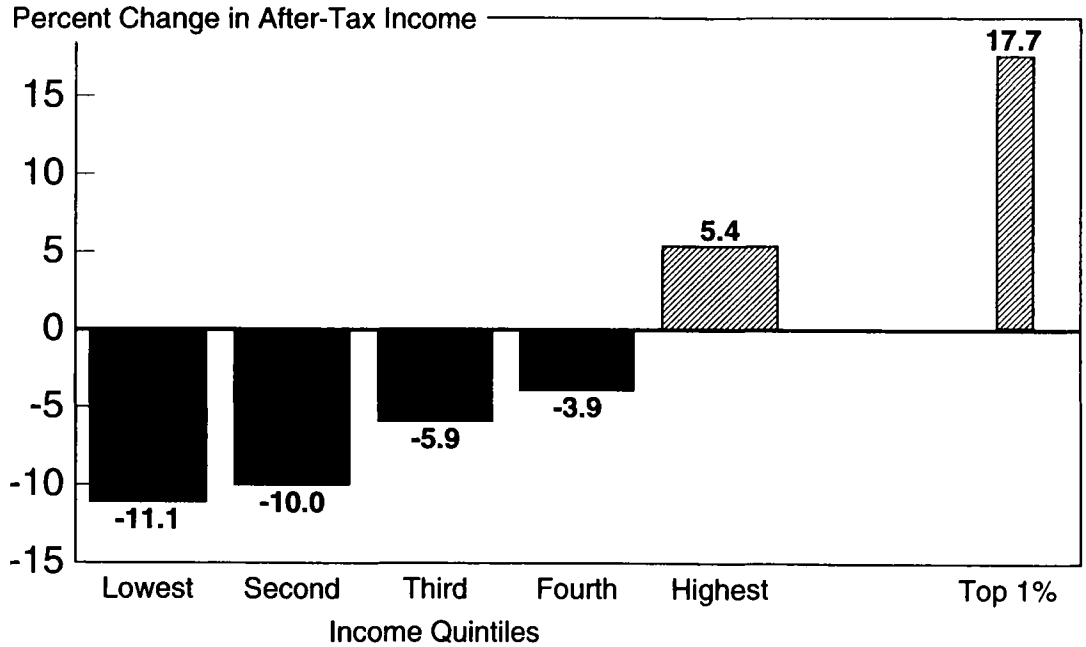
(3) The taxes included are individual and corporate income, payroll (Social Security and unemployment), and excises. Estate and gift taxes and customs duties are excluded. The individual income tax is assumed to be borne by payors; the corporate income tax by capital income generally; payroll taxes (employer and employee shares) by labor (wages and self-employment income); excises on purchases by individuals by the purchaser; and excises on purchases by business in proportion to total consumption expenditures. Taxes due to provisions that expire prior to the end of the Budget period (i.e., before 2000) are excluded.

(4) The change in Federal taxes is estimated at 1996 income levels but assuming fully phased in law and static behavior. The incidence assumptions for the repealed income taxes is the same as for the current law taxes (see footnote 3). The portion of the flat rate consumption tax that falls on wages, fringe benefits, and pension benefits is assumed to be borne proportionately by wages, fringe benefits, and pension benefits. The remaining portion of the flat rate consumption tax, which falls on business cash flow, is assumed to be borne by capital income generally.

(5) Families with negative incomes are excluded from the lowest quintile but included in the total line.

NOTE: Quintiles begin at FEI of: Second $15,604; Third $29,717; Fourth $48,660; Highest $79,056; Top 10% $108,704; Top 5% $145,412; Top 1% $349,438.

Chart 1: Distributional Effect of Replacing Current Income Taxes with a 14.5% Flat Rate Consumption Tax



Source: Department of the Treasury (see Table 1 for details)

them as well-off currently.[7] Nevertheless, some studies show that distributing a general consumption tax to families according to their estimated lifetime income makes the tax appear to be less regressive.

Addressing the regressivity of a consumption tax

An important difference among the various forms of consumption taxes lies in the mechanisms available for distributing the tax more equitably among families with different incomes. One way that European countries attempt to reduce the regressivity of the VAT is by exempting specific goods and services from the tax or taxing them at a lower rate. This approach does not reduce regressivity effectively because tax relief from exempting specific goods and services is difficult to target to low-income families. While the tax preference does relieve the burden on low-income families, middle- and upper-income households also benefit when they purchase tax-preferred goods and services, requiring higher rates on other goods and services that low-income families buy to raise the same revenue. Other approaches, such as refundable credits and expansion in government transfer programs are more effective ways to offset regressivity, but would add to administrative and compliance costs and require explicit increases in government outlays.

A consumption tax that is collected at least in part from individuals can better account for differences in ability to pay among families and individuals than one that is collected solely from businesses. Such a tax can be made less regressive through standard deductions, as under Representative Armey's and Senator Specter's flat tax proposals, and/or graduated rates, as under the Nunn-Domenici plan. Refundable credits like the earned income tax credit (EITC) can also be used to reduce the tax burden on low-income families, but credits carry with them administrative costs. For example, low-income families, who otherwise might be excluded from the tax system, would be required to file a return in order to receive the credit.

As an illustration of the effect of including standard deductions and personal exemptions in a general consumption tax, Table 2 shows the distributional effect of replacing the corporate and individual income taxes with a stylized flat tax similar to the Armey proposal.[8] With standard deductions of $24,700 (for joint returns) or $12,350 (for single-filers) and a $5,000 exemption for each dependent, the revenue-neutral rate for the flat tax rises to 22.9 percent. Under this version of the flat tax, the aggregate after-tax income for the group of families in the first through fourth income quintiles would still be lower than under current law (i.e., a net tax increase), while the aggregate after-tax income for the group of families in the highest income quintile would be higher under the flat tax (a net tax cut). However, compared to the proposal without exemptions, the Armey-style proposal would cause a smaller reduction in aggregate after-tax income (between 1.0 percent and 2.2 percent of current-law after-tax income) for the group of families in the first through fourth income quintiles. The percentage increase in after-tax income for the group of families in the highest income quintile, 1.6 percent, would also be smaller than the increase shown in Table 1. These changes amount to aggregate increases in Federal taxes ranging from 8.9 percent to 12.2 percent for the group of families in the first through fourth income quintiles (compared to 15.5 percent and 134.1 percent, respectively, under the proposal without exemptions), and a 5.6 percent reduction in taxes (compared to 18.6 percent in Table 1) for the group of families in the highest income quintile.[9]

Table 3 compares the progressivity of the current Federal tax system together with the revenue-neutral, stylized flat tax described above. The last two columns in the table show taxes

[7]For a more detailed discussion of these points, see Joint Committee on Taxation, *Methodology and Issues in Measuring Changes in the Distribution of Tax Burdens*, U.S. Government Printing Office, 1993, pp. 82-6.

[8]Except for the inclusion of standard deductions and personal exemptions and the disallowance of certain deductions for taxes paid by businesses, the distributional estimates shown in the Table 2 are based on the same assumptions as those in Table 1.

[9]These results are illustrated in Chart 2.

Table 2
Replace Current Individual and Corporate Income Taxes with a 22.9% (Modified) Flat Rate Tax (1)

(1996 Income Levels)

Family Economic Income Quintile (2)	After-Tax (3) Income Under Current Law ($B)	Change in After-Tax Income Under Proposal (4): Repeal Income Tax (except EITC) ($B)	22.9% Tax on Wages Over Stand. Ded. (5) ($B)	22.9% Tax on Fringes and Payroll Tax (6) ($B)	22.9% Tax on Business Cash Flow ($B)	Total Change ($B)	Percentage Change (%)	Percentage Change In Total Federal Taxes (%)
Lowest (7)	171.1	3.8	-0.9	-2.7	-1.9	-1.7	-1.0	12.2
Second	431.0	25.0	-11.8	-9.0	-9.5	-5.2	-1.2	8.5
Third	697.9	64.1	-38.7	-17.0	-20.7	-12.2	-1.8	8.3
Fourth	1,091.9	127.6	-91.5	-26.5	-33.8	-24.2	-2.2	8.9
Highest	2,693.1	537.0	-300.1	-39.5	-154.1	43.3	1.6	-5.6
Total (7)	5,054.7	758.6	-443.7	-94.9	-220.0	0.0	0.0	0.0
Top 10%	1,899.8	427.9	-211.0	-21.0	-128.8	67.0	3.5	-11.9
Top 5%	1,371.5	341.2	-142.2	-10.6	-108.6	79.7	5.8	-19.2
Top 1%	683.5	202.7	-58.5	-2.3	-68.3	73.7	10.8	-33.2

Department of the Treasury / Office of Tax Analysis — March 7, 1995

(1) This table distributes the estimated change in after-tax income due to the proposal with a revenue-neutral rate of 22.9 percent (approximately).

(2) Family Economic Income (FEI) is a broad-based income concept. FEI is constructed by adding to AGI unreported and underreported income; IRA and Keogh deductions; nontaxable transfer payments, such as Social Security and AFDC; employer-provided fringe benefits; inside build-up on pensions, IRAs, Keoghs, and life insurance; tax-exempt interest; and imputed rent on owner-occupied housing. Capital gains are computed on an accrual basis, adjusted for inflation to the extent reliable data allow. Inflationary losses of lenders are subtracted and of borrowers are added. There is also an adjustment for accelerated depreciation of noncorporate businesses. FEI is shown on a family, rather than on a tax return basis. The economic incomes of all members of a family unit are added to arrive at the family's economic income used in the distributions.

(3) The taxes included are individual and corporate income, payroll (Social Security and unemployment), and excises. Estate and gift taxes and customs duties are excluded. The individual income tax is assumed to be borne by payors, the corporate income tax by capital income generally, payroll taxes (employer and employee shares) by labor (wages and self-employment income), excises on purchases by individuals by the purchaser, and excises on purchases by business in proportion to total consumption expenditures. Taxes due to provisions that expire prior to the end of the Budget period (i.e., before 2000) are excluded.

(4) The change in Federal taxes is estimated at 1996 income levels but assuming fully phased in law and static behavior. The incidence assumptions for the repealed income taxes is the same as for the current law taxes (see footnote 3). The flat tax on wages (plus pension benefits received) is assumed to be borne by wages plus pension benefits received in excess of the standard deduction. The flat tax on employer-provided fringe benefits (except pension contributions) and payroll taxes is assumed to be borne by employees in proportion to benefits or taxes. The flat tax on business cash flow is assumed to be borne by capital income generally.

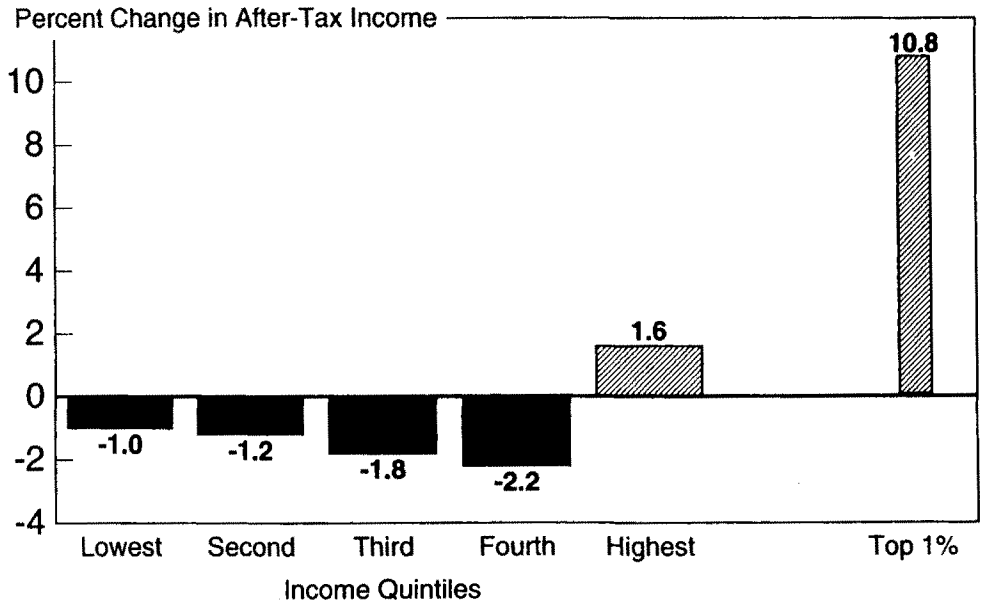
(5) The standard deduction (in 1995$) is $24,700 (joint) or $12,350 (single) plus $5,000 for each dependent. Non-pension fringe benefits of government and nonprofit employees are included in wages.

(6) The proposal would disallow a deduction for employer-provided fringe benefits (except pension contributions) making these benefits (primarily employer-provided health insurance) subject to the 22.9 percent flat tax. The employer portion of payroll taxes would likewise be nondeductible.

(7) Families with negative incomes are excluded from the lowest quintile but included in the total line.

NOTE: Quintiles begin at FEI of: Second $15,604; Third $29,717; Fourth $48,660; Highest $79,056; Top 10% $108,704; Top 5% $145,412; Top 1% $349,436

Chart 2: Distributional Effect of Replacing Current Income Taxes with a 22.9% (Modified) Flat Rate Consumption Tax



Source: Department of the Treasury (see Table 2 for details)

Table 3
Replace Current Individual and Corporate Income Taxes with a 22.9% (Modified) Flat Rate Tax (1)

(1996 Income Levels)

Family Economic Income Quintile (2)	Federal Taxes Under Current Law (3) ($B)	Federal Taxes with 22.9% Flat Rate Tax (4) ($B)	Change in Federal Taxes ($B)	Taxes as a Percent of Pre-Tax Income Under: Current Law (%)	Taxes as a Percent of Pre-Tax Income Under: with 22.9% Flat Rate Tax (%)
Lowest (7)	14.2	15.9	1.7	7.6	8.6
Second	61.2	66.4	5.2	12.4	13.5
Third	146.5	158.7	12.2	17.3	18.8
Fourth	271.8	296.0	24.2	19.9	21.7
Highest	779.5	736.2	-43.3	22.4	21.2
Total (7)	1275.1	1275.1	0.0	20.1	20.1
Top 10%	565.3	498.3	-67.0	22.9	20.2
Top 5%	415.3	335.6	-79.7	23.2	18.8
Top 1%	221.9	148.3	-73.7	24.5	16.4

Department of the Treasury
Office of Tax Analysis

June 5, 1995

(1) This table distributes the estimated change in Federal taxes due to a (modified) flat rate tax with a revenue-neutral rate of 22.9 percent (approximately) which replaces the current individual and corporate income taxes.

(2) Family Economic Income (FEI) is a broad-based income concept. FEI is constructed by adding to AGI unreported and underreported income; IRA and Keogh deductions; nontaxable transfer payments, such as Social Security and AFDC; employer-provided fringe benefits; inside build-up on pensions, IRAs, Keoghs, and life insurance; tax-exempt interest; and imputed rent on owner-occupied housing. Capital gains are computed on an accrual basis, adjusted for inflation to the extent reliable data allow. Inflationary losses of lenders are subtracted and of borrowers are added. There is also an adjustment for accelerated depreciation of noncorporate businesses. FEI is shown on a family, rather than on a tax return basis. The economic incomes of all members of a family unit are added to arrive at the family's economic income used in the distributions.

(3) The taxes included are individual and corporate income, payroll (Social Security and unemployment), and excises. Estate and gift taxes and customs duties are excluded. The individual income tax is assumed to be borne by payors, the corporate income tax by capital income generally, payroll taxes (employer and employee shares) by labor (wages and self-employment income), excises on purchases by individuals by the purchaser, and excises on purchases by business in proportion to total consumption expenditures. Taxes due to provisions that expire prior to the end of the Budget period (i.e., before 2000) are excluded.

(4) The change in Federal taxes is estimated at 1996 income levels but assuming fully phased in law and static behavior. The incidence assumptions for the repealed income taxes is the same as for the current law taxes (see footnote 3). The flat tax on wages (plus pension benefits received) is assumed to be borne by wages plus pension benefits received in excess of the standard deduction. The flat tax on employer-provided fringe benefits (except pension contributions) and payroll taxes is assumed to be borne by employees in proportion to benefits or taxes. The flat tax on business cash flow is assumed to be borne by capital income generally.
The standard deduction (in 1995$) is $24,700 (joint) or $12,350 (single) plus $5,000 for each dependent. Non-pension fringe benefits of government and nonprofit employees are included in wages.
The proposal would disallow a deduction for employer-provided fringe benefits (except pension contributions) making these benefits (primarily employer-provided health insurance) subject to the 22.9 percent flat tax. The employer portion of payroll taxes would likewise be nondeductible.

(5) Families with negative incomes are included in the total line but not shown separately.

as a percentage of pre-tax income (effective tax rates) for groups of taxpayers. The current tax system is progressive with respect to income by quintile -- that is, effective tax rates rise with each income quintile -- and the flat tax is progressive through the fourth income quintile, although the effective tax rate falls slightly from the fourth income quintile to the highest. The flat tax proposal, however, ceases to be progressive for the group of families with the very highest incomes. The effective tax rates for the groups of families in the top ten percent, five percent, and one percent of the income distribution fall to 20.2 percent, 18.8 percent, and 16.4 percent, compared with a rate of 21.7 percent for families in the fourth income quintile. Under current law, effective tax rates continue to rise for the families with the very highest incomes.[10] This decrease in tax burden on higher-income families under the flat tax occurs because income from new saving and investment (which is not taxed under a consumption tax) is concentrated among families at the top of the income distribution.

While Treasury has not completed a study of the distributional effect of the Nunn-Domenici consumption tax, their proposal was designed to achieve progressivity through graduated rates under the individual consumed income tax. A top statutory individual tax rate of 40 percent, together with the loss of a deduction for labor costs under the 11 percent business tax, means that consumed labor income in excess of $24,000 (for joint filers) would be taxed at an effective rate of 46.6 percent under the Nunn-Domenici proposal. With the family living allowance and personal and dependent exemptions, a family of four would pay income tax at an effective rate of 46.6 percent on consumed labor income in excess of $41,600.

As an alternative to a complete replacement of the income tax system, a VAT or BTT could be imposed at a moderate rate to replace a portion of the revenue from the income tax. A variant of this approach, taken by Representative Gibbons, would impose a VAT to replace most of the revenue from income and payroll taxes, but would retain an income tax for high-income individuals to ensure that they continue to pay an equitable share of taxes. Refundable credits or other mechanisms could be used to offset the effects of the consumption tax on low-income families.

While consumption taxes can be made less regressive, there is a clear and important tradeoff between progressivity and simplicity. The forms of tax that are the simplest and probably the least costly to administer and with which to comply (the RST and VAT) cannot be made progressive without retaining some income-based taxes on high-income families and credits for low-income families. The forms that are collected solely from individuals are more easily made progressive, but would be at least as complex -- and probably *more* complex -- than our current tax system. Consumption taxes collected from individuals -- such as the individual portion of the Nunn-Domenici USA Tax -- would impose numerous reporting requirements on taxpayers and would introduce complicated tax calculations in ways that would be new to taxpayers, tax preparers, and the IRS. I will describe some of these complexities in more detail later in my testimony when I evaluate the effects of tax reform on simplicity.

Transition from the existing income tax to a new consumption tax raises an additional series of issues regarding equity, compliance, economic efficiency, and the impact on wages, prices, interest rates, and the values of assets. These important issues are also discussed below.

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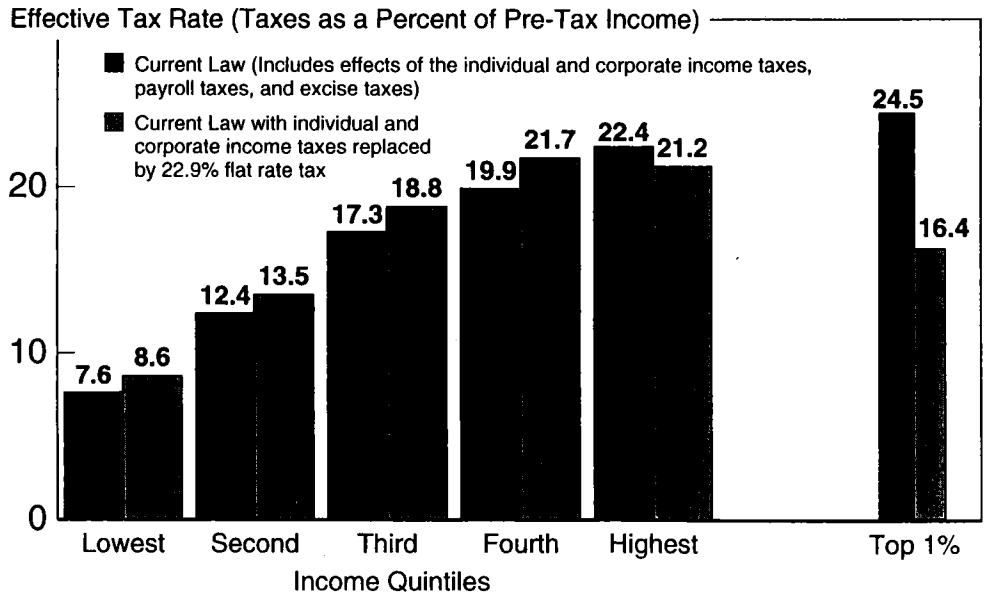
[10] These results are illustrated in Chart 3.

Chart 3: Distributional Effect of Federal Tax System Under Current Law and With Income Taxes Replaced by a 22.9% (Modified) Flat Rate ConsumptionTax



Source: Department of the Treasury

Economic effects of replacing the income tax with a consumption tax[11]

Saving and investment[12]

The main reason to consider replacing the income tax with a consumption tax is that this change could encourage domestic saving and capital formation and promote economic growth. A consumption tax would not tax the return to new saving and investment. The income tax does tax this return, and thereby discourages saving and investment to some degree. The key issue is whether substituting a consumption tax for an income tax will raise saving enough to overcome its other problems.

1. National saving. The low rate of U.S. saving is a serious concern. The national saving rate in the United States has declined in the 1980s compared to the previous three decades (Table 4). Although private saving decreased during this period, it remained positive. Public saving, however, has been consistently negative as a result of Federal budget deficits.

Table 4. Components of Net U.S. National Savings as a Percentage of GDP: 1950-1994

Year	Net Personal Saving	Net Business Saving	Total Net Private Saving	Public Saving	Total Net National Saving
Average 1950-59	4.7	2.9	7.6	-0.1	7.5
Average 1960-69	4.7	3.6	8.2	-0.1	8.1
Average 1970-79	5.5	2.6	8.1	-1.0	7.2
Average 1980-89	4.5	1.5	6.0	-2.4	3.6
Average 1990-94	3.4	1.8	5.1	-3.1	2.1

Source: Department of Commerce, Bureau of Economic Analysis

The reasons for the decline in private saving rates in the United States are unclear. It could be due to demographic factors that may reverse as the baby boom generation enters later middle age and saves for retirement. It may also be attributable to an increase in the availability of insurance and Social Security benefits, which reduce the necessity for private saving.[13] The decline in saving does not appear to have been caused by changes in tax policy. Marginal tax rates were lowered substantially during the 1980s and new saving incentives were introduced, but the rate of saving still fell.

According to a recent report by the Organization for Economic Cooperation and Development, the saving rates of our major trading partners also have declined since the 1960s.[14] All of these countries except Japan, however, rely more heavily on consumption taxes for revenues than does the United States, both as a percentage of gross domestic product (GDP) and as a share of total tax revenues (Tables 5 and 6). While Japan depends the least on consumption taxes for revenues, it also had the highest saving rate during the 1980s (Table 7) and the highest rate of growth in real per capita GDP (Table 8).

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[11]This section analyzes the long-run economic effects of switching to a consumption tax system. The short-run effects could be quite different from the long-run effects, but analysis of short-run effects is beyond the scope of this testimony.

[12]Discussion of the points made in this section of the testimony appears in Joint Committee on Taxation, *Factors Affecting the Competitiveness of the United States*, U.S. Government Printing Office, 1991, pp. 44-52; U.S. Congressional Budget Office, *Effects of Adopting a Value-Added Tax*, Congressional Budget Office, 1992, pp. 51-5; and Joint Committee on Taxation, *Description and Analysis of Tax Proposals Relating to Individual Saving*, U.S. Government Printing Office, 1995, pp. 63-72.

[13]For a more detailed discussion, see Joint Committee on Taxation, *Description and Analysis of Tax Proposals Relating to Individual Saving*, U.S. Government Printing Office, 1991, p 72.

[14]Organization for Economic Cooperation and Development, *Taxation and Household Saving*, 1994, pp. 17-24.

The most direct way to increase national saving is to reduce the Federal budget deficit. The Federal government may also be able to affect private saving through changes in tax policy. However, if tax policy changes also increase the Federal budget deficit, there may be no net increase in national saving.

Table 5. Tax Revenues by Type of Tax as a Percentage of GDP for Selected Countries: 1992[1]

	Total	Income & Profits	Social Security	Property	Goods & Services	Other[2]
Canada	36.5	16.4	6.0	4.0	9.5	0.5
France	43.6	7.6	19.5	2.2	11.7	2.7
Germany	39.6	12.7	15.2	1.1	10.6	0.0
Italy	42.4	16.6	13.3	1.0	11.4	0.1
Japan	29.4	12.5	9.7	3.1	4.1	0.1
United Kingdom	35.2	12.7	6.3	2.8	12.1	1.3
United States	29.4	12.2	8.8	3.3	5.0	-

Source: Organization for Economic Cooperation and Development, Revenue Statistics of OECD Member Countries, 1965-1993, 1994.

[1] Includes taxes at all levels of government.
[2] Includes certain payroll taxes that are not earmarked for social security, taxes imposed on other bases not otherwise identified or identifiable and fines and penalties.

Table 6. Tax Revenues by Type of Tax as a Percentage of Total Taxation for Selected Countries: 1992[1]

	Income & Profits	Social Security	Property	Goods & Services	Other[2]
Canada	45.0	16.5	11.1	26.1	1.4
France	17.3	44.6	5.0	26.8	6.3
Germany	32.0	38.4	2.7	26.9	-
Italy	39.1	31.3	2.4	26.9	0.3
Japan	42.4	32.8	10.5	14.0	0.3
United Kingdom	36.1	17.8	7.9	34.4	3.7
United States	41.5	29.9	11.4	17.1	-

Source: Organization for Economic Cooperation and Development, Revenue Statistics of OECD Member Countries, 1965-1993, 1994.

[1] Includes taxes at all levels of government.
[2] Includes certain payroll taxes that are not earmarked for social security, taxes imposed on other bases not otherwise identified or identifiable and fines and penalties.

Table 7. Average Net National Saving Rates for Selected Countries

Country	1980's	1990	1991	1992
Canada	8.4	5.0	2.5	1.5
France	7.9	8.6	7.6	6.5
Germany	9.8	12.5	10.4	9.8
Italy	9.8	7.8	6.8	5.2
Japan	18.2	19.8	20.0	18.2
United Kingdom	4.8	3.6	2.4	2.0
United States	4.5	3.1	2.8	1.9

Source: OECD, National Accounts 1980-1992, 1994.

Note: Data are based on the OECD System of National Accounts (SNA) methodology which differs slightly from the U.S. National Income Accounts System.

Table 8. Average Annual Growth Rates of Real Per Capita GDP for Selected Countries: 1980-1992 (percent)

Country	1980 to 1990	1990 to 1992
Canada	1.9	-1.9
France	1.8	0.4
Germany	2.0	2.0
Italy	2.0	0.9
Japan	3.5	2.4
United Kingdom	2.5	-1.8
United States	1.8	-0.1

Source: Organization for Economic Cooperation and Development

2. Tax policy and private saving. Two effects from substituting a consumption tax for the income tax could boost total private saving. Economic theory suggests that if the after-tax rate of return on savings goes up, individuals would increase saving to consume more in the future since the "price" of future consumption in terms of foregone current consumption is lower. However, most empirical studies find that the effect of increasing the rate of return on the level of saving would be quite small.[15] In addition, some people are "savers," while others consume essentially all their income. Shifting the overall burden of taxes from saver to consumer households can increase aggregate private saving, but it would also result in an increased concentration of private wealth.

While a pure consumption tax would encourage private saving more than a pure income tax, the effect on saving of substituting a consumption tax for our existing income tax is less clear. Our current income tax includes powerful incentives for employees to receive part of their compensation in the form of retirement savings plan contributions, and for employers to provide such plans for all their employees -- including low-income employees who would not

[15]See Joint Committee on Taxation, *Description and Analysis of Tax Proposals Relating to Individual Saving*, U.S. Government Printing Office, 1995, p. 46. For additional discussion of this point, see Organization for Economic Cooperation and Development, *Taxation and Household Saving*, 1994. In *Descriptions and Analysis of Proposals to Replace the Federal Income Tax* (U.S. Government Printing Office, 1995, p. 69), the staff of the Joint Committee on Taxation states that the results of studies of the empirical response of saving to changes in the after-tax rate-of-return are inconclusive.

be likely to respond to direct tax incentives. The incentive to establish retirement plans would be much weaker under a consumption tax.

An alternative way to use tax policy to increase private saving is to broaden saving incentives within the framework of the existing income tax. Provisions that directly encourage people to deposit some of their earnings in tax-favored accounts, such as IRAs and 401(k) plans, could be more cost-effective ways of increasing saving without replacing the entire tax system. Toward that end, the Administration's budget has proposed an expansion in the eligibility rules for contributing to IRAs.

3. Saving and investment. Advocates of replacing the income tax with a consumption tax often discuss effects on saving and investment as if they are interchangeable. But saving and investment can diverge significantly because of the increased amount of international capital flows in today's global economy. More specifically, the relative effects on saving and investment would depend in part on the extent to which the consumption tax revenues were used to reduce corporate or individual income tax rates. Eliminating the corporate tax would increase domestic investment more than private saving, while eliminating the individual tax would increase private saving more than domestic investment.[16]

4. Interest rates. It is not clear how a switch to a consumption tax would affect U.S. interest rates in the long run.[17] The net demand by U.S. investors for interest-bearing assets would be expected to increase, pushing bond prices up and yields down. This would occur because the consumption tax would remove interest flows from tax calculations. Also, under a consumption tax, domestic borrowers would not be willing to pay as high a rate of interest because interest would no longer be deductible, and U.S. lenders would be willing to accept a lower rate of interest because interest income would no longer be taxed. But in today's world economy, the U.S. interest rate is closely linked to rates in other advanced countries. With foreign interest rates unchanged and debt capital flowing freely across international borders, any reduction in U.S. interest rates would be dampened significantly. The likely result is that U.S. interest rates would fall somewhat, but by much less than the initial tax benefit to savers. After-tax yields to U.S. savers and after-tax interest costs to U.S. borrowers would increase.

Prices and wages

A frequent concern is that the introduction of certain types of consumption taxes, particularly RSTs and VATs, would lead to a higher price level because such taxes are generally added to the price of the product.

It is likely that such a one-time increase in the prices of consumption goods could occur. In addition, the indexing provisions of social welfare benefits and some labor contracts could lead to continuing inflationary pressures in later periods as a delayed effect of the initial price level change. The extent of this one-time increase and any further increases in the price level depend on the actions of the Federal Reserve. Such price increases can only occur if the Federal Reserve provides accommodative monetary policy.[18,19]

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[16]Under U.S. tax rules, corporate income tax is imposed on the return to equity-financed capital used in the United States regardless of who owns it, whereas the individual income tax is imposed on the return to capital owned by U.S. residents regardless of where it is used. (U.S. corporations are taxed on their worldwide income, but receive a tax credit for foreign income taxes paid. The residual U.S. tax rate on active foreign-source income of U.S. corporations, after accounting for foreign taxes, is generally quite low.) Eliminating the corporate tax would be expected to increase domestic investment more than saving, because it would reduce the cost of capital to both U.S. corporations and foreign corporations investing in the United States by much more than it would increase the after-tax return to U.S. savers. In contrast, eliminating the individual income tax would be expected to increase saving more than domestic investment because it would increase the after-tax return to U.S. personal saving invested both in the United States and abroad, but, with internationally-linked capital markets, would not provide a relative advantage to capital invested in the United States.

[17]The short-run effects on interest rates would depend on actions taken by the Federal Reserve during the period of transition to a new tax system.

[18]For additional discussion of the effects on prices of adopting a VAT, see U.S. Congressional Budget Office, *Effects of Adopting a Value-Added Tax*, Congressional Budget Office, 1992, pp. 64-65.

If the introduction of a consumption tax does lead to an increase in the overall price level, wage-earners will suffer a proportionate reduction in their purchasing power. If the price level does not rise, however, after-tax payments to factors of production such as wages would have to be reduced. In either case, the net after-tax returns to labor are likely to be reduced under a consumption tax because of the need to obtain revenues to offset the reduction in taxes on capital income.

Asset values

Changing from income taxation to consumption taxation is likely to have material effects on the values of different kinds of assets. It is clear that there will be major winners and losers. But it is difficult to identify all effects on assets because such effects depend in complex ways on the details of specific proposals and on the economic responses to some of the changes. We can only comment generally on what some of the effects might be.

Several economists have argued that expensing of new investments under a consumption tax will adversely affect stock prices to the extent that those prices reflect the value of existing capital.[20] Expensing of new investment lowers the rental price of capital that is required to make new investment profitable. These lower rents, in turn, depress the value of claims to existing assets. But the actual effect on the overall level of stock prices is likely to be less than predicted by these studies. These studies are based on changing from pure income to pure consumption taxes, but the current income tax system already incorporates some features of a consumption tax such as accelerated depreciation and savings preferences. The short-run adverse effects on overall levels of stock prices are likely to be further cushioned because the adjustment costs associated with incorporating new investment will reduce the rate at which the capital stock increases. This will keep rental returns of capital from falling by maintaining the value of scarce capital.[21]

The exemption under a consumption tax for interest income and the elimination of interest deductions would tend to reduce interest rates, pushing up the price of existing taxable bonds. But in today's international capital markets, high-grade bonds of different countries are close substitutes. Consequently, a change in the tax treatment of debt in the United States is not likely to affect world interest rates. On net, interest rates in the United States would probably fall only slightly in response to the imposition of a consumption tax, pushing bond values up only slightly.

If the consumption tax is collected from businesses, and the Federal Reserve accommodates the tax by expanding the money supply, the price level will rise. Increased prices will effectively transfer real wealth from lenders (current holders of long-term bonds) to borrowers (current issuers of long-term bonds). New borrowers and lenders would be unaffected by this wealth transfer.

Tax-exempt interest rates would be expected to rise in response to a switch to a consumption tax because, under most consumption tax proposals, tax-exempt bonds would no longer be favored relative to taxable bonds. Consequently, existing holders of long-term municipal bonds would suffer a capital loss.

Under the current income tax, investment in owner occupied housing is substantially tax favored compared to other forms of investment. These advantages include allowing deductions for certain homeownership costs, such as mortgage interest and property taxes, even though housing produces no taxable income. Under most consumption tax proposals, housing would lose its relative advantage over other forms of investment. The switch to a consumption tax

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[19]If the consumption tax is a replacement for part of the income tax, however, there may be decreases in the prices of investment goods that would produce an offsetting effect and further reduce the likelihood of price increases.

[20]See, for example, Alan Auerbach and Laurence Kotlikoff, *Dynamic Fiscal Policy*, Cambridge University Press, 1987, and David Bradford "Consumption Tax Alternatives: Implementation and Transition Issues," paper at Hoover Institution Conference, May 11, 1995.

[21]See Andrew Lyon, "The Effect of the Investment Tax Credit on the Value of the Firm," *Journal of Public Economics*, 38 (1988), pp.227-247.

would affect housing most directly through the repeal of the mortgage interest deduction and corresponding elimination of the tax on interest income. Consequently, the cost of both debt and equity capital invested in housing would increase.[22] The loss of preferential treatment means that the consumption benefits from housing would rise relative to the returns from other investment. This would lower the price of existing housing and substantially reduce the number of new homes that are built.[23] In the absence of special transition rules or a continuation of tax preferences, housing values could fall considerably in the short run. Over time, the housing stock would be expected to decline, and the resulting scarcity of homes would push the prices of existing houses back towards their initial level.

Economic efficiency

1. Allocation of capital.

Because a consumption tax does not tax the return to new investment and treats all businesses uniformly, it would not favor some assets or industries over others. Unlike the current U.S. income tax, it would not favor non-corporate over corporate investment or investments in capital owned by State and local governments, owner-occupied housing, consumer durables, and other personal assets over business investments. As a consequence, investors would be encouraged to hold assets that were expected to produce the highest economic returns. Investment would be expected to shift out of the sectors that enjoy favor under the income tax -- owner-occupied housing, other personal assets, and noncorporate and State and local capital -- and into corporate capital. In addition, a consumption tax, unlike the current income tax, would not favor corporate debt over equity financing, reducing tax considerations from business financial decisions.

The resulting gains in economic efficiency are substantially reduced if the replacement consumption tax departs from a very broad base. However, such departures may be desired for a number of reasons. For example, most countries attempt to reduce the number of taxpayers in the system by exempting small businesses from the VAT. Some industries, such as banking and insurance, are typically excluded from the VAT because their tax bases are difficult to define. Some forms of capital, such as owner-occupied housing, might be given a preference to support social and economic goals. Each such exemption reduces the efficiency and simplification benefits attributable to the uniform treatment of capital.

2. Taxation of existing wealth.

Economic analyses show that much of the gain in economic efficiency predicted to result from a switch to a consumption tax arises from the taxation of wealth in place at the time of transition to the new tax. Saving and investment that take place after the imposition of a consumption tax will be exempt from tax, but consumption out of existing wealth will be taxed, unless provisions are made to relieve this burden explicitly. Economists believe that a tax on existing wealth will not distort taxpayer behavior. Therefore, collecting revenue through this non-distorting tax will allow lower tax rates on the remainder of the consumption tax base, significantly increasing economic efficiency. Nevertheless, a full or partial exemption for existing wealth might be desired to prevent savings that had been taxed under the income tax from being taxed a second time under the consumption tax. An exemption for all existing wealth would effectively convert the consumption tax to a tax on wage income alone, however, requiring higher tax rates on wages to compensate for the lost revenue.[24] Consequently, allowing a full exemption for existing wealth under a new consumption tax will substantially

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[22] A similar conclusion is drawn in Joint Committee on Taxation, *Descriptions and Analysis of Proposals to Replace the Income Tax*, 1995, U.S. Government Printing Office, p. 86.

[23] The decline in housing prices would be proportionately greater for high-priced homes than for low-priced homes. The owners of high-priced homes are typically in high tax brackets, making the mortgage interest deduction relatively more valuable to them, while the owners of low-priced homes may be in low brackets or may be non-itemizers.

[24] A consumption tax with an exemption for existing wealth would be levied not only on wages, but would also collect revenue on profits that reflect "economic rents," for example, profits resulting from the ownership of a monopoly.

reduce, and could entirely eliminate, the gains in economic efficiency that many economists expect from the switch.[25]

3. Labor supply.

Both an income tax and a consumption tax affect the choice between work and leisure by reducing the relative purchasing power of wages. An income tax reduces the relative value of wages by taxing them directly. A consumption tax that is collected from businesses reduces the value of wages to the extent that the business tax is passed forward to consumers in the form of higher prices or back to workers in the form of lower wages.[26]

The effect on labor supply of switching to a consumption tax depends on changes in effective tax rates. Effective tax rates reflect the combined effects of the statutory rate structure and other tax proposal provisions, such as denying deductions for wages and employee fringe benefits at the business level and retaining payroll taxes. Examining the proposed statutory rate structure alone would overstate the possible decline in tax rates and the increase in work incentives.

4. Consumption-saving choice.

One source of economic inefficiency under an income tax is the distortion the tax imposes on a consumer's choice of how much to save. Because an income tax is imposed on the return to savings, it effectively increases the "price" of consumption in the future in terms of consumption foregone today. That is, under an income tax, a consumer must deposit more money in the bank today to finance a given amount of spending in the future than would be required in the absence of the income tax. Economic theory suggests that this increase in the price of future consumption reduces consumers' incentive to save. A consumption tax, which does not tax the return to savings, does not increase the price of future consumption relative to current consumption. A consumption tax is, therefore, neutral with respect to the consumer's choice of how much to save. As I stated earlier in my testimony, however, while economic theory suggests that individuals might increase saving in response to the higher return to saving resulting from the switch to a consumption tax, most empirical studies find that the effect of increasing the rate of return on the level of saving would be quite small.

International trade

It is sometimes argued that, because indirect taxes can be imposed on imports and refunded on exports, the adoption of a VAT or other indirect consumption tax to replace part or all of our current income taxes would encourage U.S. exports. However, trade economists generally agree that such a tax change would not permanently improve either U.S. exports or the U.S. trade balance.[27]

To see how a refund or exemption for exports under a consumption tax and the imposition of the tax on imports (called border tax adjustments), in fact, amount to neither a subsidy for domestic exports nor a penalty on imported goods, consider a very simple example. Imagine that both New York and New Jersey produce apples for consumption within the state and for "export" to neighboring states. Assume a competitive market for apples sets the price per bushel at $5.00. Now imagine that New York adopts a broad-based, 10 percent VAT that exempts exports and is imposed on imports. The price of apples produced and bought in New York would be expected to rise to $5.50. Since the New Jersey apples that are trucked into New York are subject to the 10 percent VAT, they would also sell for $5.50 per bushel. Imports into New York would, therefore, not be penalized relative to domestic produce. Over

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[25]For a discussion of the relative economic benefits of a consumption tax, wage tax, and income tax, see Alan Auerbach and Laurence Kotlikoff, *Dynamic Fiscal Policy*, Cambridge University Press, 1987.

[26]See U.S. Congressional Budget Office, *Effects of Adopting a Value-Added Tax*, U.S. Congressional Budget Office, 1992, p. 57.

[27]See U.S. Congressional Budget Office, *Effects of Adopting a Value-Added Tax*, U.S. Congressional Budget Office, 1992, p. 63. A similar conclusion is drawn in Joint Committee on Taxation, *Description and Analysis of Proposals to Replace the Federal Income Tax*, U.S. Government Printing Office, 1995, pp. 69-70.

the border, New Jersey apples would still sell for $5.00 per bushel, as would imported New York apples that are exempt from New York's VAT. The exemption for exports, therefore, results in no subsidy for New York's exports.[28]

While adopting a consumption tax with border tax adjustments is generally considered to have no long-run effect on the balance of trade, eliminating or substantially reducing income taxes could affect the trade balance, because income taxes may discourage both saving by U.S. residents and investment in the United States, and lowering U.S. income taxes could affect private saving and investment by differing and uncertain amounts. If private saving increased more than investment, the United States would import less capital and net exports would increase; if investment increased more than private saving, net exports would decline. Which effect would dominate depends on the specific form of the income tax cut and on the relative responsiveness of saving and investment.

Eliminating or reducing U.S. income taxes could also affect the relative competitiveness of different industries, because the income tax imposes different effective tax rates on production in different economic sectors. For example, reducing the cost of capital in the United States would generally favor the production of capital-intensive goods over labor-intensive goods. This differential benefit would affect the composition of trade, because goods that became relatively more expensive to produce in the United States would be increasingly imported, and goods that became relatively inexpensive to produce at home would be increasingly exported. However, there is little reason to believe that the net trade balance would be much affected by this change in relative trade positions.[29]

Although border tax adjustments under a consumption tax are generally considered to have no long-run affect on the balance of trade, it should be noted that some types of consumption taxes are accepted as border-adjustable under the General Agreement on Tariffs and Trade (GATT), and others are not. Indirect taxes, such as credit-invoice VATs used in most other countries, are border-adjustable under the GATT. Consumption taxes collected wholly or in part from individuals, such as a consumed income tax and a flat-rate tax of the type proposed by Representative Armey and Senator Specter, are unlikely to be refundable under the GATT. Although a broad-based, single-rate subtraction method VAT is economically equivalent to a similarly broad-based credit-invoice VAT, a GATT ruling would consider other factors. Whether a subtraction method VAT would survive a GATT challenge is an untested issue.[30,31]

Sector-specific issues of adopting a consumption tax[32]

Special treatment may be appropriate for specific business sectors under those forms of tax that are collected at least in part from businesses. High administrative and compliance costs relative to revenue collected may justify special treatment for certain sectors and for small businesses. Special rules are required for taxing goods and services with hard-to-measure tax

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[28]It is not necessary to have border tax adjustments to obtain this result. If the market price for apples is $5.00, it will not be possible for producers to increase the price charged or lower the price and remain in business. Labor will bear the burden of the tax through a fall in wages and there will be no effect on trade between New York and New Jersey. In the international context, it is also possible for the currency of the country that imposed the tax to depreciate, offsetting the effect of the tax on the exported good.

[29]The Joint Committee on Taxation finds that replacing part or all of the corporate income tax with a VAT does not directly affect the U.S. trade balance. See Joint Committee on Taxation, *Factors Affecting the Competitiveness of the United States*, U.S. Government Printing Office, 1991, pp. 303-4.

[30]These points are discussed in more detail in Joint Committee on Taxation, *Factors Affecting the Competitiveness of the United States*, U.S. Government Printing Office, 1991, pp. 302-4, and U.S. Congressional Budget Office, *Effects of Adopting a Value-Added Tax*, U.S. Congressional Budget Office, 1992, pp. 63-4.

[31]The Treasury Department responded on February 3, 1995, to a query by Senators Nunn and Domenici on this issue.

[32]These issues are discussed in detail in Joint Committee on Taxation, *Factors Affecting the Competitiveness of the United States*, U.S. Congressional Budget Office, 1991, pp. 314-20, and U.S. Congressional Budget Office, *Effects of Adopting a Value-Added Tax*, U.S. Congressional Budget Office, 1992, pp. 26-30.

bases, such as financial services.[33] The tax base for these services is not explicitly separated from other charges, and it is difficult to apportion the benefit from financial services to those who receive them. For example, the charge for intermediation services provided by banks is included in the difference between the interest rates charged to borrowers and paid on deposits. That difference also includes the return to equity-holders. Moreover, it is difficult to allocate the intermediation charge to a specific savings account or loan.

While the current version of the Armey and Specter proposals contain no special rules for the treatment of financial institutions, the Nunn-Domenici plan would tax banks and insurance companies under a separate set of rules from those applied to non-financial businesses.[34]

Taxing governments and non-profit organizations is difficult because there often is no market price for their production and many are currently not subject to tax. Most countries with VATs attempt to tax the commercial operations of this sector, but this approach requires differentiating between taxable and non-taxable activities which can be administratively complex. While special treatment for specific sectors might ease administration of a consumption tax, exclusions from the tax base would increase economic distortions relative to a very broad-based consumption tax. The business tax portions of the Nunn-Domenici proposal would generally include the commercial activities of governments and many currently non-taxable non-profit organizations in the tax system.

Taxation of housing and consumer durables also raises important issues. To minimize economic distortions, rental housing, owner-occupied housing, and other durable goods should be treated similarly. When businesses are allowed to expense capital purchases, purchases of buildings or durables for use as rentals would be deductible, and rental receipts would be taxed. However, the same theoretical treatment of owner-occupied housing and durable goods would require taxing the total purchase price, which reflects the current value of the services the home or durable good provides over its useful life.[35] This approach can lead to significant tax bills for buyers and windfall gains for current owners, who would not owe tax on the consumption of their existing housing or durable good.

Many consumption tax proposals assume that exports will be relieved of the tax and imports will be taxed. Making the appropriate adjustments can be difficult if the tax base is not broad or if tax rates vary. Border adjustments for certain services also create complexity, because it is generally more difficult to determine the location of supply or purchase in the case of non-tangible services than for goods.

Simplicity

Simplification of the tax system is a primary goal of many tax reform proposals, and one which we support. A simpler tax system would have lower compliance costs for individuals and businesses, such as the costs related to learning the tax rules, recordkeeping, and preparing tax returns, and lower administrative costs for the government, such as the costs of processing tax returns and conducting audits.

To evaluate reform proposals on the basis of simplification, however, it is useful to examine the sources of the complexity that plagues our current system. One source of complexity, the measurement of capital income, would be reduced under some forms of consumption tax. Three other sources of complexity, the desire to distribute the tax burden equitably, the necessity to measure the consumption component of business income properly, and

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[33] For a discussion of the difficulties related to taxing insurance and other financial services under a VAT, see Joint Committee on Taxation, *Factors Affecting the Competitiveness of the United States*, U.S. Government Printing Office, 1991, pp. 315-18.

[34] This is less of a problem under two-part consumption taxes like the Armey and Specter proposals than under other forms of consumption taxes, because the portion of value-added generated within the financial services sector by labor would be captured under the wage tax. Only the portion of value-added generated by capital would be lost.

[35] See U.S. Congressional Budget Office, *Effects of Adopting a Value-Added Tax*, U.S. Congressional Budget Office, 1992, pp. 28-9.

the use of the tax system to advance certain non-tax social and economic policies, would likely persist under any consumption tax. If a consumption tax were implemented in the United States, the final form of the tax would likely differ from the ideal for these same reasons. Divergence from the simple, broad-based, flat-rate, consumption tax model -- for whatever reason -- will tend to lead to complexity, with higher administrative and compliance costs, higher tax rates overall, and reduced efficiency gains.

Correctly measuring capital income is difficult, and approximations designed to reduce that complexity can invite tax avoidance and an inefficient use of economic resources. Therefore, one of the attractions of a consumption tax is that many of the onerous calculations related to capital income would be eliminated, and no tax would be owed on interest, dividends, and capital gains. Under a RST, capital purchases by businesses and capital income are excluded. Under a consumption tax levied at the business level, such as Representative Gibbon's VAT or the business tax portions of the Armey and Nunn-Domenici proposals, depreciation and other cost-recovery provisions would be replaced with expensing. Administrative and compliance costs would be reduced, since it would not be necessary to maintain records on asset costs in order to compute cost-recovery allowances and gains on the sale of assets.

Unlike the existing income tax, however, a consumed income tax collected from individuals would require the measurement of annual changes in wealth. As suggested earlier in this testimony, a consumed income tax system like the Nunn-Domenici individual level tax could, therefore, be at least as complex as the current system, posing numerous new taxpayer reporting requirements and introducing new tax concepts and calculations. Compliance costs are likely to be significant for individuals who must report their net savings, particularly for taxpayers that both borrow and save and roll over prior savings into new accounts, and for the banks, mutual funds and other businesses that would be required to provide reports on investment and borrowing activities of individuals. Under one approach to a consumed income tax, proceeds from all forms of borrowing -- whether through a loan or a balance carried over to the next year on a credit card -- would be added to a family's tax base. The net contribution to all forms of savings would be deducted from the tax base and withdrawals from savings would be taxed. It might not be complicated to calculate tax liability under this approach for a family that borrowed no money during the year, had no end-of-the-year credit card balance, and only made contributions to a passbook savings account. But in the modern U.S. economy, even a moderate-income family might in a typical year purchase deductible mutual fund shares through a dividend reinvestment plan, sell a taxable bond, and carry taxable balances on several credit cards. Some proposals might not require families to pay tax on some minimum amount of borrowing, such as under the Nunn-Domenici proposal, or might allow tax-free withdrawals from savings in cases of hardship, but these modifications would require complex rules to determine eligibility for exemptions and to prevent tax avoidance.

Distribution of the tax burden

Most of the mechanisms available under a consumption tax for minimizing the regressivity of the tax introduce complexities and their resultant costs. Exempting certain goods and services from a national RST or VAT and taxing others at alternate rates increases the compliance burden on businesses that would have to determine which rates to charge for their products and, in some cases, would be required to apportion their deductible costs among taxable and non-taxable sales. To make up the revenue loss from reducing tax on some goods and services, tax rates on the remaining goods and services would have to be raised. None of the proposals discussed in this testimony exempt specific goods and services, though State retail sales taxes in the United States and VATs in most OECD countries do use this approach.

A tax that is collected wholly or in part from individuals can be applied at graduated tax rates, which would complicate the tax slightly: it is not much more difficult for taxpayers to look up their tax liability on a table -- as they do now -- than it would be for them to apply a single rate to all taxable income. In the case of a two-part consumption tax, like the Armey proposal, ensuring that the same top statutory rate applies to both individuals and businesses would lower administration and compliance costs by enabling taxes on some forms of income to be collected wholly from businesses.

Many consumption tax proposals, such as those of Gibbons, Armey, and Nunn and Domenici, offer large standard deductions and exemptions for dependents in order to relieve

some income from tax and to remove large numbers of people from the tax system altogether. The latter benefit is reduced, however, if refundable tax credits -- like the EITC -- are used to minimize the burden of the tax, as is done in some proposals. Low-income families that otherwise might not be required to file a tax return would have to fill out a return in order to receive the credit. So that credits can be targeted to needy households, a family might be required to calculate income, which it otherwise would not have to report under some forms of a consumption tax. The relative increase in administrative and compliance burdens of offering refundable credits might be small in the case of a consumed income tax, under which much of the income tax structure would be retained. The relative burden would be more significant, however, if the income tax had been completely replaced by a business-level consumption tax.

Measuring consumption

Like the existing income tax, a consumption tax that is collected from businesses, such as a VAT or two-part flat tax, would require rules for determining deductible business costs. Some business purchases have a consumption component that should be excluded from deductible business purchases. For example, a business' purchase of a company car that is also available for an employee's personal use has a consumption component, as do many business expenditures for travel and entertainment. The rules for determining allowable costs under a consumption tax would be similarly complex to the related rules under the income tax. Moreover, the timing of deductions for capital purchases would make the problem more serious under a consumption tax. Under a consumption tax, business assets would be expensed, accelerating the benefit received by the taxpayer -- and tax revenue lost to the government-- from circumventing the rules.

Promoting social and economic goals

A U.S. consumption tax is likely to be used to advance certain widely-held social and economic goals. To the extent that these goals are promoted through the tax system, administrative and compliance costs are increased under a consumption tax as they are now under the current income tax system. Home-ownership is treated preferentially under the current income tax primarily by allowing families a deduction for interest they paid on their home mortgages. Allowing current law treatment of mortgage interest under a consumption tax would encourage homeowners to incur additional borrowing beyond their financing needs. Because mortgage loan proceeds under current law are not included in taxable income, while the amounts deposited in a savings account under a consumption tax would be deductible, mortgage loans used to transfer money to a savings account would reduce tax liability. In addition, allowing only some forms of loans to be exempt, such as under the Nunn-Domenici proposal, would introduce complexity and distortions relative to a system that treated all borrowing equally. As under the existing income tax, taxpayers would have an incentive to reclassify all forms of household debt as mortgage debt to maximize the benefit of the tax preference.

Deductions for charitable contributions and State and local taxes paid could be allowed for families under a consumed income tax and for wage-earners and businesses under a two-part consumption tax. A tax preference for employer purchases of health insurance and fringe benefits could be provided under a two-part consumption tax by allowing businesses to deduct these costs. Under an individual-level consumption tax, employer-provided health insurance and other fringe benefits could be taxed by imputing their value to the recipients and including the imputed value in taxable income; not imputing the value to recipients would treat these benefits preferentially relative to other forms of compensation. Each of these tax preferences, however, would require rules to determine which fringe benefits are included in or excluded from the tax base, and these rules would be equally complex as those under current law. Rules would also be required to determine which business expenses to include or exclude from the tax base. The Armey and Specter proposals would disallow deductions for state and local taxes, and the employer portion of the FICA tax. The Nunn-Domenici proposal also would disallow those deductions, but would permit a credit for the employer portion of the payroll tax.

The underground economy

The underground economy consists of illegal activities and those which are "informal," but not illegal. A suggested benefit of a consumption tax system is that it may promote greater compliance with the tax laws from those presently operating in the underground economy. Some

commentators have suggested that a consumption tax collected at the business level would enable tax to be imposed on income of the underground economy, particularly the informal sector, that is untaxed under the current individual income tax.

This benefit may easily be overstated. The reporting of income and sales from illegal activities, such as sales of illegal drugs, is unlikely to be affected by changes in the tax system. Incentives for not reporting income or sales from informal activities are likely to be similar under an individual income tax or a business-level consumption tax. For example, an electrician who does not pay income tax can charge a lower price, just as an electrician who does not collect a national RST or VAT for his services. Since income and sales from purchases of goods and services in the legal sector by the underground economy, such as the electrician's tools and supplies, are taxable now, it is unclear whether additional revenues would be obtained from this source by switching to a consumption tax.

Coordination with State and local sales taxes

An additional administrative consideration is the coordination of a Federal consumption tax with State and local government tax systems. Historically, States have depended heavily on retail sales taxes and excise taxes for revenues.[36] The adoption of a national sales tax or Federal VAT is likely to be seen as an infringement upon this important revenue source for State and local governments. In addition, a Federal VAT or national sales tax would create a new type of tax for businesses to administer. Some businesses would be responsible for either the VAT (or national RST) or a State sales tax, while others would be liable for both. The amount of State sales tax or VAT (or national RST) collected would depend on which tax was applied first and whether that tax was included in the tax base for the other one. Particular goods and services might be taxable under a VAT (or national RST) and exempted under the State sales tax, or vice versa, thereby creating additional administrative and compliance problems. Although sales taxes are generally under the purview of the States, the closeness of the tax bases would put the States under pressure to conform to Federal law.

Transition to a consumption tax and the tax on existing wealth

The most significant issue in converting from an income to a consumption tax system is deciding how to treat the return to wealth that was accumulated out of after-tax income under the income tax. The return to new saving and investment would be exempt under a consumption tax, but without an explicit exemption for old wealth, the return to and withdrawals from the stock of existing assets that are not reinvested will be taxed. For example, imposing a Federal VAT would automatically tax all withdrawals from existing savings that are used for consumption -- even if those savings were accumulated out of after-tax income. A full or partial exemption for current wealth might be desired to relieve the tax burden on individuals with accumulated savings, many of whom are elderly. But such an exemption would reduce the taxes paid by the holders of wealth, making the tax less progressive. In addition, economists believe that a tax on existing wealth would not distort taxpayer behavior, and that this non-distorting wealth tax is the source of much of the gain in economic efficiency predicted to result from a switch to a consumption tax. Consequently, an exemption for all existing wealth would effectively convert the tax into a tax on wage income alone, requiring higher tax rates on wages. The effect would be to reduce significantly, and possibly completely eliminate, the gains in economic efficiency that some economists expect from a consumption tax.[37]

To illustrate the magnitude of this problem, consider the value of current household wealth. The total wealth of U.S. households is estimated at about $23 trillion.[38] Much of this wealth is in the form of assets, such as pensions and unrealized capital gains, which have not yet been taxed. Excluding housing, the basis of private assets in the United States could be as much as $10 trillion. Rules governing the treatment of consumption financed by existing wealth

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[36]See Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism, Volume 2*, Washington, DC, 1994, Table 31, p.4.

[37]For a discussion of the relative economic benefits of a consumption tax, wage tax, and income tax, see Alan Auerbach and Laurence Kotlikoff, *Dynamic Fiscal Policy*, Cambridge University Press, 1987.

[38]Board of Governors of the Federal Reserve System, *Balance Sheets of U.S. Households*.

during the period of transition to the new tax will determine to what extent this significant amount of previously taxed savings is subject to the consumption tax. In this case, transition rules are not merely an inconsequential technical issue; how existing wealth is treated during the transition could have material economic effects.

Transition rules could be designed to relieve completely the tax burden on savers who have already paid income taxes on their savings and would otherwise be taxed again when those savings were spent under a consumed income tax. For example, without a transition rule for past savings, a retiree who accumulated $100,000 in a savings account out of after-tax income before the imposition of a consumption tax would be taxed on withdrawals from that account that are for consumption expenditures. A transition rule could allow savings that were accumulated under the income tax to be segregated from "new" savings and deducted from income. This rule would treat the $100,000 as tax-paid savings and would enable the retiree to make tax-free withdrawals from the savings account. It is difficult, however, to design rules that differentiate between individuals who reduce their accumulated savings in order to consume, and individuals who only rearrange assets among accounts. Allowing tax-free withdrawals from past savings, for example, would enable any individual with accumulated wealth to gain a tax deduction simply by transferring old assets into "new" savings accounts. Such a rule would enable a millionaire living off the interest on her accumulated assets, for example, to receive the equivalent of tax-free interest income -- a substantial benefit compared with current law.[39] The Nunn-Domenici plan includes detailed rules that would prevent the taxation of most previously-taxed savings while prohibiting taxpayers from generating savings deductions out of existing savings. While these rules would largely prevent the imposition of unfair burdens on elderly households, they would add to the complexity and costs of the tax system and would result in lower economic benefits than if the return to accumulated assets were subject to tax.

A similar problem exists for businesses that have purchased equipment prior to the tax change and have unused depreciation allowances. Denying depreciation deductions under the consumption tax would mean that businesses would not be able to recover fully the cost of those capital purchases, and that income from capital purchased before the effective date would be overtaxed. It would impose windfall losses on firms that invested prior to the effective date, placing them at a disadvantage relative to businesses that purchased equipment just after the effective date of the new consumption tax.

Transition rules could reduce windfall losses in this case, but they would likely sacrifice tax revenue and lead to greater complexity. For example, if the consumption tax is collected only at the business level, businesses could be allowed to deduct immediately the balance of their depreciation allowances, though little revenue would be collected from businesses during the early years of the tax under this scheme. Extending the depreciation deductions over a number of years, an approach taken by the Nunn-Domenici plan, would spread out the revenue loss, but it would require businesses to segregate old and new assets during the transition period and, therefore, would increase complexity.

Conclusion

A change as dramatic as replacing the income tax system with a consumption tax should only be attempted if the expected economic benefits of taxing consumption are reasonably certain to be larger than the total costs, burdens, and risks of moving to a completely new tax system. In making such a determination, it is misleading to compare a theoretically ideal consumption tax and the income tax system in place today. A realistic comparison would recognize that exclusions would likely be made under the replacement system -- either for administrative reasons or to support social and economic goals -- and that those exclusions would reduce the economic benefits of the change and increase complexity. A realistic comparison would also recognize that what we call an income tax in the United States is really a hybrid tax system. While it is based on income, it incorporates a number of consumption tax features that help

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[39]Under a transition rule that treats withdrawals from existing savings that are deposited into new savings accounts as new savings, an individual could draw down existing savings, deposit the amount in a new savings vehicle, and receive a tax deduction for the amount deposited. If the return to this "new" savings is used for consumption, the individual would pay tax on that return. But the original tax deduction would provide a benefit that would be equivalent to receiving the interest income tax-free. For an illustration of this result, see the example in the "Background" section of the testimony.

promote saving. For example, contributions to pensions, deductible IRAs, and other types of retirement savings are deducted from taxable income, and the earnings on these savings are not taxed until they are withdrawn. Most of the savings of middle-income Americans are in assets such as pensions and home equity that are already exempt from tax. Proposals for further reduction in taxes on income from savings of middle-income Americans, such as the proposal in the President's budget to expand the use of IRAs, should be carefully examined before we consider doing away with the income tax.

Based on all of the considerations described in my testimony today, we are not convinced that the case for completely replacing the income tax with a consumption tax is compelling. The most frequently cited economic benefit of such a change, an increase in private saving, is uncertain and could be small. The fairness of replacing the income tax with a consumption tax is also a concern. Moving to a flat-rate consumption tax would increase the tax burden on low-income families and lower the tax burden on high-income families. Efforts to improve the progressivity of consumption tax proposals result in complexity. In addition, the effect of switching to a consumption tax on wage and price levels, interest rates, and value of existing assets -- including homes -- is uncertain.

In general, divergence from the simple, broad-based, flat-rate, consumption tax model -- for administrative reasons, to address distributional problems, or to promote social and economic goals -- will result in more complicated tax calculations, higher tax rates overall, and reduced efficiency gains. In addition, the transition could take many years to complete, and could be very costly and complex. Absent special transition rules, the move to a consumption tax could create many unintended winners and losers. New savers would be advantaged relative to those who saved in the past, including many of the elderly. Businesses that invest after enactment of the consumption tax would have a competitive advantage over businesses that invested just prior to the change. Rules could be designed to address these situations, but they would be complex and could lead to significant reductions in the economic benefits expected from a switch to a consumption tax.

We commend efforts to develop consumption tax proposals that are progressive and revenue-neutral. We recognize that the details of some of the recent tax reform proposals have not yet been provided, and that the details will affect the analysis of any particular proposal. However, we believe that completely replacing the income tax with a consumption tax ultimately could be excessively complex and could create economic disruption. Moreover, while there has been substantial international experience with credit-invoice VATs and broad familiarity within the United States with State retail sales taxes, adopting a form of consumption tax other than a credit-invoice VAT or national RST would be venturing into the unknown. We can only speculate as to how a consumption tax collected at the individual taxpayer level would work. There is no experience upon which to gauge its effects on the U.S. economy or its administrative and compliance costs, and no way to anticipate all the potential tax avoidance schemes that could be designed to exploit the new tax rules.

Other countries have typically introduced consumption taxes, not as replacements for progressive income taxes, but in place of existing distorting sales or turnover taxes. Most of our trading partners now rely on a mixed tax system that combines income and consumption taxes. Consequently, a wholesale replacement of the income tax with a consumption tax would represent a grand international experiment. The burden lies with the proponents of consumption taxes to show that it is worthwhile to conduct this experiment on the world's largest and most complex economy.

Mr. Chairman, the Administration is keenly aware of growing taxpayer frustration with the complexity of the income tax system, and we think that greater weight should be given to simplification in evaluating tax reform proposals than has been given in the past. A simpler tax system would have lower compliance costs for individuals and businesses and lower administrative costs for the government. Moreover, while the debate is in process, simplification should be given greater weight in evaluating any changes to our existing tax law. In this regard, we note that last year's House of Representatives passed H.R. 3419, the Simplification and Technical Corrections Act of 1994. We urge the Committee to consider this legislation again on an expedited basis. We look forward to working with the Congress on these and other initiatives to improve our tax system. While continuing to work to improve our current income tax, we will give serious consideration to broader reform proposals that meet the tax policy objectives set forth above -- proposals that would simplify the tax system and improve economic incentives without sacrificing revenue or fairness.

Chairman ARCHER. Thank you, Mr. Secretary. Obviously there are going to be many questions and colloquies with you by Members of the Committee. I would like to commence just by asking you, for the purpose of establishing a predicate of the discussion on your charts, are the distributional tables that you use as the basis of these charts based on the old family economic income distributional concept that was discarded by the Joint Committee in the last Congress as being inappropriate, such as the imputing of income for the ownership of one's home and a number of other arbitrary and subjective numbers?

Or have you changed it in the way that the Joint Tax Committee, under the previous Majority, in the last year changed theirs?

Mr. SAMUELS. Mr. Chairman, the distributional analysis has been done according to the traditional method that Treasury has used since the end of the Ford administration, which includes family economic income.

Chairman ARCHER. So the answer is that you have not changed your standard, whereas the Joint Committee, under the previous Majority, in the last Congress, recognized that it was inaccurate and changed it.

Yours is the same, correct?

Mr. TODER. Our standard is the same, Mr. Chairman.

Chairman ARCHER. OK. Thank you very much.

Now, have you considered the impact of reduction in interest rates and increased value of the dollar in benefiting every American in the determination of these comparisons in these charts?

For example, if one who wishes to buy a home, particularly a first-time home purchaser, is able to buy that home at interest rates that are 1 or 2 percent lower over the long term, isn't that a massive reduction in the price of that home? And have you taken any of that into account?

Mr. SAMUELS. Mr. Chairman, let me just say that the economic benefits that are discussed in the context of moving to a consumption tax as set forth in our testimony are uncertain. So we have not taken any economic benefits or detriments, because there will be—there are possibilities of significant changes, as I said, in wages, prices, and asset values; and we haven't taken those into account either way. Either way, we haven't taken them into account, because I don't think at this point there is on—there can be a reasonable prediction as to what those might be.

Mr. TODER. Let me just add, we believe that interest rates are set primarily on the world economy, and it is very unlikely that interest rates would fall very much. Americans would still be taxed the same on their interest at home and overseas, and foreign lenders would still not be basically taxed on the interest they receive from lending to the United States.

The consequence, we believe, is that aftertax interest costs of housing would rise significantly from changing to a consumption tax, and that the value of existing housing equity would fall substantially.

Chairman ARCHER. Well, I sort of operate off of the basis of what my colleague from Georgia says is common sense, and maybe that doesn't fit into the ivory tower. But common sense tells me that if you have zero tax on savings, you are going to have more savings.

If you have more savings, interest rates are going to go down. If you don't tax income production in the United States to foreign investments, more money is going to flood into the United States, which will increase the amount of savings and investment capital in the United States. And I think, if I am not incorrect, that money, as you say, on a worldwide basis is a fungible commodity, and that is going to relate directly to market forces. And if you have more savings coming into the United States, more demand, more interest in people putting them in here, the price of money is going to go down in the United States.

Now, maybe that is too common sense for an ivory tower, but it seems pretty clear to me that interest rates are going to go down dramatically if you can convert to a consumption tax; and then, in addition, as Mr. Gibbons has articulated so well over the years, if you can remove the price of government as an expense of a product and thereby reduce its price in the world marketplace, you are going to sell more American products, which in turn is going to give you a lower trade deficit, which in turn is going to stabilize the value of the dollar and give people more purchasing power for their dollars in the United States.

Now, that is not ivory tower; that is just kind of the Archer rule of common sense. The important point is, whether I am right or whether I am wrong, that is not being considered in these charts.

Now, finally let me ask you this, Mr. Samuels. I appreciate your support of our effort to get into this evaluation of the current system and what we might do to replace it, and we welcome you aboard in that process.

I am curious as to when you will have a proposal for us that we can look at as to what you think is the appropriate way to replace the current Income Tax Code.

Mr. SAMUELS. Mr. Chairman, we are evaluating these proposals that have been made, and we are also evaluating how one might change the existing system to make it better, and that is the process that we are going through.

In looking at the proposals that are on the table, one of the interesting things to me in considering them is that they are all idealized proposals. I actually haven't kind of thought about them as being ivory tower; I have kind of talked to my colleagues when they explained them to me as kind of being on another planet, because they assume an idealized system; and I think that—as a practical person, I don't think they will ever actually be adopted through the political system.

For example, the idealized consumption tax system assumes, as I mentioned in my testimony, in obtaining the efficiencies that people hope to get out of them, that there will be a tax on existing wealth in the transition; and I think that would be a very hard objective to obtain in designing a practical system, and I think that is a serious problem.

So what we are trying to do is evaluate all of these proposals, understand where the real pitfalls are. This is like peeling an onion, there are whole layers of issues, and we think at the end of the day, based on what we know, that the proponents of these have a very high burden that the projected benefits will, in fact, occur. And so, therefore, we think that at the same time we should be

carefully and seriously looking at what we can do to our existing system to make it simpler and easier for taxpayers; and so that is what we are doing.

Chairman ARCHER. I am not sure what your answer is to my question. My question is, When will you have a proposal that we can look at in comparison to these other proposals?

Mr. SAMUELS. Mr. Chairman, at this point we aren't making a proposal. What we are saying is that we have looked at these proposals and consumption taxes—proposals to replace the entire income tax with a consumption tax, and we see very serious questions that need to be answered. So we are not in the position to propose a new system that would completely replace the income tax, and we think that you should be making comparisons and evaluating these, and hopefully, out of this debate will emerge a consensus about how to make our existing system simpler and easier for taxpayers to understand, while maintaining fairness and raising the same amount of money; and we think that is the way the process should move forward.

Chairman ARCHER. Well, it seems very difficult to get a precise answer from you, but I will say that we are not just considering consumption taxes. We are considering a flat tax. The proposal that Congressman Armey has made, and a number of other proposals, and we would welcome——

Mr. SAMUELS. Mr. Chairman——

Chairman ARCHER. We would welcome a proposal from the administration. You have tremendous resources through the IRS and through your own Treasury Department, resources that are of a far greater magnitude than we have up here at the Congress. And inasmuch as you applaud this effort and you think something should be done, we would like to have your proposal in the mix so that we can look at it.

And so I will ask you again, will you submit a proposal, and, if so, when?

Mr. SAMUELS. Mr. Chairman, we are looking at these proposals; we have spent a great deal of time—I am sure you can tell by reading our testimony—in listing the criteria by which these consumption tax proposals should be evaluated.

I would add, the Armey flat tax proposal is a consumption tax. When you talk to the economists through your hearings, if you ask them, they will tell you it is a consumption tax proposal.

We think that the right way to go through this process is to evaluate variations of the proposals and try to understand how they might come out of the political process and compare it to our existing system as it might be improved.

Chairman ARCHER. I know. You have said that. You have said that several times. But do you not have any original ideas of your own?

Mr. SAMUELS. Mr. Chairman, I think if you read our testimony, you will see that we have spent a great deal of time analyzing the proposals to try to make sure that everyone understands what the problems are.

Chairman ARCHER. That is still not responsive to my question. You are talking about analyzing other people's proposals. I am ask-

ing you whether you have an original proposal of your own and when we might be able to receive it?

Mr. SAMUELS. Mr. Chairman, over the years, the Treasury Department has set forth analytical frameworks for all of the proposals that this Committee is discussing today. The Treasury Department in 1977 put out an analysis of proposals; in 1984 the Treasury Department put out analytical proposals. I don't think that we are scratching around for some ideas that haven't been thought of before. I think if you talked to the people who have been doing the research on the tax system and alternative tax systems, that you will see variations on the theme and the pros and cons of the variations, and that is what we are suggesting.

Chairman ARCHER. But which ones do you support? Let me see if I can get at this in a different way, because I am not getting a responsive answer to my question. I am getting the continued response of, well, we want to examine all of the various alternatives that have been submitted by somebody else, that we have a framework whereby we can evaluate those, and I really, I really, hope in fairness you will not respond that way to me again, because I would like something a little more precise. So let me try another way to get at it.

If we had no tax system today to generate the money to pay the Federal Government's bills, if we were starting from scratch, would you adopt as the best way to raise money the current Federal income tax system? That should be easily answered yes or no.

Mr. SAMUELS. The current Federal income tax system? No.

Chairman ARCHER. All right. In that event, and if you had the challenge, which is what we are accepting here today, to try to look, from scratch, at a system that would be the best for the United States for the raising of the money to pay the bills, what would it be, in your opinion; and if you don't have it for me today to answer that, could you have it for me in 1, 2, 3, or 6 months?

Mr. SAMUELS. Mr. Chairman, I think that at this point in time that you ask what is the ideal, as opposed to what in fact will actually happen——

Chairman ARCHER. No, I am asking you for a proposal to help us make something happen. And certainly you have got ideas down there; you have got all kinds of, as you say, framework and background and resources of a gigantic magnitude. Would you let us know what you think is the most appropriate way for us to raise money to pay the government's bills; and if so—and either yes or no—will you or will you not? If the answer is yes, then in what timeframe might we expect to hear from you?

Mr. SAMUELS. Mr. Chairman, we are in the position, as you can tell from our testimony, of saying that we should be analyzing——

Chairman ARCHER. No, no, no. I just said, please don't give me that answer again. Answer me specifically whether you will have a proposal for us that you believe is the appropriate way, the best way, for us to raise the revenue to pay the government's bills, yes or no; and second, if the answer is yes, in what timeframe?

Mr. SAMUELS. Mr. Chairman——

Chairman ARCHER. I mean, it is very simple. Will you or will you not have a proposal?

Mr. SAMUELS. I think that——

Chairman ARCHER. You can say "not in my lifetime, no." It is a very simple question. Either you will or you won't.

Mr. SAMUELS. I really think that it is a way of looking at this that we at this point have determined is not the path that we are going to follow.

Chairman ARCHER. So you will not have a proposal for us; you will sit on the sidelines and criticize every proposal that is introduced. Whether it be by Mr. Gibbons or by Senators Nunn and Domenici or whether it be a proposal ultimately specified by me, you will sit and you will target those and you will criticize, but you will not come forward with a proposal of your own.

Mr. SAMUELS. I don't actually think that is what we are doing. We are not going to sit by and just criticize proposals. We are going to try to tell you what the pros and cons of various proposals are, and what we think——

Chairman ARCHER. You know, I don't want to belabor this. You will not have a proposal for us. That is what you are saying; is that correct?

Mr. SAMUELS. What I have said is that—explained to you how we are going to participate in the process at this point in time.

Chairman ARCHER. No, no, no. It is a simple thing. Will you have a proposal or will you not have a proposal? It is very simple, a yes or no answer.

Mr. SAMUELS. Mr. Chairman, we are here to discuss the pros and cons of these various——

Chairman ARCHER. That is not responsive. I mean, the administration has a wonderful computer programming system that must be embedded in the minds of every Representative that appears before the Congress, and it is to pattern their answers in the way that you have patterned your answer, but it is not responsive.

Just say, no, you are not going to have one and then we can go on.

Mr. SAMUELS. But I think that that isn't really the point of this.

Chairman ARCHER. That is my question. That is the point of the question.

Mr. SAMUELS. I think that the point is that there are various ideas for how to design an income tax system. They have been around—they have been around now for quite a while, and I think it is an excellent idea to review our current system and the alternatives that have been put on the table.

Chairman ARCHER. Which one do you like?

Mr. SAMUELS. I think——

Chairman ARCHER. Which one do you support of the various alternatives? And if you don't support one of them, will you modify one and make that proposal to the Congress?

Mr. SAMUELS. I think that given the——

Chairman ARCHER. Well, clearly you are programmed not to give a definitive answer to the Congress, and I accept it. I know you are put personally in a very difficult position. But it is very, very clear that the administration has instructed you that you are not to give us a specific proposal that will be the administration's idea of how we can better raise money. So we then have to, as in Medicare—where we face the same thing—we have to move forward with our responsibility to do what is right for the people of this country.

Mr. Gibbons.

Mr. GIBBONS. Mr. Archer, I think you did an excellent job of cross-examining the witness. Maybe they could use you out in the O.J. trial.

Let me say, I have read Mr. Samuel's statement, I have discussed it with him. He gives a good analytical analysis of what the problems are. I don't necessarily agree with all of his conclusions in his statement, wherever you can find a conclusion, but I don't have any questions at this time. I would like to get on, so I can get down there and talk a little while.

Chairman ARCHER. Well, we are going to be very interested, because you at least are willing to come forward with a specific proposal and defend it.

Mr. Crane.

Mr. CRANE. Thank you, Mr. Chairman.

Mr. Secretary, you have cited three criteria that should be employed in evaluating alternatives to the existing Tax Code—namely, fairness, simplicity, and efficiency. Does the existing Tax Code, in your estimation, meet any of those criteria?

Mr. SAMUELS. Mr. Crane, I think that to start, the existing Tax Code does not meet the criteria of simplicity. I think we have got ourselves in a situation where the complexity of the Code has obviously resulted in enormous resentment and frustration among taxpayers, and we need to do something about it. So on that score, I think the simplicity criteria is not met and needs to be addressed.

With respect to fairness, I think when you look at the progressivity nature of the system, I think that—in very general terms, I think it is a fair system.

With respect to efficiency, I think that the system could be significantly improved. I think that when you look at the number of the incentives in the system, which give rise to complexity, that you have to wonder at the end of the day how much those incentives actually achieve their goal. So I think that we need—we have a lot of work to do with our existing system.

Mr. CRANE. Now, when you talk about the fairness question, you cite progressivity as evidence of the fairness in the system. Do you think it is perfect as it exists right now? For example, on your chart over here, the top 1 percent of taxpayers are paying 24.5 percent of the total taxes; is that not correct?

Mr. SAMUELS. That is correct.

Mr. TODER. Excuse me. They are paying 24.5 percent of their income in taxes.

Mr. CRANE. All right.

Mr. TODER. They are not paying 24.5 percent of taxes.

Mr. CRANE. All right, they are paying 24.5 percent of their total income in taxes. The bottom 20 percent are currently paying 7 percent?

Mr. TODER. 7.6.

Mr. CRANE. 7.6. That kind of spread is evidence of fairness in your judgment?

Mr. SAMUELS. I think that when you look at the issue of fairness, you should look at who is best able to bear the burden of taxes for running our government, and I think when you start with that premise, you look at those who have total command on resources

as the best measure of a taxpayer's ability to pay tax, and I think that that type of progressivity, roughly speaking, is an appropriate measure.

Mr. CRANE. But is it ideal as it exists right now?

Mr. SAMUELS. It is hard to say anything is ideal. I think that is a reasonable—that is a reasonable——

Mr. CRANE. Well, let me ask this question hypothetically. Personal income, that top 1 percent of the taxpayers could probably pay 30 percent of all of the taxes, right?

Mr. TODER. I think——

Mr. CRANE. They would have a better standard of living than the bottom 20 percent?

Mr. TODER. Yes.

Mr. CRANE. Yes?

Mr. TODER. You are asking if the top 1 percent have a better standard of living than the bottom 20 percent?

Mr. CRANE. If their taxes were raised to say 30 percent of total taxes that we are taking in, they would still have a better standard of living than the bottom 20 percent of taxpayers, right?

Mr. TODER. That is correct.

Mr. CRANE. So that would even be preferable to the existing system in your estimation?

Mr. TODER. No, I don't think Mr. Samuels was saying that. I think what he is saying is that it is appropriate for people in the higher income brackets to pay a higher percentage of their income tax.

Mr. CRANE. To be sure, I got that.

Mr. TODER. I don't think he said that any level——

Mr. CRANE. Well, then, let me ask this question quickly before time runs out. If they paid 16.5 percent of total revenue out of their personal income, and the bottom 20 percent paid 8.6 percent, that would be unfair; is that your estimation?

Mr. SAMUELS. Mr. Crane, I think that the question is if you wanted to raise the same amount of revenue that we are—pick a target and apply this progressivity to it, the existing revenue that we are raising, I don't see how one could design a system that would take the numbers that you used and raise the revenue that we need. Somebody is going to have to——

Mr. CRANE. Well, except on your chart over here, you are raising the same amount under this consumption tax approach as you are raising under the existing tax structure.

Mr. SAMUELS. Right.

Mr. CRANE. But you are saying under the consumption tax, that the top 1 percent of taxpayers would be reduced in their total payment from 24.5 percent of the total to 16.4 percent of the total. And I am asking, is that evidence of unfairness?

Mr. SAMUELS. I think what would be—give me great cause for concern is the fact that the top 1 percent, who have the effective rate of 16.4 percent, are paying less as an effective rate than the people in the third and fourth and most of the fifth quintile. So you compare them to the people in the second—I am sorry, the third quintile, who are paying 18.8 percent of their income as an effective rate. Why is the top 1 percent—as a matter of judging the fairness, should they be paying less than the people in the——

Mr. CRANE. Because you are comparing 1 percent of the population with 20 percent of the population.

Mr. TODER. No. We are talking about the taxes as a percentage of their income, not their share of taxes. So it would say if somebody had $200,000 of income, they would pay $32,000 in tax at a 16 percent rate, and if somebody had $50,000 of income, they would pay $9,000 in tax at an 18 percent rate. That is the comparison that we are making here.

Mr. CRANE. All right. Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Thomas.

Mr. THOMAS. Thank you, Mr. Chairman.

Mr. Samuels, having read your testimony and then listening to your responses to the Chairman, I wind up, I think, much in the same position as my friend from Florida. It is difficult to ask you any questions, because I think I know what the answer is going to be.

But you need to understand the level of frustration for us, and I mean on a bipartisan basis. When you respond to the Chairman that you are not going to criticize, you are just going to examine the pluses and minuses of the various proposals that are going to come before us, I shook my head at that point and went to the dictionary; and "criticize," on page 308 of the Webster's Ninth New Collegiate Dictionary, says: criticize, number one, to consider the merits and demerits of and judge accordingly, to evaluate.

That is what I thought criticism was, and you said you are not going to do that, you are just going to examine the pluses and minuses of various proposals.

You know, when you use the retiree example and the need for transition rules, maybe some of us here don't have a long enough memory to recall what we did in the 1986 tax bill to folks who were retiring without a transition rule on a retroactive measure which destroyed people's plans, based upon the belief that government would do what government said it was going to do and then didn't. And I think that was just part of the ground swell that has led us here today. And, frankly, people sitting at this table were part of that, OK?

So when you come in and preach to us about the need not to deal with theory, but to deal with the real world, and when you presume to tell us what is going to come out of the congressional process and that you know it is not going to be what we are talking about, frankly, I will stack up what we say we are going to do with this new Majority in comparison to what we do with your administration, Mr. Samuels.

It is a little galling to have you tell us you know we are not going to do what we say we are going to do, especially when you have seen that the fundamental changes that are proposed are being proposed on a bipartisan basis, that there is a level of frustration here that transcends the partisan question.

So when you find us talking to you, or Mr. Gibbons simply throwing up his hands saying, I don't have any questions for this person, you need to know that it is based upon a frustration with the recent past in trying to deal with the present system.

And when you sit and give us testimony that you know we are not going to deliver what we think we are going to deliver—which

argues to me that we start with the bolder concept since you have now told us it is going to get whittled back—but then that your request is for something far less than kind of basic rethinking, you know we are going to get less than that even, if, in fact, you are correct; and when you tell us that you are shooting for fairness, efficiency, and simplicity, that is awfully close to fairness, simplicity, and growth, which was the whole pursuit of the eighties in terms of the Tax Code. And so it is very difficult for me to sit here and listen to this administration, first of all, tell us what we are going to do in the legislative process, but not offer any alternative.

The Reagan administration during that period, Treasury offered Treasury one and Treasury two, which were fairly bold flat tax concepts, which at least showed they were thinking about the issue. They were willing to engage.

You have told us you are not willing to engage in fundamental tax proposals. But that is nothing new; you weren't willing to engage on the budget, you didn't engage on welfare, you haven't engaged on reform in the health system, you are not engaged in the Medicare reform, so, gee, what is new, you are not engaged in tax proposals either.

So you sit back and criticize. You tell us the pluses and the minuses of the ideas that we are offering, which obviously are theoretical because they are not in place. But, Mr. Samuels, if you and your President really want to participate in an area that needs fundamental change, you are going to have to participate. Sitting back on some higher level and offering criticisms of the work product that we are going to be presenting and telling us that we are not going to be able to accomplish what we are trying to accomplish isn't worth very much.

You occupy an important position. The Chairman has said that you have enormous resources on hand. You are cheating the American people by not participating in a very active and aggressive way.

Chairman ARCHER. Mrs. Kennelly.

Mrs. KENNELLY. Thank you, Mr. Archer. I think sometimes things can be looked at differently. Mr. Thomas and I were both here in 1988 and there was Treasury one and Treasury two. But I do remember Secretary Baker sat down there day in and day out as we did tax reform and he did exactly what you suggest, Mr. Samuels, you were going to do. He very definitely told us the pros and cons of the various things that we were looking at, the various votes that we took and how we moved forward in tax reform. And I think that over the years that has been the relationship of the Congress with the Treasury.

In fact, I am quite sure Mr. Archer is very committed to this consumer tax, as Mr. Armey is very committed to the flat tax; and I think every one of us at this table and on the other side in the Senate knows that the system right now is very complicated and needs reform. So I am quite sure, Mr. Samuels, that you will be right there telling us what would happen if we did certain things; and I am totally convinced that the Congress, no matter who is in the Majority, will do exactly what they want.

So I think what is happening here this morning is just a difference in semantics for how we look at things.

Yesterday——

Mr. THOMAS. Will the gentlewoman yield just very briefly on that point?

Mrs. KENNELLY. Sure.

Mr. THOMAS. I think it is telling, because I think you are accurate in that—but I think it is ironic that you used Secretary of the Treasury James Baker as the example who sat down with us day after day and talked about the changes. We asked for Secretary of the Treasury Rubin to come, but they chose not to send the Secretary of the Treasury, they sent someone else. So when Les Samuels is going to be sitting there, compare that with the previous commitment of the Secretary of the Treasury sitting there and working out the details. I thank the gentlewoman for yielding.

Mrs. KENNELLY. Mr. Samuels, yesterday Dr. Kotlikoff was here from Boston University and he testified that he thought since the Treasury and the IRS had made such advances in electronics, that there could be a card that every family could have, that as they bought consumer goods would tally their tax and then when April 15 came the IRS could figure out what taxes these people owed or if they were going to get a refund.

Could you tell me, knowing what you know now about the IRS and the Treasury, is this something that is possible, and if possible, could this really happen in the near future, or would this be something that would take huge changes in the system to bring this about?

Mr. SAMUELS. Mrs. Kennelly, we have been spending a lot of time thinking about modernization of the IRS and enhancing their computer capability. As you know, they have a long-term program—tax systems modernization that they have been requesting funding, so that they can do a much better job, and seeing the problems that they are having in getting that funding. And I would hope that Congress would respond and properly fund them so that they are able to not only collect the taxes, but provide better service to taxpayers. That is a fundamental part of that proposal.

Mrs. KENNELLY. So you think this was a practical proposal?

Mr. SAMUELS. No. I think that that type of proposal would need an enormous amount of work, and a very significant commitment of resources, including financial resources, to have basically the capability to try to make it work.

I am not familiar with the details of that particular idea, and I would be happy to consider it. We have thought about cards in other contexts and have run up against various administrative problems, so I just—I would want to know more about the proposal before I would be able to make any judgment.

Mrs. KENNELLY. Thank you, Mr. Samuels.

Quickly, in your written statement, you talked about taxation of existing wealth, and I agree with you. I think one of the things we have to look at as we look at a new tax system, or the possibility of a new tax system, is what happens in transition. As we know, the older members of our society have a great deal of the wealth at this present time in the form of savings. And yet if we leave that in place as we transfer it into a new system, it would mean the rates would have to be higher for the working individuals.

Mr. SAMUELS. Right. And, in fact, if you don't tax existing wealth, you effectively have—you have turned the consumption tax into a wage tax. That is, if you talk to the economists, that is what you have.

Mrs. KENNELLY. So as a policy, you would say you would have to tax existing wealth in savings?

Mr. SAMUELS. I think the economists and Mr. Toder here can comment on it. They all assume that in order to get the efficiencies in talking about a consumption tax that you would, in fact, tax existing wealth. We think that would raise very serious problems.

Mrs. KENNELLY. Because it would be aftertax dollars?

Mr. SAMUELS. Yes.

Chairman ARCHER. The gentlelady's time has expired.

Mrs. KENNELLY. Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Bunning.

Mr. BUNNING. Thank you, Mr. Chairman.

Mr. Samuels, do you believe that there is a lot of public dissatisfaction under the present Tax Code?

Mr. SAMUELS. Mr. Bunning, absolutely, yes.

Mr. BUNNING. Do you believe also, then, that the burden of proof should be placed on those who defend the current tax system rather than on those who want to change it? In other words, if you think that there is a public upheaval occurring in this country about the Tax Code, those who want to defend it ought to be able to defend it and those who want to change it ought to be the ones that are encouraged to get the job done, that is my followup on Chairman Archer's questioning of you.

Why wouldn't the administration, recognizing the public dissatisfaction with the Tax Code, come forward with a proposal to do just that?

Mr. SAMUELS. Mr. Bunning, I think that when you look at the dissatisfaction with the tax system, which we agree is there, when you—and I saw a recent poll that was quite interesting, it asked about dissatisfaction with the tax system, and a majority said, yes, they were dissatisfied, they would like to have substantial, fundamental reform.

Mr. BUNNING. They want a fair Code.

Mr. SAMUELS. And they also said that—a majority of those people also said, one, they want a progressive income tax and, two, they wanted to maintain itemized tax deductions.

Mr. BUNNING. I have never ever heard anybody say they want a progressive income tax. In fact, just the opposite. I have seen polls that say we don't want an income tax, period.

Mr. SAMUELS. I am just telling you the poll I saw. It is interesting to see. There are different polls. This was a poll that was just taken that I saw, and that was, because people in some ways they like kind of the basics of our current income tax system in the sense that it is a progressive income tax and provides——

Mr. BUNNING. That must be a Treasury poll, because I have never seen that anywhere public.

Mr. SAMUELS. No, it was not a Treasury poll. They also like certain incentives in the income tax, like home mortgage deductions, charitable contributions, pension, the pension system.

Mr. BUNNING. Only if the current type of system is continued. In other words, if everybody is treated fairly and we take out all deductions and all exemptions, then everybody seems to be OK, you can do whatever you want so long as the public sees that it is fundamentally fair.

Let me ask you, if I asked the question across the country do you think the United States should do away with the IRS, what kind of response do you think I would get?

Mr. SAMUELS. Well, since no one likes paying taxes, I haven't found anybody that likes to pay taxes, when you ask whether they would like to get rid of the IRS, I think most people would say I would like to live in a country where there are no taxes collected, and one doesn't have to deal with any tax administration. The IRS, obviously, they have a very difficult job administering the laws that are written by Congress. That is a tough job.

Mr. BUNNING. You realize the tax system currently is a voluntary tax system.

Mr. SAMUELS. It is, and we should be extremely proud of it. And that part of it, the voluntary nature of the system is something that is, I think, a tradition here in this country. On the other hand——

Mr. BUNNING. Mr. Samuels, let me just get to the point I am trying to make. Are you defending the current system? That seems to be the case based on your testimony.

Mr. SAMUELS. I don't think I am defending the current system. What I have said that we simplify, I said we need to simplify our existing system.

Mr. BUNNING. Can I quote you at different functions that you have gone to where you have defended the current tax system, in other words, you have said if somebody wants to change this system, they better have a good reason for doing it because this is the system that is in place, even if it is bad?

Mr. SAMUELS. No, I haven't said that.

Let me just say in my testimony today, as I said, I think that the proponents of changing the entire system, that is getting rid of the entire income tax, the individual income tax and the corporate income tax have a high hurdle to meet, and the comparison is what can we do to our existing system to make it better. There are a number of things that we could do to our existing system that would relieve burdens on taxpayers.

Mr. BUNNING. Mr. Samuels, if we don't change the current system, the compliance or the voluntary part of it eventually will be severely eroded and that is what is happening presently. Voluntary compliance is eroding and the voluntary system will fall apart if we don't change and make it more simple for people to comply. Thank you.

Chairman ARCHER. Mr. Herger.

Mr. HERGER. Thank you, Mr. Chairman.

Mr. Samuels, in your testimony you stated that you are concerned that any consumption tax Congress may enact could be excessively complex.

Do you seriously believe that a new consumption tax would be as complex as the current system?

Mr. SAMUELS. Mr. Herger, I think it depends on the form of a consumption tax. I think when you look at the proposals that Senators Nunn and Domenici have set forth, and by the way, I commend them for their proposal, it is detailed. They spent an enormous amount of time thinking about how to make their system work, and when you look at that system I think you have to conclude in evaluating it that one of the serious questions is its complexity, and you could wind up in a system where you are basically collecting the consumption tax at the individual level, that you could wind up with a more complicated system because you have to keep track not only of your consumption, but the way you keep track of it is you look at your income, then deduct from it your net savings, and calculating your net savings is a brandnew calculation that taxpayers now don't have to do.

You don't have to keep a balance sheet now, thank goodness. We have a complicated enough system as it is. Under a consumed income tax system you would have to keep some kind of balance sheet, and Senators Nunn and Domenici have tried to minimize that burden in their proposal, and they have spent a lot of time at it, but it is still a new level of calculations in determining your net savings the taxpayers have to make that they don't have to make now, and we think that that additional computation would lead some to think that it is more complicated than the existing system.

Mr. HERGER. So much of the complexity of our tax law today is because of the years and years of additions and underbrush, if you would, of refinements. Wouldn't doing away with that also do away with all that underbrush and at least in a new system we would be starting new and would not be nearly as complex as the system we currently have? I mean, what you describe sounds very simplistic compared to what we go through today.

Mr. SAMUELS. I think that the——

Mr. HERGER. In comparison.

Mr. SAMUELS. Right. The issue is when we are talking about consumption taxes, and I think one of the things that we hope we could add to the discussion is trying to explain what, in fact, people mean when they talk about the consumption tax.

I am sure you will have other witnesses, along with economists, as you go through these hearings that will also provide that information. It is a theoretical model, and moving from that model to our very complicated and sophisticated economy, we have the largest economy in the world. We have the most complex economy in the world, and as you think about starting over with a brandnew tax system, you are going to run into a whole series of issues, like these transition issues of how to deal with the taxation of existing wealth under a consumption tax. Under a consumption tax, if you don't have a transition rule, people who have earned money under the income tax system and paid taxes have now saved money in aftertax dollars. They have their $100,000 in the bank and they are retired and now they are dissaving because they are spending some of their savings in their retirement.

To move just cold turkey into a consumption tax, they will pay consumption tax when they spend down their savings. They will be taxed twice on their efforts, and that is, I think, a very serious question as to how to deal with that issue.

Mr. HERGER. My time is almost up, please excuse me, but you are now referring, as I understand it, to a transition period which obviously we will have in any type of change we make, but it is a transition period that we will work through, I think the point is. I don't know how we could have a system that is more complex as is perceived by the American public, the American taxpayer, than what we have now.

I share the concerns of those who have questioned before me on the fact that we seem to see a trend now with the administration. We had Secretary Shalala who was here on the Medicare bankruptcy. No suggestions from the administration, no plans.

We see you here representing the administration again on taxes, again no plan, no timetable when, if ever, we will have a plan. I believe that if there is a reason for the American public perceiving the President as being irrelevant, it is precisely because of this. We aren't seeing any plans, we are not seeing any leadership, and I think this is regrettable. I believe the American public deserves much more than what we are seeing. Thank you.

Chairman ARCHER. Mr. Levin.

Mr. LEVIN. Thank you. Mr. Samuels, I think the frustration with the present system is bipartisan, and I hope that the response can be accordingly. I think the question is whether we are going to use that frustration in part for political purposes or if we are going to respond to it. I hope we respond to it. So let me just ask you, because I think, in a sense, the issue is clear, and that is whether we are going to undertake major reforms in the present system or discard it and essentially totally replace it.

The answer may not be simple. I don't think it is, but the issue is clear. I think that essentially your position today is one of reforming the present system or your preference or your tendency rather than totally replacing it. Is that a fair characterization?

Mr. SAMUELS. Mr. Levin, I think that that is a fair characterization in the sense that we are concerned about the consequences of trying to apply a model that no other country in the world has adopted to the most complex and largest economy of the world, and we think that there are significant things that you could do with the existing system that would go a long way to satisfying or trying to meet and reduce taxpayer frustration.

Mr. LEVIN. All right. In answer to Mr. Crane you said on complexity it is much too complex; it needs improvement.

Mr. SAMUELS. Absolutely.

Mr. LEVIN. You gave it a decent grade on fairness, but also a somewhat poor grade on efficiency.

Mr. SAMUELS. Right.

Mr. LEVIN. So now the question becomes whether you have some proposals relating to complexity and inefficiency. In your testimony, you referred to the Technical Corrections Act of last year. Will you have some proposals relating to complexity and efficiency?

Mr. SAMUELS. Mr. Levin, we are actively working on those proposals and the types of things that we are considering are issues of trying to—we have asked people about what they don't like about the system, and for example the so-called Pease and Personal Exemption Phaseout is something that people find excessively com-

plex, so I think one ought to kind of look to see about how one would eliminate that.

The individual AMT is too complicated, needs to be reformed. We have—as an example, we have 3 million people filing AMT forms and only 300,000 people pay the AMT. There is no reason why we need to have all those people filing forms that don't owe AMT.

Mr. LEVIN. So I think, then, is your answer that you may not be coming up with a totally new system in terms of a proposal, but you are going to be proposing some major reforms in the present system?

Mr. SAMUELS. We are going to be proposing what we believe will have a material benefit on the simplification front.

Mr. LEVIN. OK. When do you think that will happen?

Mr. SAMUELS. We are working on it. We have a series of ideas. I don't have a timetable as to when they are going to be released, but we are working on some actively, and I think one set is going to be released relatively soon.

Mr. LEVIN. All right.

Chairman Archer, I think, is perhaps interested in the answer to that. You are going to be coming forth with some proposals.

Let me ask you, yesterday we heard testimony that the cost of compliance was $202 billion. Mr. Hall suggested that the annual cost is based on 5.1 billion hours of work. Is that at all in the ballpark, do you think?

Mr. TODER. We have not looked very closely at that. From what people have advised me, that number, we think, is too high, but we would be happy to supply you with an analysis of it.

Mr. LEVIN. So whatever the number is today, it is too high, the compliance; is that correct?

Mr. TODER. Absolutely.

Mr. LEVIN. And so there is a basis for frustration among the public?

Mr. TODER. That is correct.

Mr. LEVIN. And the administration intends to present some specific proposals that relate to complexity as well as efficiency?

Mr. SAMUELS. Correct.

Mr. LEVIN. Will you in the next week or month, if possible, give us some kind of a timetable as to when those proposals will be presented?

Mr. SAMUELS. Sure.

Mr. LEVIN. You will?

Mr. SAMUELS. Yes.

[The information was not received at the time of printing.]

Mr. LEVIN. OK. Thank you. My time is up.

Chairman ARCHER. Mr. Hancock.

Mr. HANCOCK. Thank you, Mr. Chairman.

Mr. Samuels, we have kind of had a basic philosophy on taxation that the best tax is a tax with as broad a base as possible and as low a rate as possible. Would you concur in that thinking?

Mr. SAMUELS. I think that that is an objective that we should try to achieve.

Mr. HANCOCK. I said yesterday I didn't think this ever would happen in my lifetime, that we would really be holding hearings considering elimination of the income tax. I would like to see it

done and as quickly as possible, but under those circumstances, even though we realize it is going to be a slow process, we are going to be extremely deliberate. We are talking about major, major changes in the way we finance the Federal Government.

Would Treasury or anybody consider an absolute total moratorium on any changes whatsoever in the income tax laws and regulations, just leave it the way it is so that the public could understand what they are dealing with? I mean, would Treasury even consider it or would the administration even consider making that recommendation to the Congress until we can work out something better?

Mr. SAMUELS. Mr. Hancock, I think we believe that we should be giving simplification greater weight in all legislation that is currently under consideration. That is a serious issue right now. We all know people are frustrated, and I think that we should all, in considering legislation and regulations, give simplification a much greater weight.

On the regulatory side, we have recently announced a proposal that we have asked comments on where small businesses will be able to decide whether they want to be a corporation or a partnership by checking a box to get rid of all the difficulties of deciding whether an unincorporated entity is a corporation or a partnership. So we have been—we are committed in our regulatory process to simplification.

On the legislative side, I would urge the Committee to take simplification into account and give it a much stronger weight than it has in the past because of the frustration the taxpayers have. We know we have a system that is too complex, and it is tilting. It is tilting over. There is no doubt about it. So I would hope that that would be the case, and I think that—when you talk to tax practitioners, one of the things that they say is that the constant change of the tax law is one of the things that, for them, is the most frustrating, that they get to understand something and then the law is changed. So the idea to slow down the change in tax law, I think, is a valuable one.

Mr. HANCOCK. In my business career, in my life, you know, I have lived through several simplifications, and it got so simple that I can't figure it out.

What I am asking you is would the administration and would the Treasury recommend to the administration or somebody that we just leave it alone at least for a couple of years so the practitioners and the businesspeople and the people that are planning the estates would know what they are dealing with. I mean, a 5-year moratorium or a 4-year moratorium or something because you can do something 1 day and then find out they have already made a regulation that messed it up. I am not talking about simplification. I am just talking about saying, look, leave it the way it is until we can work out something, a major change, would Treasury recommend that?

Mr. SAMUELS. Mr. Hancock, what we would recommend is that as Congress is considering legislation that they give simplification a greater weight and in the meantime, while they are considering this, there are some things that I think Congress could do to simplify the existing system, so I think that would be how I would do

it. I think the system now is so complex and there are so many problems I think there are some things that could be done. I wouldn't want to wait 4 or 5 years while everybody has to live with——

Mr. HANCOCK. Here again, when I hear Treasury and Internal Revenue talk about simplifying something, I get nervous. I get real nervous.

Quite frankly, I think there are a lot of people out there who think don't try to simplify it again, just don't change it at all for a while. I mean just leave it alone for a while. We have got a depreciation schedule now. Let us live with that one; don't hit us with a different one next month. Anyway.

Mr. SAMUELS. I think, as I say, we have said before, we think that constant change to the tax law is a serious problem in terms of the issue of complexity and frustration, so I would think that given all the frustration that is out there that we ought to give significant weight, much more weight than we have in the past to simplification in considering tax law proposals.

Chairman ARCHER. Mr. Hancock, your time has expired.

Mr. Camp.

Mr. HANCOCK. Thank you.

Mr. CAMP. Thank you, Mr. Chairman.

Mr. Samuels, in your opening statement you state that frustration with the current tax system is unacceptably high, and you also say that this frustration is a serious problem, and I think in response to one of the questions from Mr. Bunning, who asked you if there was a lot of dissatisfaction with the current system, you responded absolutely in testimony today.

Are those all fair characterizations of what you think about our current tax system? Yes or no?

Mr. SAMUELS. That is my view of how taxpayers are reacting to today's tax system.

Mr. CAMP. Would some of those causes be—in response to Mr. Levin, you mentioned the complexity, the inefficiency, the equitability of the system, complexity, even the audit process, the fact that small business people literally have to hire a professional in order to prepare your returns, would all those be some of the reasons that you make the statements you do about the frustration with our current system?

Mr. SAMUELS. I think that there are a variety of factors in the frustration. One is the sheer complexity of the system. It is interesting, about over 70 percent of taxpayers claim the standard deduction, but about half the taxpayers go to professional preparers.

Obviously, you know, if you have half the taxpayers going to professional preparers it is because they are intimidated by the system. They don't think it works very well.

I also think that there is a sense among some that they are frustrated with the system because they feel that there are some taxpayers, very wealthy taxpayers, big companies who aren't paying their fair share because of loopholes and so forth, so that they are frustrated about that as well, so I think it is a variety of problems.

Mr. CAMP. Do you think the taxpayers are satisfied with IRS audit procedures?

Mr. SAMUELS. I don't——

Mr. CAMP. I know obviously you have thought about this issue if you have testified that taxpayers are frustrated with the system. Do you think they are?

Mr. SAMUELS. I think that the IRS has been given—has a very difficult job of administering this complicated system, and I think that we—my personal view is that we should be proud of all of the employees who are doing a difficult and, to some extent, unwelcome task under difficult circumstances, and I think that they are trying to do their best, and I think that, obviously, no one likes——

Mr. CAMP. Do you think the procedures in themselves are such that they would cause taxpayers to be unduly frustrated with the system, the fact that there are reach backs, the fact that they may be audited and their audit is approved and then a few years later the IRS issues a regulation and changes that procedure. Do you think that might cause some problem?

Mr. SAMUELS. Actually, I think if you look at—one of the issues that has been discussed is actually the decline in audits by the IRS over the years so that the audit rate has gone down, so it is hard to engage in that question. There are very, very few——

Mr. CAMP. Let me move on to something we do agree on. We do agree there is a growing dissatisfaction with the current income tax system. Wouldn't it then seem proper to consider an alternative system, given that huge amount of frustration?

Mr. SAMUELS. I think we should consider alternative systems and consider how we could make the existing system substantially better.

Mr. CAMP. I know you mention in your testimony that the consumption tax, your concern is that it may be regressive.

Mr. SAMUELS. That is correct.

Mr. CAMP. OK. Would you suggest exempting some specific items?

Mr. SAMUELS. No, no, absolutely we have not said that. We think that as one tries to deal with regressivity, that is, if you look to the Europeans that have VATs, that is one of the ways that they try to deal with regressivity is by providing exemptions for specific items or having different rates, and I think that their experience is that when they do that, that introduces complexity into the system and also it doesn't do that much to address the problem of regressivity because if you exempt an item, you exempt it for all taxpayers, not just the low-income taxpayers.

Mr. CAMP. So you would not advocate exempting certain goods and services or changing rates?

Mr. SAMUELS. Absolutely not.

Mr. CAMP. Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Cardin.

Mr. CARDIN. Thank you, Mr. Chairman.

Mr. Samuels, thank you for your testimony today.

Chairman ARCHER. Mr. Cardin, could I ask you to suspend just a moment? Please don't take this out of his time.

For the benefit of everyone and their schedules today, we plan to take a break between 1 and 2. We will not be in the hearing room between 1 and 2. You may proceed.

Mr. CARDIN. Thank you, Mr. Chairman.

In response to some of the questions that have been raised by my Republican colleagues, I think it would be premature and perhaps irresponsible for either the Republican leadership or the administration to come forward with a specific proposal to change our current tax structure, knowing the sensitivity of the markets and the fact that riding here from Baltimore this morning the stock exchange reached an all-time high.

I am not so sure it would be a good idea to put out there a specific proposal, particularly when we haven't had the Committee hearings necessary in order to try to formulate some national consensus as to which way we should move.

Mr. Chairman, I have been very complimentary of the fact that we are holding these hearings. I think we need to hear about the current tax structure and various proposals that are under development, but I think it would be premature for the administration to come down on a side of this debate, and I am glad to see that you are here participating with us.

I happen to believe that it is time to radically change our tax structure and believe that we need to move from an income-based tax to a consumption-based tax.

Mr. Samuels, I would appreciate some of your thoughts here. I think many of us have been fixed on the income tax because in our college classes we learned that if we believe that ability to pay should be one factor in collecting taxes, the income tax is the easiest way to get at that, but it seems to me as we look at the evolution of the current income tax here in the United States, we find that it has become so complex and that the progressivity of it has been compromised to such a point that perhaps we could work with consumption-based tax and accomplish the same progressiveness as we do under the current income tax structure. I point out the fact that many of us are concerned about the current use of the income tax or concerned about the savings ratios in this country which are at a historically low level.

In just the last 12 years we have seen that the savings ratios in this country have dipped about 50 percent. We are close to what it was in 1929, which should alarm all of us. From the international competitiveness standpoint, a consumption tax makes our companies more competitive internationally because it is border adjustable. My question to you is that you have raised the three standards which I agree with—efficiency, fairness, and simplification. They are very important factors.

You have acknowledged the fact that the current structure is less than simple and has some shortcomings as to efficiency. As far as fairness, couldn't we construct a consumption-based tax that brings out fairness through use of low-income or modest-income tax credits or perhaps combining it with some modified income tax for higher incomes?

Couldn't we construct such a tax structure that, in fact, could meet your definition of fairness using consumption rather than income?

Mr. SAMUELS. Mr. Cardin, I think that it is theoretically possible to design such a system, and I just would mention that you were talking about the nature. You said, well, we would have a consumption tax and then also some kind of income tax.

Mr. CARDIN. Well, maybe a modified tax, but certainly not——

Mr. SAMUELS. Some kind of modified tax, and I think that is what Senators Nunn and Domenici have tried to achieve with their proposal is to try to deal with the progressivity issue. I think that when you—we are very concerned about the savings rate. It is abysmally low and needs to be increased, and I think the issue is how much can tax policy affect the increase in the savings rate, and I think that when you look at the evidence that the economists have generated through their studies, it is unfortunate because thinking as a logical matter, well, if you reduce taxes or you increase the aftertax rate of return on savings, savings should go up.

I wish that were the case, but when you look at the economic studies that have been done, they don't have evidence that there would be more than a small or negligible change. And so the question is do you want to change the entire system for something where the economists have been working for years, we don't have extraordinarily good evidence that it will work, and you think about all the disruptions that will occur to the economy and to people in terms of the prices and wages, the prices of goods, the value of assets, all of those things you have to think about as a cost of going to a new system.

Mr. CARDIN. These are very valid questions and ones which I hope we will examine as we determine which way we want to move on our tax structure. We have two competing thoughts out there, a flat tax versus a consumption-based tax. I hope we gel around the consumption-based tax.

Obviously, as we move toward dealing with the issues of fairness, we will be introducing complexity. There is no question about it. There is that tradeoff. But it seems to me there is also a balance here, and we could reach a better balance using a model of a consumption-based tax than we can our current income tax and I would welcome your thoughts as we move through these mazes as to how we can try to accomplish all of these goals. Once again, I appreciate your presence here today. Thank you, Mr. Chairman.

Mr. CRANE [presiding]. Mr. Zimmer.

Mr. ZIMMER. Thank you, Mr. Chairman.

Mr. Samuels, you just said that a consumption tax would have an impact on the value of assets, on wages, and on goods, but in your initial testimony you and Mr. Toder said that it may not have any effect on savings or interest rates. How do you square those two views, that it could have profound impact on the economy, but won't do the kind of things that we think it might do for the economy?

Mr. TODER. Yes, Mr. Zimmer, we believe that people hold very different kinds of assets, and we believe depending on what your asset position is, whether you are invested in houses or corporate equities or bonds, your wealth would be substantially altered or could be substantially altered by changing the tax system.

It will affect the different returns on different kinds of investments in a very big way. The point that I believe that Mr. Samuels was making is the main overall effect is that the aftertax rate of return to saving will go up because we will no longer be taxing the return to new saving. We think as a theoretical matter that it would raise the rate of saving.

However, when we look at all the studies that have been done by the OECD, by many economists, we don't really find very much evidence that aftertax rates of return affect saving very much, so while we do believe it will have many different effects across industries and across people depending on people's circumstances, we don't believe that the overall effect on the economy will be very large in the long run. I think there will be adjustment costs which will be very significant.

Mr. ZIMMER. You have also said that a consumption tax won't reduce interest rates because interest rates are set by the international market in debt securities. That is interesting because——

Mr. TODER. We believe they will come down a little bit, but not very much.

Mr. ZIMMER. OK, good. How much?

Mr. TODER. I can't give you a precise figure, but——

Mr. ZIMMER. The reason I raised this is because your boss, Secretary Rubin, sat in the chair where you are and told us that the reason why U.S. interest rates declined over the first part of the Clinton administration, and even before that, was because of the policies of the Clinton administration, and so I wouldn't ask you to contradict Secretary Rubin, but do you believe that international factors are much more important than domestic fiscal policy on domestic interest rates?

Mr. TODER. We believe both have an effect. We also believe that changing the Federal deficit would have a much bigger effect on the national saving rate than changing the tax system, and so we think there was a much bigger effect from deficit reduction.

Mr. ZIMMER. I think we are in agreement that reducing the deficit would, in fact, lower interest rates, which is why we are pushing forward for a balanced budget. Other than balancing the budget, could you name any other steps that you believe would either increase the savings rate or reduce interest rates?

Mr. SAMUELS. Mr. Zimmer, we think that targeted savings proposals through the pension system may increase savings. The House-passed tax bill has some new incentives for IRAs, the President's budget has new incentives for IRAs that are somewhat different than what the House passed, so we think that those are the types of savings proposals that we ought to be thinking about, how to make the pension system simpler so not so much money is spent on administration, and more of that money can be kept in the pension system and investment, but those are the types of things that we think would be helpful for the tax system to do, but we shouldn't expect the tax system is going to solve our low savings rate.

It is very interesting, and it is actually kind of distressing that our trading partners, it is just not the United States whose savings rate has gone down. Our major trading partners' savings rates have gone down. We have been kind of the leading edge, but the OECD has done a report and shows that our trading partners' savings rates have gone down, and Japan who has the highest savings rate, they have the lowest consumption taxes. Their consumption taxes are quite low. So I wish I could, from my position, I wish I could figure out some important ways that tax policy could make a real significant contribution to increasing savings, but when you

look at the experience here in the United States and look at the experience of other countries, there seem to be so many different factors that tax policy is not going to drive increases in savings rates in the way that we hope they would. We are frustrated about it, too, and think that this is an extraordinarily serious problem for the country.

Mr. ZIMMER. One final question. Do you believe that the IRA proposals that the President has made and those that are in the House bill will or will not increase savings rates in the aggregate?

Mr. SAMUELS. We think that there are differences between the proposals.

Mr. ZIMMER. Well, the President's.

Mr. SAMUELS. We think the President's proposals will have a positive effect on savings of middle-income Americans to whom it is targeted. We developed those proposals to give people a choice to kind of feed into the existing IRA system that people understand and know and so we think that it will be a positive contribution to improving the savings rate. But we also, I think, all have to realize that it is not going to solve our national problem. It is a step, but we shouldn't assume that it is going to solve the problem.

Mr. ZIMMER. Thank you.

Mr. CRANE. Mr. Collins.

Mr. COLLINS. Thank you, Mr. Chairman. Mr. Samuels, I can only give you one example of how the tax policy affects savings, and that is mine. I save all year to pay my tax liability on August 15. I save past the April 15 deadline with an extension to pay those taxes.

I find it interesting you changed within an hour's time from when Chairman Archer asked are you going to come forth with any type of proposals to when Mr. Levin asked you the same question. Now, which one of those answers did I misunderstand or understand?

Mr. SAMUELS. Mr. Collins, I explained to Mr. Levin, who said we have some proposals to simplify the existing system. I mentioned in my testimony the Simplification and Technical Corrections Act which the House passed last year, which we asked, we think that that is an important bill. It will improve the current system.

Mr. COLLINS. I did understand, then, you are coming back with some type of proposal for simplification?

Mr. SAMUELS. We are working on simplification ideas, and we will be coming up with simplification proposals for our existing system.

Mr. COLLINS. I find it of interest, too, that you have compassion for a taxpayer who has accumulated, as you put it, wealth. Do you not have compassion for those taxpayers who leave an estate that you tax? This wealth is an aftertax accumulation of wealth, is it not true?

Mr. SAMUELS. Our estate tax depends on the composition of a decedent's estate. Some assets in the estate, for example, assets that have unrealized capital gains are taxed not on the capital gains, but on the estate tax.

Mr. COLLINS. Assets in an estate are accumulated after tax. You have compassion one way, but you lose the compassion the other.

Mr. SAMUELS. No, I wouldn't agree with that, Mr. Collins.

Mr. COLLINS. You don't agree with many things anyway. That brings me to the next point that you say you are willing to work with the Congress, but every time I see you sitting across on that side you are countering anything that is proposed, changes that this side of the aisle proposes. You are over there countering those measures, but yet you are willing to work with the Congress. So I am not surprised that you have a difference of opinion on the last question.

Is it not true that we already have two systems of taxation; one is income and the other is consumption?

Mr. SAMUELS. Mr. Collins, actually our current income tax system is a hybrid of an income tax and a consumption tax system. We already have elements of a consumption tax in our existing system, and those elements are our pension system, where we give people a deduction for contributions to their pensions or their IRAs, and in addition we, the way we treat residential housing, owner-occupied housing is similar to a consumption tax system.

Mr. COLLINS. How about excise tax, motor fuel tax and taxes of that nature?

Mr. TODER. We have those taxes, but they account for a very small proportion of total Federal revenues. Other countries' consumption taxes account for a larger proportion of their total revenues. I think the consumption tax at the State and local level are more important.

Mr. COLLINS. We do have the two systems at the Federal level, too, but you mention intimidation. You know, the IRS is the most intimidating agency that I hear complaints about from my constituency. Have you felt intimidated by the threat of abolishing the IRS?

Mr. SAMUELS. No, sir.

Mr. COLLINS. Let me just ask you this. When I hear the question asked to constituents do they favor revamping the current system, very few say, yes, but when you ask about a flat tax versus a consumption tax, usually it is split about 50-50, but if you mention at all abolishing the IRS, it is usually unanimous. The intimidation is real among people.

Have you ever been audited?

Mr. SAMUELS. Yes, sir.

Mr. COLLINS. You have. Did you feel intimidated then?

Mr. SAMUELS. One, I would say, never likes to go through that experience.

Mr. COLLINS. The answer is, yes, with the intimidation? Well, I am glad you were intimidated at one time or another.

Thank you, Mr. Samuels.

Chairman ARCHER. Mr. Payne.

Mr. PAYNE. Thank you very much, Mr. Chairman, and thank you, Mr. Samuels, and Mr. Toder, for your testimony today. I think as you have heard today and as we heard yesterday, there seems to be a broad consensus on the Ways and Means Committee on both sides of the aisle that the tax system that exists is broken. It is badly broken and it needs to be fixed, and I, yesterday, commended the Chairman and I do again today for bringing forth these hearings to talk seriously about how that might be done.

Let me see if I understand where you are relative to that same proposition. First of all, I understand you to say that you agree that the present system is broken and needs to be fixed, and so you are certainly in agreement about that. You also say to move from the income tax to a consumption tax and do what the Chairman said yesterday which is to pull this system up by the roots and throw it away so that it won't come back is, in your view, a very radical fix.

You mention that you see such a change as a major risk and we could incur major costs as a result of it. Then you go on to say nobody really knows what would happen if we made such a change and there is no other country that has ever done it, and so forth. The difficulty with that is how is it that we could ever make radical changes, then, in the system, given the fact that there will never be enough information or we will never know enough about the future to be able to say with certainty that there won't be some negative and perhaps some unintended consequences.

Could I first get you to comment on that.

Mr. SAMUELS. Mr. Payne, I think that when we think about dealing with a major change that we should do our best and use our best judgment in trying to evaluate what the benefits and the risks and the disruption to the economy might be. I think in this particular context we think that if you look at the evidence of what the benefits are going to be based on the economic research in terms of increasing the savings rate and when you talk to the economists who have thought a lot about this about what these different systems inherently mean—in other words, when people talk about a consumption tax and try to decide what efficiencies might arise from a consumption tax—they talk about a model, and that model includes a broad base. Everything is taxed, and you would tax existing wealth in order to get the efficiencies that they would hope to achieve in a consumption tax, and I think that those kinds of assumptions that if you went forward with them would carry significant risks of plunging into the unknown.

I think we would be very careful with plunging into the unknown.

Mr. PAYNE. I think we should be careful about plunging into the unknown, but would you say that there is an acceptable way to move into the unknown? As you have already mentioned, we have a hybrid system. I noticed from the information given to us by Joint Tax that compared to countries in the OECD, presently our general consumption taxes are 7.6 percent of all of our tax revenues, whereas the other nations are in excess of 17 percent, meaning that other countries have adopted more consumption taxes than we have.

Would it make sense for us to be moving more in that direction? That then could be a test, if you will, to provide some of these answers so that if we don't make the transition immediately or in a radical way, as you said, but if we begin to look at a way to make that transition over a longer period of time, would that be an acceptable way to proceed?

Mr. SAMUELS. I think it is hard to answer the question without exactly having a proposal, but the fact is the statistics that you referred to, all of our major trading partners use different taxes.

They all have kind of a mixed system. They all rely on the income tax for an important part of their revenues, and they also all rely to a different extent on consumption taxes.

And they also, I would say, if you look at the list, it is another interesting fact that Japan and the United States, that have the lowest consumption taxes as a percentage of the taxes raised, also raise as a percentage of GDP less than our other trading partners, so everybody has a different system that they have evolved which kind of—they have applied what they think is important for their society. And look at the G–7, the United States and Japan are at the bottom in terms of percentages of tax that we take out of our GDP and our other trading partners take a greater percentage and they tend to rely more on consumption taxes.

Mr. PAYNE. But let me just say if, in fact, we can't make the radical change are you saying that perhaps we shouldn't be making any kind of an incremental change either?

Mr. SAMUELS. No, I am not saying that. I think when you evaluate these proposals that you need to kind of—it is helpful to look on the experience of other countries and how their systems evolved and what their composition of taxes are, and it seems to me that if you wanted your suggestion of increasing the percent of consumption tax that we look to as a revenue source, that is an idea worth considering, but you would have to decide how you were going to get there and how you would do it and whether it would be worth it.

Mr. PAYNE. So while you can't support a revolution in the tax system, you might look at an evolution where we would move incrementally to a different kind of system over a period of time, testing as we go what the impact would be on the economy and then making that transition as smoothly as possible?

Mr. SAMUELS. What we have said is we will consider serious proposals that will simplify the system and improve economic incentives without sacrificing revenue or fairness. That is how we would look at that, absolutely.

Mr. PAYNE. Thank you very much.

Mr. CRANE. Mr. Ensign.

Mr. ENSIGN. Thank you, Mr. Chairman.

I want to address the issue of fairness because I think that it is fundamental, the fundamental issue when we are looking at overhauling our tax system, so I want to explore that just a little bit with you. You mentioned that your criteria for fairness is based on one's ability to pay; is that correct?

Mr. TODER. Yes.

Mr. SAMUELS. Yes.

Mr. ENSIGN. In your previous comments if somebody makes, let's just throw out a couple of numbers here, if somebody makes $1 million a year, is it not true that their ability to pay a 90 percent tax rate would be much greater than somebody's ability to pay a 10 percent tax rate that only makes $20,000 a year? I mean, that is a true statement.

Mr. TODER. Well, certainly——

Mr. ENSIGN. Is that a true statement?

Mr. TODER. That is a true statement.

Mr. ENSIGN. OK, OK.

Mr. TODER. We are not endorsing 90 percent tax rates.

Mr. ENSIGN. Let me go further with this. Based on your definition, that would be fair.

Mr. TODER. No, no, we would say that a person with $1 million has a greater ability to pay tax than a person who makes $20,000.

Mr. ENSIGN. You said that was one of your criteria for fairness.

Mr. TODER. But that doesn't mean that that person has a greater ability to pay a particular tax rate.

Mr. ENSIGN. You said that our current system is fair because of the progressivity. What determines that fairness? In other words, if we have 39.6 at the top, is that high enough? Should we go to 90 percent for somebody who makes $1 million a year? At what point is it fair is my point.

Let me address this another way. If you have two farmers that are farming fields, and farmer A over here produces x amount of crops and farmer B over here produces y amount of crops and the person over here works twice as hard as the person over there, should we tax at a higher rate farmer B that worked twice as hard as farmer A and produced twice as much crop?

Now, his ability to pay is greater, but should he be taxed on his crops at a higher rate because he worked harder? Aren't you, in fact, punishing someone for working harder? Don't our current tax rates, based on progressivity, punish people for working harder and producing more?

Mr. TODER. Mr. Ensign, it is clear that any tax system which, even if it is a flat tax system, which causes people to pay more taxes if their income is higher is going to have some adverse effect on incentives to work. That would also be true.

Mr. ENSIGN. Not if it is at the same rate. In other words, if I produce 100 bushels and somebody else produces 10 bushels, I pay 10 and they pay one. Yes, I am paying more bushels, but I am paying the same rate, so I have the same incentive to make more, more and more, but if I make 100 bushels, somebody makes 10 and they pay 1 and I pay 40, that is where the unfairness to me comes in. It would seem the only fairness is when people pay the same rate.

Mr. TODER. I suppose you can make that definition of fairness, and that is——

Mr. ENSIGN. Well, where do you come up with your definition of "fairness"? You said it was one's ability to pay, and I just pointed out to you that, by that definition, you could have somebody paying a 90 percent tax rate and that would be fair. So where do you come up with your definition for "fairness"?

Mr. TODER. We believe as general matter, and this has been discussed in many writings of economists going back to John Stuart Mill in the 19th century, that people who have higher incomes can afford to pay a higher percentage.

Mr. ENSIGN. They may be able to afford it, but is it right? I mean, we are talking about fairness here. Is it fair? Is it right?

Mr. TODER. The question really is, do you want to tax somebody on the bread and milk for their kids by taxing——

Mr. ENSIGN. Is not socialism based on redistribution of wealth? Is not that what the whole system of socialism and Marxism is about, that it doesn't matter how hard you work, we are going to

take all of your money and we are going to redistribute it to make everybody equal? That is not the system the United States was set up on. We are set up on capitalism to reward somebody for working hard.

Progressivity punishes people for working hard. It is one step closer to socialism.

Mr. SAMUELS. Mr. Ensign, I think that our progressive income tax system, if you look back over the years—it has many faults now and needs to be revised, but it has served this country well. In times of national need and emergency and wars, our income tax system was able to raise funds for this country, for the government, to satisfy needs of the society. And I think that if you look back over the years to the beginning of the income tax——

Mr. ENSIGN. You are skirting the issue of fairness. I mean——

Mr. SAMUELS. You asked about a progressive income tax.

Mr. ENSIGN. No. I asked you where your definition of "fairness" came from, and you haven't answered that, just like you didn't answer Chairman Archer. Where does your definition come from for "fairness"? What are your criteria to determine what is fair and what is not? You haven't answered that, and I guess you are not going to answer that.

Thank you, Mr. Chairman.

Mr. CRANE [presiding]. Mr. Portman.

Mr. PORTMAN. I thank the Chairman and thank the witnesses for coming today. I have read your testimony before the hearing and listened patiently today to the questions and answers and to your remarks; and I guess my view is that, in fact, your testimony is "criticism" more in the common usage than the usage that Mr. Thomas found in Webster's, and that is that it is mostly con and not much pro. And I guess what I would hope we could do over the next several months, now that Chairman Archer and Ranking Member Gibbons and others have begun this great debate, is to hear a more objective analysis.

I think we all need to go into this with our options open. I think the biases need to be put aside, and I would hope that—particularly with regard to various consumption tax proposals, that you all could give us a more balanced analysis.

With regard to the three criteria use of fairness, efficiency, and simplicity we have discussed today, I think we disagree on efficiency. I would hope that you could go back and look at some of the testimony from our hearing yesterday on the savings and investment on going to a consumption-based tax. I think you are wrong, frankly, but I may be wrong. You may be right.

Maybe it is not going to affect interest rates. It certainly runs counter to common sense and some of the testimony we have heard from the economists. But I won't get into that.

Simplicity, I think it is plain from your testimony and others' and the other analyses we have heard that the current system needs to be vastly revamped, that either a flat tax system or something closer to a VAT would be simpler for most Americans and most American businesses.

Let me focus on fairness again, following up on my colleague from Nevada's questions.

Again, when I look at your testimony, you say in your oral statement that addressing regressivity is one of the great challenges of a consumption tax system, and I like that, because you are at least saying, it is a challenge, it is not something that can't be addressed. I look at your testimony and you mostly point out the problems from a regressive or progressive standpoint. You talk about the fact that some European countries tax certain goods more than others through their VAT. You also mention the possibility of standard deductions for low-income families and so on, and in fact your charts reflect your certain assumptions with regard to that, which is why this chart is just based on assumptions, which is fine. But one could lower or raise those deductions and change the assumptions and the bars would all change.

But from your experience from other countries, in addition to the European experience, would taxing certain goods more than others address some of what you consider to be the challenges of regressivity in a consumption tax system?

Mr. TODER. Mr. Portman, I think the difficulty with addressing this by taxing goods, some goods more than others, is that there are very few goods in the economy that aren't consumed by everybody. So if you exempt food because you want to help low-income families, as many of our States do and many European countries do, you exempt a lot of the consumption of high-income families—all of us eat—and you end up having to raise tax rates on everything else to fund the same revenue. So if you want to address the progressivity issue, it is much easier to do so by collecting some of the tax from individuals as opposed to collecting it from businesses; that is, to have some mechanism to differentiate among individuals.

The Armey flat tax does that to a degree, because it taxes wages at the individual level, and the Nunn-Domenici tax does that more completely and also has progressive rates. But as we have testified, having that kind of a system is more complicated.

Mr. PORTMAN. But, Mr. Toder, within the context of a consumption tax, are you aware of any other countries that have a progressive element other than the higher VAT taxes or other excise-type taxes on goods?

Mr. TODER. No——

Mr. PORTMAN. Take your rates in your testimony, as an example. Are you referring to some sort of an income tax that would be concurrent with a consumption tax?

Mr. TODER. That is correct.

No, actually, I am referring to a way of collecting the consumption tax. I mean Dr. Kotlikoff suggested electronic filing, which was mentioned here as a way to try to measure the total consumption.

Mr. PORTMAN. But the measurement of income as a part of that would be needed in order to meet your standard of progressivity; is that correct? In other words, you could have an annual aggregate consumption tax through the use of the technology that Mrs. Kennelly and others have talked about, but you would still need to address the issue of income?

Mr. TODER. Well, you wouldn't need to measure people's income, you would actually measure people's consumption by taking their

income and letting them deduct their saving. But you would have to collect it from individuals. I think that is the distinction.

Mr. PORTMAN. Are there any other examples of countries where consumption tax has a progressivity element?

Mr. TODER. As far as I am aware, what other countries have done is that they have used other taxes to bring progressivity into their system. So they have a flat rate consumption tax with some exemptions, and then they have income tax systems along with that.

Mr. PORTMAN. Any comments, Mr. Samuels?

Mr. SAMUELS. I think that is generally the way our trading partners have—who have been using value-added taxes have tried to deal with the issue of regressivity. They have a mixed system, and then they deal with that——

Mr. PORTMAN. On the income side.

Mr. SAMUELS. On the income tax side.

Mr. PORTMAN. Thank you, Mr. Chairman.

Mr. CRANE. Mr. McDermott.

Mr. MCDERMOTT. Thank you, Mr. Chairman.

Mr. Samuels, you know the House of Representatives is led by a man who declared himself to be a radical, and so you have to take in context what has happened to you here today. I want to ask you some simple questions.

Are you aware that the U.S. Government has three branches?

Mr. SAMUELS. Yes, sir.

Mr. MCDERMOTT. And one of the branches is the legislative branch covered under article I of the Constitution; you are aware of that?

Mr. SAMUELS. Yes.

Mr. MCDERMOTT. And as I understand article I, section 7, it gives to the House of Representatives the responsibility for authoring all tax bills; is that correct?

Mr. SAMUELS. That is correct.

Mr. MCDERMOTT. Were you invited up today as the Assistant Secretary of the Treasury to make a proposal from the administration or to comment on proposals which are before this Committee?

Mr. SAMUELS. I believe I was invited to make comments on proposals.

Mr. MCDERMOTT. So you were sandbagged. You were asked to come up here. I wouldn't make you comment on that, but it seems to me that the Majority here today has taken unfair advantage of you, putting you in a position where you are asked to come up and comment on proposals and then they demand that you make a proposal. That is not fair. I think that you ought to take the advice of the Revolutionary War, which is to hold your fire until you see the whites of their eyes.

Are you aware of any agreement between the House and Senate on this proposal or that proposal, either flat tax or a consumption tax?

Mr. SAMUELS. No, sir.

Mr. MCDERMOTT. You have heard another proposal from Mr. Hancock today to do absolutely nothing, just to hold steady, so we have another proposal here on the table today. So you have at least three proposals floating around; is that correct?

Mr. SAMUELS. There are many proposals floating around, yes.

Mr. MCDERMOTT. And according to the Constitution, all bills have to pass both Houses, House and Senate, and be sent to the President for his judgment, and at that point, you will make a recommendation to him about whether it is a good bill or a bad bill; is that correct?

Mr. SAMUELS. That is correct, Mr. McDermott.

Mr. MCDERMOTT. You might, of course, be willing to participate in the process of the groups drawing proposals up here, but you are not up here to force one on us, are you?

Mr. SAMUELS. No, sir.

Mr. MCDERMOTT. You would never see that as your role?

Mr. SAMUELS. No, sir.

Mr. MCDERMOTT. Let me ask you another question, because I do have another question.

There is a recent GAO report, June 1995, that indicated that the estimated amount of taxes not voluntarily paid has held steady at about 17 percent of the total Federal income tax due to the IRS. In 1992 that is estimated to be about $127 billion. And the largest component of noncompliance appears to be that people do not report all taxable income on their tax returns. Now, is there any proposal that is before this Committee, as far as you know, that will tighten up compliance and force people to report all of their income?

Mr. SAMUELS. Mr. McDermott, I am aware of that report, and that that is a problem that is kind of well-known and long standing; and I am not aware of any proposal that, at this point, is before this Committee on that issue.

Mr. MCDERMOTT. Are you aware of any proposal that is being proposed by—to this Committee that would make the noncompliance worse? I mean, you are looking at these proposals, are they going to be tighter in terms of getting taxes owed to the Federal Government, or are they going to be more easily evaded?

Mr. SAMUELS. Mr. McDermott, I think it depends on the type of proposal. For example, if the proposal is to replace the current system with a retail sales tax, that is one where one worries about compliance, because there is only one taxing point. And if you miss that point, you have lost all of the revenues. So we are, in looking at these proposals, we are trying to evaluate the compliance issues associated with them, and that is, I think, the one that we would have at this point the most concern about.

Mr. MCDERMOTT. So you are talking, in that sense, about a consumption tax, about a VAT or that kind of tax where it all is collected at one point or another.

Mr. SAMUELS. A retail sales tax.

Mr. MCDERMOTT. A retail sales tax, not the VAT?

Mr. SAMUELS. Right.

Mr. MCDERMOTT. The VAT, you think, is more efficient in terms of the ability to collect the tax, because there are more places where you can pick it up?

Mr. SAMUELS. I think from the compliance point of view, the VAT has kind of this built-in safeguard that you have to report your purchases to get the credit. And I think—my understanding is that the experience of European countries that have both VATs and in-

come taxes is when they introduce the VAT, their income taxes went up, because people were paying more attention to their purchases and sales.

Now, obviously, you can try to avoid the VAT by not reporting your purchases or your sales. That is a problem you have to watch out for. But it is, I think—a VAT, I think people feel, would have this safeguard for compliance and the tradeoff, of course, is that it is more complex, because you have more people who are paying the tax.

Mr. MCDERMOTT. Is there any proposal being made before this Committee that will not have rules and regulations?

Mr. SAMUELS. Mr. McDermott, I think all of these proposals will have rules and regulations.

Mr. MCDERMOTT. So it is a myth to tell people that we are going to pass a bill that will allow you to compute your taxes on a postcard and that will be the end of it, no problem, just take a postcard and you will be all done?

Mr. SAMUELS. Mr. McDermott, I think all of these proposals are more complicated than that.

Mr. MCDERMOTT. Thank you.

Mr. CRANE. Ms. Dunn.

Ms. DUNN. Thank you very much, Mr. Chairman. And Mr. Chairman, my personal view of the Presidency is that this is not supposed to be a ministerial position, but it should be a leadership position. And the President of the United States and his agencies that are subject to his direction ought to be coming up with visions for this country. As a result, I believe that Treasury, in coalition with the Presidency, ought to have a proposal for a good replacement tax system.

So I think that—regardless of what you have been invited up here to testify on, Mr. Samuels—I think that you leave the country without leadership by not proposing some strong system that is simple, that is fair, that would replace our current income tax system, which everybody agrees lacks totally in common sense, fairness, and simplicity.

I would just ask you, since apparently while I was gone at a press conference you did state to Mr. Levin that you will come up with some proposed changes to the current income tax system. My only question to you would be, how do you intend to handle the informal or underground income problem?

Mr. SAMUELS. That is a difficult problem that all systems face. Under today's conditions the underground economy is a problem. But I would note that there are kind of two parts to the underground economy. There is the illegal part of it, which I don't think will change under a new system, that part of the economy is going to remain out of the system.

The informal part of the underground economy would be someone who is engaged in activities that are not reported or are underreported. I don't think, as we have said in our testimony, that you are going to make major inroads in that area, and I think it is unfortunate. And the reason is that if you have a consumption tax, the people who are in the informal economy, to the extent that they are dealing directly with persons who are not businesses, they can just as well go and say to you, I will paint your house and I

won't charge you tax. That will be as possible under a consumption tax as it is now; there is no difference.

The issue where you could have some impact on the informal economy is when you are dealing with taxable businesses, and in a value-added context, the business wants to have an invoice so that the way you could get some extra compliance from the informal economy in a consumption tax system is through those transactions. But again, even there, some businesses will say, I won't report my purchases or my sales, so you don't necessarily solve the problem of an underground economy.

I think if you talk to tax administrators from countries that have consumption taxes, they will explain that issue, that they have a problem with their underground economy, as well, even though they have a consumption—obviously, it is not a full consumption tax; no country has a full consumption tax, but it is not their only tax. But the countries that have a consumption tax will tell you of the problems that they have with compliance.

So it is a vexing problem, and I think information reporting is a way of trying to improve that problem.

The GAO report that Mr. McDermott referred to I think had some suggestions of how to deal with it. It is a problem that deserves attention and I think that taxpayers who are paying are playing by the rules and paying what they should. They are the ones who are suffering because the underground economy isn't paying their share.

Ms. DUNN. Do you believe, then, Mr. Samuels, that the underground economy is simply one of those problems that can't be solved?

Mr. SAMUELS. I would never, I would never give up. I am always an optimist. But it is a difficult, it is a difficult situation; and I think, for example, dealing with illegal activities is extraordinarily difficult, and we basically have to rely on our law enforcement efforts to try to deal with that.

Ms. DUNN. Thank you.

Mr. CRANE. Mr. English.

Mr. ENGLISH. Thank you, Mr. Chairman.

Secretary Samuels, in your view, is a consumed income tax, like the U.S.A. tax, border adjustable under GATT?

Mr. SAMUELS. Mr. English, we have looked at that and have written a letter to Senators Nunn and Domenici on that, and we concluded that we don't know.

Mr. ENGLISH. OK. Well, that is a direct answer, and——

Mr. SAMUELS. And we would be happy to share——

Mr. ENGLISH. I would like a copy of that.

[The information was not received at the time of printing.]

Mr. SAMUELS. It is a complicated issue, and the so-called subtraction method VATs are GATT-legal, and there is uncertainty about a subtraction method.

Mr. ENGLISH. And that would have to be, I believe, decided by an administrative procedure under GATT?

Mr. TODER. That is correct.

Mr. ENGLISH. OK. I would like to explore the equity issue that a couple of my colleagues raised.

I noticed in your analysis of the progressivity of a couple of different proposals, particularly the consumption tax proposal, the usual distributional tables. I wonder if your analysis takes into account the secondary effects of tax changes, Mr. Secretary? In other words, are you simply looking at what immediate effect someone sees on their tax bill; or are you also taking into account the probable economic consequences and changes in economic activity? For example, for someone in the lowest quintile, although they might not see an actual immediate tax break, they might experience greater economic opportunity, a greater likelihood of getting a job, and the other things that flow from economic growth. Does your analysis take that into account?

Mr. SAMUELS. Mr. English, our analysis takes into account all Federal taxes.

Mr. TODER. Our analysis is somewhere in between the two things you said. We look at more than what is on an individual's tax return.

Mr. ENGLISH. OK.

Mr. TODER. For example, we believe, and I think any economist will tell you, that businesses don't pay taxes, that people do; and so we allocate taxes collected from businesses to people. And many of these proposals change the way taxes are collected from businesses, and so we look at how those tax changes would affect people's incomes. That is part of their tax burden.

Mr. ENGLISH. But as I understand it from your answer, you don't take into account all of the effects, including secondary effects, from tax changes. And you don't take into account behavioral changes, you don't take into account likely impacts on the economy and the spinoff effects that are going to occur that do really affect individuals.

You have offered an incomplete analysis here, but one consistent with the sorts of distributional analyses that are common in Washington; is that fair to say?

Mr. TODER. Well, we—let's put it this way. We are not—don't have any great expectation that these changes in the economy—and as we have testified, as Mr. Samuels has testified on the effects of aftertax returns to saving—will have any material or significant or predictable effect on economic growth. If you believe the economy will grow, you would have to—obviously, people will be somewhat better off than is shown in the tables.

Mr. ENGLISH. So your position is that tax changes of this sort don't affect economic growth?

I also understand, and I assume this is the administration's view, that tax changes don't affect the savings rate. Is that accurate?

Mr. TODER. We believe there would be a modest improvement in the savings rate.

Mr. ENGLISH. OK. Could you envision any tax change that would lower the cost of capital without making the Tax Code less progressive under your analysis?

Mr. TODER. I believe that we could change—there have been many proposals that have been made. For example, there was a Treasury report in 1992 on integrating the corporate and individual income taxes. That idea has been floated a number of times.

People have not responded to it very enthusiastically. But I believe—and it costs money.

But I believe one can develop proposals; to change the mix of taxation on businesses, if they are appropriately financed, could lower the cost of capital.

Mr. ENGLISH. Thank you, Mr. Chairman. Let me just say, I avoided in my questioning what the gentleman from Washington characterized as sandbagging our witness, but I would like to say for the record that I am also deeply disappointed that we have not been given guidance by the Clinton administration on what they would like to see in an alternative tax system in the form of a specific.

It was clear from the testimony that Secretary Samuels—you weren't here to offer that, and that the administration apparently is not developing a proposal; and I intend to send to Secretary Rubin—and I hope you will take this back to him—a formal request that they do so, which I believe is entirely appropriate.

Thank you, Mr. Secretary.

Chairman ARCHER [presiding]. Mr. Christensen.

Mr. CHRISTENSEN. Thank you, Mr. Chairman.

I too subscribe to the Archer rule of common sense, and after listening to the testimony here today by the administration, it is obvious that we are not going to have any leadership out of the White House on this issue either.

You know, as a freshman on this Committee, I have sat here in amazement and listened through the first 5 months when you punted on Medicare and punted on balancing the budget. As a matter of fact, the President's budget had deficits as far as the eye could see, he has threatened to veto the rescissions package, and now he's offering no suggestions to help us overhaul the Tax Code and come up with a new system.

You know, being a farmboy from Nebraska, I wonder what all of you are doing over there. Frankly, there is no leadership at all.

I heard you answer Mr. Cardin's question that you are going to offer a proposal. Do you have any idea when that might come out? You have been very careful in your words, and I know that you have been told to not say anything specific. Will you have it this month or next month?

Mr. SAMUELS. Mr. Christensen, what we said is we are working on simplification proposals of the existing system and we are working on that. We are considering options, and I don't have a timetable for when we will make them public.

Mr. CHRISTENSEN. OK. Let's say that you were simplifying the current system. Precisely how do you plan to simplify the current system? What are some suggestions that you have looked at?

Mr. SAMUELS. Well, here are the types of things that we are looking at. For example, the alternative minimum tax system for individuals needs to be reviewed. Right now, you have about 3 million individuals who have to file forms that don't pay AMT. Only about 300,000 individuals pay AMT. So you have 3 million people filing forms and only 300,000 people actually pay it.

We think that we should be looking at that area to see whether we can simplify the system. We think we should try to figure out

how to expand the number of people using 1040EZs and 1040As, that that would be a useful thing for today's system.

We think that we should look at the definition of "dependent," because it is somewhat complicated, to see whether there are any simplification things that we can do there.

We have a series of those types of proposals that we are considering and evaluating.

Mr. CHRISTENSEN. Is the administration spending more time in this area of looking at simplifying the current Code, or do you think the administration is looking at the ideas that the Congress is exploring in terms of revamping the whole system and moving to a consumption-based tax that both the Ranking Member, Mr. Gibbons, and the Chairman are looking at, or the flat tax that has been floated out there by Mr. Armey and others?

I hear more from your testimony that you are looking at trying to fix a bad tire rather than put a new tire on.

Mr. SAMUELS. Mr. Christensen, we have been spending a substantial amount of time evaluating the proposals that have been made—the flat tax proposal, that consumption tax proposal we have looked at and we are continuing to look at. We are looking at the proposal by Senators Nunn and Domenici. So we are spending a very significant amount of time on those proposals, and if you look at our testimonies and you see the analysis that we have done and the simulations that we have done to try to understand how these proposals will work, who are the winners and who are the losers, you can see that we are spending a very significant amount of time on those proposals.

Mr. CHRISTENSEN. I will look forward to the President and his administration taking a stand and coming out with their specific recommendation, rather than being a reactionary, irrelevant part of the process. I hope that you will join the Republican Majority and help us change what has been a very complex, cumbersome, bureaucratic tax system. I appreciate your help on this.

Chairman ARCHER. Is there any Member who has not inquired, who wishes to inquire?

Mr. Samuels, thank you for spending so much time with us today and responding to some very difficult inquiries. One thing that was not mentioned today is that it is estimated that there will be 40 million Americans who will have a confrontation with the IRS this year: 40 million Americans. Now, some of those will be very small. But each of them will get a letter from the IRS, and when an individual citizen gets a letter from the IRS, it is not a very pleasant experience.

Interestingly enough, it is estimated that over 50 percent of those confrontations will be won by the taxpayer, and yet what I hear you saying, that what you want to come to this Committee with at some point in time is a further tinkering around the edges, as we have done over and over and over again for the last 20 years, and still have a system that puts us in the position that we are in today.

What are you going to do, for example, for a head of household? That is a fairly basic thing for people under this tax system. The IRS has to ask 42 specific questions of an inquirer before they can

give a definitive answer as to whether you are or are not a head of household.

I think inherent in the fabric of this income tax is an impossibility of fixing it, and so I really would hope that when you go back and you talk to Secretary Rubin, and perhaps to the President, that you will urge them to come forward with some sort of broad recommendation that we can consider; and we will give full consideration to it, because we are looking for answers. And you have the capability, I think, to give us a lot of good suggestions as to what answers might be the best for this country to put us ahead in the global marketplace, to put us ahead in capital savings and investment and productivity and better real jobs for all Americans.

So again I want to thank you very much for coming today, and I am sure it won't be the last time that we will see you before the Committee.

Thank you, Mr. Toder, as well.

Mr. TODER. Thank you, Mr. Chairman.

Chairman ARCHER. Our next witness is our colleague, Chris Cox.

Chris, we are happy to have you before the Committee, and know that you will feel welcome; and we would encourage you under our Committee rules, and probably those of your Committee too, to try to limit your oral presentation to 5 minutes or less, and anything that is more extensive will be submitted for the record and accepted in the record.

So welcome, and you may proceed.

STATEMENT OF HON. CHRISTOPHER COX, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Mr. COX. Thank you very much. I will be pleased to do so.

Chairman ARCHER. If you will suspend for just 1 second, Chris.

Our colleague, Sam Gibbons, was due to testify today; and because of the way the time has worked out, he will be testifying tomorrow, and we will have a greater opportunity to spend the time in developing his recommendations.

So Chris, you may proceed now.

Mr. COX. Chairman Archer, I am here to congratulate you on your vision and courage in proposing not simply to reform, but to replace, the income tax. I am here as the Chairman of the Republican Policy Committee because this is the most pure issue of policy that our Congress will have the opportunity to debate. And I am here because the national debate that you have ignited is of such enormous importance that I am certain it will eclipse even such issues as term limits or the flat tax itself.

For a brief time in my career, I taught Federal income tax, as you know, at Harvard University; and I became as familiar as a teacher might become with 8 volumes of IRS Code and regulations and 14,700 pages and another 200,000 pages of decisions and interpretations that ordinarily accompany our Code, and I was apprised that ignorance of the law is no excuse.

I was once on a television show with Fred Goldberg, who was then our Commissioner of the Internal Revenue Service; and I had the opportunity to ask him, do you use an accountant to help you prepare your income taxes? And I confessed that I did with mine, and he said, yes.

What kind of a system have we got?

What we have learned in the history of the income tax since it was first made possible in 1913 is that the Federal Government simply cannot be trusted with the power to wield this intrusive, destructive, wasteful and counterproductive tax. Our Founding Fathers wisely prevented against an income tax in the Constitution itself. It took a constitutional amendment to permit what has developed into the most invasive and hated interference of the Federal Government in the lives of ordinary citizens. Not only the Founding Fathers, but the authors and the sponsors of the 16th amendment itself would be horrified to learn what we have permitted their income tax to become. Even its sponsors assured the Nation that a system such as ours today would be unthinkable.

The Chairman of the Ways and Means Committee, Representative Payne of New York, who sponsored the bill, supported it, voted for it, and managed it on the floor, supported the 16th amendment because he believed the country should have an income tax only in time of war. I now quote from his floor remarks.

> As to general policy of an income tax, I am utterly opposed to it. I believe, with Gladstone, that it tends to make us a Nation of liars. It is the most easily concealed of any tax, the most difficult of enforcement, and the hardest to collect. It is, in a word, a tax upon honest men and an exemption of the income of rascals.
>
> I hope,

he added,

> that if the Constitution is amended—

and remember, he sponsored the amendment, supported it on the floor and managed it—

> I hope that if the Constitution is amended in this way, the time will not come when the American people will ever want to enact an income tax except in time of war.

That was the Chairman of the Ways and Means Committee.

How about the Democrats? As for the leading Democratic sponsor, Representative Clark of Missouri, he offered his support for the constitutional amendment in the context of the income tax bill they were then debating. It had an exemption of $5,000, which meant that nobody who made that income paid any income tax at all.

I have adjusted these figures so you can understand what it was like to hear that debate on the floor; I have adjusted the figures for inflation.

I do not believe, he said, that $82,000 per individual exemption is too much. I certainly would increase it. And for this reason: $82,000 is not an unreasonable amount for a man to support a family on or educate his children, $99,000 would not be an unreasonable amount, $115,000 would not be an unreasonable amount. But I say that when a man's net income rises above $1.65 million per year, it does not make any difference to him practically whether you take 1 percent, 2 percent, and so on.

It is easy to see why the income tax law was passed. Everyone believed someone else would pay. As recently as the eve of Pearl Harbor, only one in every seven Americans was required even to file an income tax return. The last time we had a Republican Chairman of Ways and Means was 1954. The Federal tax burden on the average American family then was one-tenth of what it is today. But today, in the late 20th century, each of you here and

each of your constituents pays several hundred percent more in taxes than your mother and father. In fact, today, over 95 percent of all taxpayers who are forced to file income tax returns are people who were promised by the sponsors of the 16th amendment that they would never be taxed at all.

Mr. Chairman, in your other responsibilities in this Committee you are looking at major spending programs. And I urge you as you go about your business of cutting spending to think of this not as an exercise in rationing pain and scarcity, but rather an exercise in making possible the kind of America that my parents knew, that I had when I was a child, as recently as the fifties.

At that time, the average American family making the average American income paid an income tax rate of 2 percent. They paid a mortgage—on their 30-year mortgage, they paid an interest rate of 4 percent, because the government then balanced its budget, had a surplus in an era of low taxes. The FICA tax rate was 1.5 percent. All of this is possible if we are willing to reduce the size and scope of government, and hand-in-hand with that exercise goes your effort to not just reform, but replace the income tax.

I will now close, because I see the red light is on. Within the memory of some of the people in our audience, on July 5, 86 years ago, Congressman McCall, a Republican from Massachusetts, looked into the future, into our own day, and he asked a troubling question about the constitutional amendment that the House voted to approve later that day. Why, he asked, drag every governmental power to Washington? So that a vast, centralized government may devour the States and individual liberty as well? I say this amendment should be more carefully considered than it has yet to be considered.

In the intervening decades, the American people have had ample opportunity to consider the income tax and they have found it wanting. It has become everything that Congressman McCall feared. It now deserves to die.

I wish you Godspeed in your efforts in igniting this debate. I thank you, Mr. Chairman.

[The prepared statement follows:]

CHRISTOPHER COX
CALIFORNIA

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JOINT ECONOMIC COMMITTEE

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CAPITAL MARKETS

JUNE 7, 1995

STATEMENT OF REP. CHRISTOPHER COX
CHAIRMAN, REPUBLICAN POLICY COMMITTEE

BEFORE THE COMMITTEE ON WAYS AND MEANS
ON ABOLISHING THE FEDERAL INCOME TAX

Chairman Archer, I appear here today to congratulate you on your vision and courage in proposing not simply to "reform," but to replace the income tax. I appear as the Chairman of the Policy Committee, because this is the most pure issue of policy that our Congress will have the opportunity to debate. And I'm here because the national debate that you've ignited is of such enormous importance that I am certain it will eventually eclipse even such issues as term limits or the flat tax itself.

For a brief time in my career, I taught federal income tax at Harvard University, and I became as familiar as a teacher might become with eight volumes of the Internal Revenue Code, and Regulations comprising 14,700 pages, and another 200,000 pages of decisions and interpretations that ordinarily accompany the Code. As a taxpayer, not to mention as a teacher, I was also daunted by the knowledge that, in the government's view, "ignorance of the law is no excuse."

I was once on a television show with Fred Goldberg, who was then our Commissioner of Internal Revenue. I had the opportunity to ask him: "Do you use an accountant to help you prepare your income taxes?" I confessed that I did with mine. He admitted that he, too, needed an accountant to figure his tax liability. When even the IRS Commissioner needs help to do his income tax, what kind of a system have we got?

What we have learned in the history of the income tax, since it was first made possible by the ratification of the 16th Amendment in 1913, is that the federal government simply cannot be trusted with the power to wield this intrusive, destructive, wasteful, and counterproductive tax. Our Founding Fathers wisely prevented against an income tax in the Constitution itself. It took a Constitutional Amendment to permit what has developed into the most invasive and hated interference of the federal government in the lives of ordinary citizens.

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Not only the Founding Fathers, but the authors and sponsors of the 16th Amendment itself, would be horrified to learn what we have permitted the income tax to become. Even the amendment's sponsors assured the nation that a system such as ours today would be unthinkable. Like many of his Republican colleagues, Rep. Sereno Payne of New York, the Chairman of the Ways and Means Committee--who sponsored the 16th Amendment, supported it, voted for it, and managed it on the floor--supported it only because he believed the country should have the option of an income tax in time of war.

I now quote from his floor remarks:

> As to the general policy of the income tax, I am utterly opposed to it. I believe with Gladstone that it tends to make a nation of liars; I believe it is the most easily concealed of any tax that can be laid, the most difficult of enforcement, and the hardest to collect; that it is, in a word, a tax upon the income of honest men and an exemption, to a greater or lesser extent, of the income of the rascals; and so I am opposed to any income tax whatever in time of peace. . . . I hope that if the Constitution is amended in this way the time will not come when the American people will ever want to enact an income tax except in time of war.

That was the Chairman of the Ways and Means Committee, the chief Republican supporter of the income tax amendment. How about the Democrats? As for the leading Democratic sponsor, Minority Leader Champ Clark of Missouri, he offered his support for the Constitutional Amendment in the context of the income tax bill that was then being debated. The bill contained a $5,000 exemption, meaning that nobody who earned this amount paid any income tax at all. I've adjusted these figures for inflation, so you can understand what it was like to hear Rep. Clark's remarks on the floor:

> I do not believe that the $82,000 exemption is too much. . . . I certainly would increase it rather than diminish it, and for this reason: $82,000 is not an unreasonable amount for a man to support a family on and educate his children; $99,000 would not be an unreasonable amount; $115,000 would not be an unreasonable amount. But I say that when a man's net income rises above $1.65 million a year it does not make any difference to him, practically, whether you take one percent, two percent, five percent, or 25 percent.

It is easy to see why the income tax law was passed. Everyone believed someone else would pay. As recently as the eve of Pearl Harbor, only one in every seven Americans was even required to file an income tax return. The last time we had a Republican Chairman of Ways and Means--1954--the federal tax burden on the average American family was one-tenth of what it is today.

But today, in the late 20th century, each of you here and each of your constituents pays several hundred percent more in income taxes than your mother and father. Today, over 95% of all taxpayers who are forced to file income tax returns are people who were promised by the sponsors of the 16th Amendment they would never be taxed at all.

Mr. Chairman, in your other responsibilities on this Committee, you are looking at major spending programs. As you go about the business of cutting spending in these huge federal programs, I urge you to keep this in mind: Cutting spending and reducing the size of government should not be an exercise in rationing pain and scarcity. Rather, it should be done in order to return the benefits of freedom to every individual citizen. Because of the twin evils of the income tax and the endlessly expanding welfare state, middle America now bears a much greater government burden that when I was a child. It need not be that way.

When I was a child, in the 1950s, government did not consume 40 percent of our gross domestic product, but half that. As a result, the average American family, making the average national income, paid an income tax rate of just two percent. The average family of my parents' generation could afford a three-bedroom home, even though the norm was that only one spouse had to work. They paid only four percent interest on their 30-year mortgage. Their FICA tax rate was one and a half percent. All of this was possible because--despite such extravagances as the Korean War, the G.I. Bill, and the Marshall Plan--the federal budget was balanced in a low-tax environment.

That kind of freedom and opportunity is again possible in our future. But it will only become reality if we are actually willing to reduce the size of government, and only if we recognize that the income tax, in the American context, is an experiment that has been tried and has miserably failed.

On July 12, eighty-six years ago--within the memory of some of the people in our audience--Congressman Samuel McCall, a Republican from Massachusetts, looked into the future, and asked a troubling question about the Constitutional amendment that the House voted to approve later that day:

> Why drag every governmental power to Washington so that a vast, centralized government may devour the states and the liberty of individuals as well? I say this Amendment should be more carefully considered than it has yet been considered.

In the intervening decades, the American people have had ample opportunity to consider the income tax, and they have found it sorely wanting. It has become exactly what Congressman McCall feared. It deserves to die. I wish you Godspeed in your efforts, Mr. Chairman.

Chairman ARCHER. Thank you, Congressman Cox, for really putting what we are about here in historical perspective. I think it is very, very good for us to look back and to see the history of what has occurred.

We had a witness here yesterday who said that 1 page of history is worth 200 pages of logic, so I thank you for your presentation today.

Mr. Thomas.

Mr. THOMAS. Thank you very much, Mr. Chairman. I too want to thank you, Chris, not just for your testimony, but your leadership in a number of areas, not the least of which is the whole tax question. Having seen it as a payer, a user and a teacher, you have probably walked around it in more facets than most of us.

You perhaps caught just a bit of the administration's testimony before you began. What we will be looking for is guidance from any number of people who want to help us in choosing from the bipartisan alternatives that are in front of us, and I would hope as Chairman of the Policy Committee of the Republican Conference that there will be a dialog carried out, not necessarily to pick a winner, but to at least indicate the general support in the direction that we are going.

What I found most ironic about Under Secretary Samuel's testimony was an unwillingness to look at where we are today and where we may be tomorrow. When you phrase the question, do you want to get rid of the income tax and also the Internal Revenue Service at the same time, a number of people would be tempted to say yes. But when you say, as a bonus, you will also get rid of the payroll tax on the employer, that you will harmonize the tax structure for trade with other countries, and that you will stop punishing savings and investment and really support accumulation of wealth all at the same time, some of us find it difficult to find people dragging their feet.

When you are out talking to your constituents, do you find anybody able to muster an argument in favor of the current system or in favor of the current system with minor changes, or even in favor of the current system with major changes?

What do you find out there?

Mr. COX. I find my constituents are not just tempted by the thought of abolishing the income tax and the IRS, they are delirious about the possibility. But frankly, because this debate is just now getting underway because of the leadership of the Chairman of the Ways and Means Committee, what I find chiefly among my constituents is that they were not aware that it was thinkable. They are used to thinking of Washington as a calcified place where nothing changes, and even though they are utterly convinced of the illogic of the system, the wastefulness of it, of the enormous costs which they are very familiar with, even if they haven't seen in the studies, they know in their own lives, their own businesses what it means.

The compliance costs, they didn't think that we were smart enough here in Washington to understand that. And now that this debate is underway and people realize that it is possible not just to tinker with the income tax, but to get rid of it, I think you have got a tiger by the tail here.

Mr. THOMAS. Well, I looked forward to this moment as a Member of the Taxwriting Committee, but I honestly thought it was going to take a change in the Majority control of the House to bring it about, and lo and behold, that is the case.

We look forward to your continued input, not just as a Member who understands the system, but as someone who is in an extremely important position to assist us in making choices among the very attractive alternatives that we will be looking at. I thank you very much for your participation.

Chairman ARCHER. Mrs. Kennelly.

Mrs. KENNELLY. Thank you, Mr. Cox. No questions.

Chairman ARCHER. Does anyone else wish to inquire?

Mr. Hancock.

Mr. HANCOCK. Yes.

Mr. Cox, what type of law or kind of law did you practice in the private sector before you came into the Congress?

Mr. COX. General business law.

Mr. HANCOCK. I understand that you were heavily involved, though, in the creation of capital—of venture capital, helping businesses get started?

Mr. COX. That is exactly my specialty. I did capital formation.

Mr. HANCOCK. OK. Under these circumstances, your business was primarily to create jobs, to start new businesses or to emerge businesses to where we could create jobs, and make us more able to compete on a worldwide basis and what have you through this type of structure.

How much of your time would you say percentagewise with one of your clients was spent in the idea of how you developed jobs, or how you can do it from within the Tax Code, and to be able to keep enough of the capital to expand the business? What percentage of your time was spent on that part of starting a business, say?

Mr. COX. Probably a third to a half. I tried to make my specialty the business side, the venture capital, the initial public offering, how to start up your company, how to expand your market, go through financing and so on. But the tax side of it was sufficiently important and dominating in many cases that when eventually I was asked to teach Federal income tax at Harvard Business School, it was based on the experience I had gained allegedly in a nontax area. But I didn't have to do too much prep work in order to teach an introductory course in Federal income tax because of that.

I tried to teach a course called "Tax Factors in Business Decisions" which—the notion that students in business school should learn that you make a business decision and only take tax factors into account, but you don't make decisions for tax reasons. It became increasingly hard to convince people, given the big numbers they were looking at with taxes, that that made sense.

Mr. HANCOCK. Did you ever have a client that made the decision to establish his business outside of the United States because of the tax structure in the United States?

Mr. COX. I never counseled anybody who did that, but I did have clients who already had established operations overseas, in many cases, who take advantage of the lower tax, lack of capital gains taxes and so on.

Mr. HANCOCK. You never had a situation where, following your counsel, that organization made the decision without your counsel, though, to go to a foreign country to establish their business?

Mr. COX. I did not, but I was counseling mostly startup companies and so on that hadn't gotten to the point yet where they had an operation to pick up and move.

Mr. HANCOCK. But you know of a lot of cases where that has happened?

Mr. COX. I am well aware that people move jobs to other countries on a routine basis in order to avoid the tax burden that is relatively higher here in the United States.

Mr. HANCOCK. Thank you very much. I really appreciate your testimony, and I appreciate the work that you have done here in the Congress. Thank you.

Chairman ARCHER. Congressman Neal.

Mr. NEAL. Thank you. Chris, you made reference to 4 percent interest rates. What kind of deficit reduction could you think would be necessary to get us to 4 percent interest rates again?

Mr. COX. Well, in those days we found that the Congress was able to support such extravagances as the Korean war, the Marshall plan, GI bill, all with a balanced budget, a surplus budget in a low tax rate environment.

It is extraordinary to think how we have failed, in comparison. I believe if we were to do the same, that is to say, operate at a surplus to take on those major responsibilities of which we were capable, but none of those of which we were not capable, that we would find ourselves in that same zero inflation environment that would permit 4 percent interest rates on 30-year mortgages.

Mr. NEAL. The interest rate on my home is 8 percent after all these years. If there is any suggestion that you could have that is going to bring interest rates down and I am not aware of any ideas in the current marketplace, could you share that with us?

Mr. COX. Roughly speaking, you are paying an inflation premium on top of the 4 percent rate that your parents paid.

Mr. NEAL. Thank you.

Thanks, Mr. Chairman.

Chairman ARCHER. Chris, would it not also have a major impact on interest rates if you had a zero tax on savings and investment? And if you were able to completely abolish the income tax, would you not have a far greater influx of interest in investment by foreigners in this country which would once again put more money available for loan purposes? And under the law of supply and demand, because money is fungible, and fungible worldwide today, if there were far more money available for loaning in the United States, would that in itself not drive the interest rates down?

Mr. COX. That is exactly what it would do. Today we have an abysmal 3.9 percent savings rate. That is woeful compared to the rate at which Americans used to save and invest when I was a child, when my parents were working in the fifties.

Interest—interest rates are one measure of the cost of capital. The price of money will, like the price of any commodity, go down as the supply goes up. If we can supply more savings, more investment capital in the system, necessarily, we will drive down interest rates at the same time. And of course, if you relieve our American

system right now of the burdensome tax on savings and investment, you will have exactly that result.

Chairman ARCHER. Thank you.

Ms. Dunn, did you wish to inquire?

Ms. DUNN. I did want to. Thank you, Mr. Chairman.

Chris, I remember last year when a group of us was putting together the Contract With America your frustrations in not being able to include in that proposal the repeal of the 16th amendment. And I just wanted to tell you that I can understand your satisfaction now, sitting here, realizing that the impossible is now occurring; and Chairman Archer has put on the agenda for discussion this major, major change in public policy.

Chairman Archer asked earlier today a question of the Treasury Assistant Secretary, who was not forthcoming with us, as to the administration's proposal for a replacement Tax Code. He said, If you could design the most appropriate way to raise the money to pay the government's bills, what would your proposal be? Are you in a position now to make a proposal to us for a new Tax Code to replace the income tax?

Mr. COX. What you replace the income tax with is of vital importance. Obviously, if we don't have an income tax any longer, we are immediately in the realm of consumption tax. Many economists, if not most economists, tell us that that is a step in the right direction, that that is an improvement, and I would dare say that that is something upon which economists who would consider themselves of liberal stripe agree upon with economists who consider themselves to be conservative or supply siders.

But what kind of a consumption tax and precisely how one implements it is very, very important. There are details here that I can't possibly cover in 5 minutes or 30 seconds or however long I am permitted to respond to the question, that if tweaked, could change the fairness of the system, the advocacy of the system, the cost of enforcement of the system and so on. And that is what these hearings are all about.

I concluded my formal remarks with a quote from Congressman McCall saying that when they passed the 16th amendment, they did it in a 4-hour debate, that they didn't spend enough time thinking about what they were up to. I hope we don't make that mistake. I know we will not.

I think what Chairman Archer has done is started a national debate that will probably last more than 1 year, probably more than 2 years. It will take some time for us to flush this out. The important thing is that today, yesterday, you began this, and this is a historic course. I just want to be sure that as we start at the front end of this process, everyone recognizes just how significant this is in the history of our country.

Ms. DUNN. Thank you.

Chairman ARCHER. Mr. Zimmer.

Mr. ZIMMER. Congressman Cox, I would like to know, at what point do you want to repeal the 16th amendment? While we are still debating tax alternatives? Because I would assume that by repealing the 16th amendment, then you take the flat tax off the table, and you take the Nunn-Domenici tax bill off the table, because they would not be constitutional any longer.

Is that your understanding as well?

Mr. COX. Yes. There are two things that one must consider in passing a constitutional amendment affecting taxes. One is that it will make possible whatever tax system you have in mind at the moment, and that is of course the milieu in which the 16th amendment first was adopted.

Second, you have to try to project what subsequent Congresses might do with the power that you have given or the power that you have subtracted. And so I believe we have to be just as sober about repealing the 16th amendment as we are when we passed the balanced budget amendment, as we are when we consider any amendment to the Constitution. As a practical matter, it will take multiple years to ratify.

In order to get us an income tax in the first place, we had about an 18-year period from the commencement of the debate in the late 19th century until final ratification by the last State in 1913. I hope it doesn't take us 18 years from the date of this hearing to get a result, but it will take as a practical matter something more than a year or two; and I think that is ample time for us to flesh out the whole debate and consider whether we have an acceptable alternative in the form of a consumption tax to substitute for today's income tax.

Mr. ZIMMER. As I understand it, one of the reasons the 16th amendment was enacted was because of some fairly cryptic language in the Constitution, as it was originally drafted, limiting the ability of Congress to impose direct taxes without allocating them among the States according to population. That is the best I can recall the language.

What does that prohibition mean and would any tax, nonincome tax that you would foresee require some kind of modification of that proscription?

Mr. COX. I don't think so. The Supreme Court ruled that the—I find, by the way, the language to be unambiguous in the Constitution.

Mr. ZIMMER. What is the direct——

Mr. COX. The Supreme Court so held, the Court at that time held that, in consistency with the language in the Constitution, any tax levied by the Congress must either be a capitation tax—that is, a head tax, if it were to be a direct tax on individuals rather than on transactions—or the proceeds of the tax would have to be apportioned among the several States. So you couldn't tax money from New Jersey, which would be a donor State, and give a net benefit to California. That was what was meant by the original constitutional provision.

I think it remains unambiguous. It has never been the subject of a lot of constitutional debate or discussion beyond those decisions.

So I think if you repeal the 16th amendment, what you are left with is the Federal capacity to tax transactions.

There was a corporation income tax that was found to be constitutional that antedated the 16th amendment because it was a franchise tax on the privilege of being a corporation. So sales tax, for example, which is one of the things that you are considering, all other manner of transaction taxes, even a VAT, although I don't

favor it, all of these things would likely be squarely within the constitutional power to tax that the framers, the Founding Fathers, conferred upon Congress to begin with in article I.

Mr. ZIMMER. Would it be possible to include deductions and exemptions as means of assuring progressivity in a consumption tax, a sales tax-based system, or VAT tax system, under the proscription of the original Constitution?

Mr. COX. Yes. In my view, that is straightforward, in the same fashion that now we make a legislative judgment that we are not in State *x* going to levy a sales tax on groceries or on rent——

Mr. ZIMMER. Or on people earning less than $10,000 a year?

Mr. COX. Well, no. Once you frame it as an income tax, I think you are going to get, at the very least, into a gray area. The whole point here is to tax transactions rather than to tax people on the basis of their incomes. That is why the language of the 16th amendment was incomes from whatever source derived.

Mr. ZIMMER. Thank you.

Chairman ARCHER. Mr. Portman, and then hopefully we are going to recess at 1 o'clock.

Mr. PORTMAN. Thank you, Mr. Chairman.

Briefly Chris, thanks for all of your work on this. And I found that last dialog fascinating; one of my questions was how much of the progressive/regressive concerns that were expressed by Mr. Samuels earlier could be addressed by not having the 16th amendment; and I think that is something we need to look into, because part of the response to my earlier questions to him I think were along the lines of having almost a concurrent system to have some income-based system in order to deal with what he considers the unfairness of the system.

You have the experience of also working in the White House Counsel's office; I believe you were there during part of the formulation of tax policy from that, independent of Pennsylvania Avenue, and then you went into the private sector and got involved with tax-motivated business decisionmaking, and then taught tax, so you are a glutton for punishment. You have a good background to talk about this.

I didn't want to have you leave here without pushing you a little bit further, therefore, on your views as to the future. Without getting into a lot of detail, in response to Jennifer Dunn's comment, you indicated that you would indeed support movement away from an income tax and therefore to a consumption tax system of some kind, the details being more difficult. You then mentioned briefly that a VAT tax wasn't necessarily your favorite or preferred option.

Are you leaning more toward, then, a retail sales-type tax, or what other ideas do you have, generally speaking, at this point as to where we might move?

Mr. COX. I would like to address two things that you raised: First, the kind of consumption tax that might operate best and what I think might be its features; and second, the notion, based on my experience with Mr. Zimmer, of repealing the 16th amendment and analyzing what powers would remain for the Federal Government.

The only reason I think it is necessary for us to address the 16th amendment at all in the form of a repeal is that I don't know that

the American people are willing to have this Congress pass a big new national tax right on top of the income tax they have already suffered through, even if some Congress promises them, don't worry, we will reduce the income tax burden so that this big new tax we are visiting upon you will be not so bad.

Because we have seen the history. I quoted to you from the original debates in Congress, when it was proposed that they tax only millionaires. Now we know 95 percent of all taxpayers fall below the line that that original Congress intended to exempt. That is to say, they have to file now, and it was intended that they should not. So it was for that reason that I think, as a political matter, we would be wise to consider, if we are going to pass a big new tax of some sort, simultaneously to promise to the American people in a binding way that we mean it, we are not kidding, we are going to take away the income tax. You don't have to trust us on this, we have taken away our power to levy, as to how best to structure the consumption tax.

The opportunity is to have a broad-based tax and therefore a very low rate. The opportunity simultaneously is to have it be efficient in collection so that the burden on individuals is taken away. You don't have to do all of that paperwork, you don't have to think about April 15 all year long. The government is not intruding into your life, and you are not going to go to jail because your shoebox was out of order.

By the way, in the constitutional debates in the House, I noticed that the sponsor said, nobody will ever go to jail. People opposed to it said, you are going to go to the penitentiary if you don't have the right papers and the government is going to snoop around and so on; and people said, that is ridiculous. But of course that is exactly the way the IRS operates today. So that is the benefit of that tax.

The problems that this Committee are going to have to address in a sales tax include noncompliance. Will people cheat, will they be able to—will we stimulate somehow the underground economy? The basic precept of a consumption tax is, you get rid of the underground economy which is flourishing under the income tax because you tax transactions that are unavoidable. Structured properly, it seems to me some kind of transaction tax, modified sales tax, maybe sales tax just like we have right now would achieve that.

You also need to make sure that it is procompetitive, that it stimulates all of the things that we as Members of Congress want to stimulate both in the economy, work, savings, investment, and so on.

Those would be my criteria, and I suspect they would be yours as well.

Mr. PORTMAN. Thank you.

Chairman ARCHER. Thank you for an excellent presentation. The Committee will stand in recess until 2 o'clock.

[Whereupon, the Committee recessed, to reconvene at 2 p.m. the same day.]

Chairman ARCHER. The Committee will come to order. Jon Christensen and I are here, and that is great quality. While we may lack in numbers up here, we have the quality to speak to at least the panelists at the beginning.

Gentlemen, welcome to the Committee. I apologize to you for the delay in how long you have had to wait today. It really was pretty much beyond our control, but we are delighted to have you with us and we are looking forward to hearing your comments on the VAT.

Cliff Massa, would you like to proceed.

STATEMENT OF CLIFF MASSA III, PARTNER, PATTON BOGGS, L.L.P.

Mr. MASSA. Thank you, Mr. Chairman, and Member of the Committee. My remarks are going to emphasize three points, on which there is more detail in my written statement. The first, just as a taxpayer and observer, we have an opportunity to perhaps try to establish some principles on which to build a tax reform package.

Second, that whatever we do, a single-rate tax should be applied to all economic value added as the most sensible base on which we can build a new tax system, one that differs dramatically, by the way, from VATs around the world. Third, my observation that the subtraction method tax is the way to proceed.

As to principles, it seems to me that if we are really going to contemplate starting from scratch, perhaps we could agree on a few basic things. Perhaps, one, that the government's general revenue system is there solely for the purpose of raising revenue; second, that it ought not be used to try to achieve particular purposes, economic, social, good, bad, or to penalize or encourage particular activities; third, that we finally integrate our tax system with those of our trading partners; fourth, that we develop a system that has the maximum amount of simplicity, but also the maximum efficiency so that we can eliminate a lot of wasted planning and compliance time and get the maximum part of the base covered. Finally, let's try to address any regressivity of the system outside the system.

Granted, those proposals, those principles can be agreed with, disagreed with, but they are ones that kind of appeal to me, and on the basis of those principles it seems to me that economic value added in its most generic sense provides this country with the best, most neutral, least distortive tax base we can come to.

I want to emphasize by this that I am not talking about VATs in the sense that most of us understand them. Systems in other countries in Europe, Canada, Mexico, which I think my colleague, Dr. Cnossen, may be able to comment more on than I am able to, are probably the worst possible models to deal with. I am going to suggest that economic value added in its most generic sense is, in fact, the best system to work with.

By that, I understand value added to be the amount that each business adds to the production of goods and services as they move through the economy. In essence, as long as a business is selling goods and services for more than it pays for its inputs from other companies, it is adding value.

Looked at another way, what it is using is its labor services, the services of its employees, and its capital services, the services of its lenders and its owners, to turn inputs into more valuable outputs. If that is the sum and substance of value added, which is what I understand it to be, it seems to me that that is as close to perfection in a tax base as we can come.

It is going to treat labor and capital or more accurately the payments for labor services and the payments for capital services the same way. It treats debt and equity the same way. It treats all businesses the same way. It treats foreign and domestic producers the same way.

There were some concerns this morning expressed by Treasury that we may not be able to reach an ideal system. Well, perhaps not, but it certainly seems to me that we ought to start there. If we are going to wipe away a rather complex system, let's try to reach for the ideal, and I think value added in its economic sense is the ideal.

Let me focus on the subtraction method value-added tax, which is what I was asked to deal with particularly. There is a different method that is used in other countries. It is known as the credit method whereby each transaction has a tax notation on the invoice. You add up your tax amounts, subtract the tax amounts on your purchase invoices, and you pay the difference.

My colleague, Alan Schenk, will go into much more detail on that. The subtraction method to me is a little simpler, although the economics are the same. Every business aggregates its sales receipts for goods and services, subtracts its purchases of goods and services, and pays a tax on the difference, which is equal to its value added. It is interesting that all the tax proposals that are put forth at the moment rely to some degree or another on a tax on value added and particularly on a subtraction method—Mr. Gibbons' proposal, the U.S.A. tax, the business portion of it from Senators Nunn and Domenici, former Senators Danforth and Boren's business activities tax. While it may be a little controversial, I will argue that the flat tax is essentially the same thing. It just taxes value added in two pieces. The subtraction method, I think, is viewed favorably by the proponents because it is viewed as being inflexible, meaning you cannot with ease try to tax different goods and services with different rates, putting different preferences and penalties into place.

Some people will argue that is a detriment, that the credit method is more flexible and you can do more things with the system. I would argue that the subtraction method being inflexible is a principal reason that it ought to be considered in this country. If we want to keep a single rate applied to every business activity, which I personally would find desirable, then the subtraction method is the best way to go. I would be glad to comment in a lot more detail when time permits. Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF CLIFF MASSA III

TO THE

COMMITTEE ON WAYS AND MEANS

"The Subtraction Method Value-Added Tax"

June 7, 1995

This statement discusses the concepts and mechanics of a ***subtraction method value-added tax***. To provide a context, section I presents five principles for the Committee's consideration as a foundation on which a new tax system could be constructed. Section II describes "value-added" and how it differs significantly from "profit" on which the business income tax is based. Section III covers the subtraction method in more detail. An *Appendix* provides additional details and commentary.

I. SUGGESTED PRINCIPLES FOR TAX REFORM

When federal tax policy is debated, two principal issues should be addressed. One is the "how much" issue -- do we tax ourselves sufficiently? The other is the "in what ways" issue -- do we tax ourselves intelligently? Recent national tax debates have focused heavily on *how much*, with little serious attention being given to *in what ways*. Our political process may never produce a lasting consensus about what percentage of gross domestic product should be claimed by the government in taxes. However, a consensus may be forming on the need to change the ways in which the federal government generates the taxes that we are willing to pay and to do so in the most efficient manner.

The early stages of the growing tax reform debate have produced a willingness on the part of many groups and policy makers to put a wide range of possibilities on the table. Such proposals and the growing public and press attention to the subject strongly suggest that the time for fundamental tax reform is approaching.

Given this opportunity, is my hope that we will step back from a contentious bout of slogans and themes long enough to make a considered judgment about some basic principles under which we can tax ourselves *intelligently*. If we develop such a context in which to work, the result may be both better and longer lasting. My recommendation that the Committee consider adoption of a subtraction method value-added tax is based on several factors, including the following five principles.

1. The role of the federal government's basic tax structure should be to generate the desired level of revenue -- nothing more. Efforts to achieve economic, political and social objectives through the income tax are inefficient, wasteful, blunt and complicating instruments.

2. The tax structure should impose minimal distortions on the economic decisions made by millions of individuals and businesses every day. Any tax imposes a drag on private sector activities as the price for the governmental services that we require. But this unavoidable impact should not be aggravated by a general revenue system which encourages, discourages, penalizes, rewards or otherwise artificially influences particular actions of consumers, investors and business managers.

3. The tax system should be able to be integrated with the systems of our trading partners. We are long past the time when the our tax system should have been reformed to allow *border adjustments* that reflect the increasing trade in goods and services across international borders and the increasing flows of capital investments across the same borders.

4. The tax system should combine maximum simplicity with maximum efficiency. Enormous amounts of money and of the time of very talented minds are expended annually in planning for and complying with federal tax laws. Also, there is a sizable underground economy that evades taxes, thereby raising taxes on everyone else. The tax system should be simple enough to eliminate extensive planning and compliance costs while also thorough enough to enable an efficient Internal Revenue Service to apply it to the maximum possible percentage of the tax base.

5. "Regressivity" should be addressed directly, not by distorting the tax system itself. There may never be a consensus about the economic "incidence" of particular taxes, but economists and others have reached a general consensus that efforts to offset regressivity should be *targeted to the intended households* through direct spending programs or tax rebates. Offsets within the tax system itself -- particularly within value-added and sales tax systems -- are exceedingly wasteful.

II. ECONOMIC "VALUE-ADDED" AS A TAX BASE

A general tax structure which can be implemented under these principles is a tax that applies to *economic value-added.* Interestingly, there is already a substantial level of agreement that value-added is the best tax base on which to build. Although not widely recognized, all of the major tax reform packages introduced in Congress or described in detail by Members of Congress rely on a system that taxes economic value-added. Included are (i) the new tax structures within the packages by Rep. Gibbons and by former Senators Danforth and Boren, (ii) the sales tax recommendation of the Cato Institute and Senator Lugar, (iii) the business portion of the *USA Tax* package by Senators Nunn and Domenici and (iv) the flat tax recommended by Rep. Armey and others. Perhaps this represents an emerging consensus which will enable us to focus more attention on the mechanics and details of a tax system with less disagreement about what the proper tax base is.

A. A Tax on "Value-Added" vs. a VAT

The term "value-added tax" may have become a proper noun in the minds of many people. "VAT" almost certainly has acquired that status. The use of either term is generally intended to suggest a specific tax structure like those in place in Europe, Canada, Mexico and most industrialized nations. That structure applies multiple tax rates, exemptions and other preferences to the sales of goods and services in the economy, with invoices listing a VAT amount for each sales transaction.

However, *this does not describe what value-added is;* it only describes a familiar means for computing taxes on a portion of value-added. In fact, most VATs in other countries are the worst possible models for a tax system that applies to value-added. The VAT's reputation for complexity and economic distortions is well deserved. Those who heap scorn on VATs do so with considerable justification. If a VAT were the only option for tax reform, I would hope we stay where we are.

But the widespread dissatisfaction with VATs as they are used in other countries is *not* grounds for opposing all value-added tax systems. I urge Members of the Committee to step back from the slogans and rhetoric and to consider what value-added really is.

B. The Basics of Value-Added

"Value-added" is what each business entity contributes to the economy as it does its part to move goods and services through the various stages of production and distribution and to the ultimate consumer. As long a company is selling its goods and services to its customers for more than it pays to purchase inputs from its suppliers, the company is producing value-added. By applying a tax to the value created by each business entity, the system is actually reaching the total value of goods and services consumed in the economy. What the retail sales tax does at the last stage, a value-added tax does in increments at every stage along the way.

To be more precise, value-added for a given company equals what that company pays to its providers of labor services and to its providers of capital services for the use of those services in converting "inputs" into more valuable "outputs." For example, when a company purchases inputs of raw materials, component parts and various goods and services from other companies, it does so with the intention of converting them into its own goods or services for sale to its customers. This conversion is accomplished by applying the company's available labor services -- *i.e.*, the work of its employees -- and the company's capital services -- *i.e.*, the use of assets acquired with its lenders' debt and its owners' equity -- to process, assemble, rebuild, move, market or in other ways make its own goods and services more valuable to its customers than the sum of the purchased parts.

Therefore, when you strip the system down to its basics, a tax on value-added is applied to the compensation that the company provides for both labor services and capital services. That means that the tax base is equal to the sum of (i) wages, salaries and benefits of all kinds for employees, plus (ii) retained earnings, dividends and interest for owners and creditors. This illustrates why value-added is

so widely regarded as a sensible, neutral and efficient tax base for a general revenue system. It taxes both labor and capital or, more accurately, the payments made for both labor services and capital services. It does so in proportion to how much of either is used by a company.

This also illustrates why the flat tax is a tax on economic value-added. The flat tax applies to the payments made for labor services (wages, salaries, pension payouts) at the individual level and to payments made for capital services (interest, profits) and for some labor services (fringe benefits) at the business level. The mechanics are different and the numbers of taxpayers are radically different, but the tax base is economic value-added in both systems.

C. Contrasting "Value-Added" With "Profit"

The value-added concept is simple to explain and easy to understand, *provided that* income tax concepts are set aside. For businesses, the income tax applies to profits for the years. "Profit" (whether distributed or retained) is a payment for capital services, so profit is an element of value-added. However, it is only one such element. Interest paid to lenders is another payment for capital services. Payments for labor services (including wages, salaries and all benefits) comprise the other element of value-added. Therefore, a company can still add value to the economy, even when it is not profitable. Labor and borrowed capital (if any) are still at work converting "inputs" into more valuable "outputs" even though the owners may be losing money (although a company which continuously pays more money to suppliers, employees and lenders than is coming in from sales will not stay in business long). But while a business activity continues, losses alone do not result in zero value-added tax liability. They merely reduce the value-added attributable to labor and to assets financed by debt capital.

A related issue is the fact that any company's value-adding activities can be negative for a period of time. If the company pays more for inputs than it receives for outputs during a particular accounting period, it has consumed more value-added than it has generated. Such temporary periods of "negative value-added" occur when a company engages in significant expansion programs such as major purchases of machinery and equipment or inventory accumulations. These purchases significantly increase the sales receipts of the company's suppliers that created the value-added represented by the equipment, inventory and other inputs. To prevent double taxation of the same value-added, the company with negative value-added for the period must be given a prompt refund equal to the tax rate multiplied by the negative amount.[1] Then, the system as a whole is taxing the net value-added in the economy for the period. A company's periods of negative value-added will be followed by periods in which its value-added is rather high, because its increased sales exceed its reduced level of purchases by considerable amounts.

III. THE SUBTRACTION METHOD

A. The Alternatives for Computing a Value-added Tax

There are two methods for computing a company's value-added and three ways to compute its value-added tax liability.

1. Subtraction Method

A simple way to measure value-added for any given period is to determine the excess of a company's gross receipts from the sale of its goods and services over its purchases of goods and services from other businesses. This is the basic "subtraction method," so named for the simple arithmetic process that it uses. The tax rate is them applied to the base. In a sense, the subtraction method computes value-added only when it is realized in a sale to customers. The subtraction method is often called a "period tax" or "books of account" tax because it can be computed for a given period using basic sales and purchases information from the company's books.

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[1] An alternative is an indefinite carry forward of the "negative value-added," plus interest. However, this does not recognize either the cash flow implications to the company or possible perpetual carry forwards of exporters because of the border adjustment rules.

2. Addition Method

A less simple but perhaps more fully descriptive method requires identifying and then adding together the component parts of value-added for the company. Value-added is created by the company's own labor services and capital services. so value-added for the period is computed as the sum of (i) wages, salaries and benefits paid to employees, plus (ii) interest paid to creditors, plus (iii) profits (either paid or retained) for the owners. The tax rate is then applied to the total. This is called the "addition method," for the obvious reason. Although in use in two states, this method is sufficiently difficult that it is not under serious consideration at the federal level, so it is not discussed further in this statement. Under this system most of the value-added is computed without regard to sales because wages, salaries, benefits and interest are incurred without regard to the timing of sales.

3. Credit Method

Often called a third method for computing value-added, the "invoice and credit method" is perhaps more accurately described as a third method for computing the tax liability itself. This method (called the "credit method" hereafter) requires the company to compute a tax amount for each sale and then record that amount on its invoice or sales receipt given to another business. The company then aggregates the tax amounts on its sales receipts to compute a tentative liability. It also aggregates the tax amounts on its purchase receipts to compute the tax attributable to what it has bought. By subtracting its purchases' tax notations from its sales' tax notations (*i.e.*, by crediting its taxes on purchase invoices against its taxes on sales invoices), the company computes its liability for the period. The credit method is often called a "transactions" tax because the rate is applied to each sales transaction.

In essence, the credit method is a variation of the basic subtraction method. The subtraction method subtracts gross purchases (P) from gross sales (S) and multiplies the balance times the tax rate (TR) to produce tax liability, so that Tax = (S - P)TR. The credit method multiplies each sale and each purchase by the tax rate and then subtracts taxes on gross purchases from taxes on gross sales to produce tax liability, so that Tax = (S)TR - (P)TR. The mathematical results under each method are the same because (S - P)TR = (S)TR - (P)TR.

B. The Merits of the Subtraction Method Versus the Credit Method

Even though the credit method and the subtraction method are substantively identical, conventional wisdom has long held that the credit method is preferable. This is due at least in part to the fact that the credit method is well known because it is used in VATs in Europe and elsewhere. Also, the credit method is generally perceived as being more flexible, easier to enforce and more visible than the subtraction method. The proponents of the major proposals in this country have chosen the subtraction method value-added tax as the preferred approach for the United States. Two basic reasons support this choice -- (i) it offers the best means for keeping the tax simple and neutral and (ii) it is readily adaptable to the accounting and bookkeeping practices already in place for the income tax, public disclosure and basic business needs.

1. Simplicity

The subtraction method is the simplest means for computing the tax because it stems from a very basic concept. By computing the excess of gross sales receipts over gross business purchases, a company can readily determine the taxable amount to which the tax rate is applied. The subtraction method is also gaining favor because it is generally perceived as being incapable of handling multiple tax rates and other complexities. Commentators believe that the accounting difficulties of tracking categories of sales and purchases for purposes of applying different rates and other rules make the subtraction method incompatible with such complexities. In contrast, the credit method is widely regarded as being flexible enough to allow multiple tax rates and various preferential rules to be imposed. The credit method can impose a categorization process on the seller which allows different tax rates to be applied to sales invoices for different categories of goods and services. This, in turn, allows both the seller and the buyer to keep track of the gross amount of tax attributable to each transaction. The subtraction method would require both the seller and buyer to categorize each sale or purchase on their books as being in one rate class or another and then apply the appropriate rates to the aggregate amounts in each category for each accounting period.

This difference in flexibility alone is sufficient reason to adopt the subtraction method. If the "inflexibility" of the subtraction method helps to assure that a value-added tax in the United States will apply a single rate to all businesses without imposing biases or distortions on the economy, then that is an invaluable advantage to this approach.

2. Familiarity

The subtraction method also allows a company to use its most basic financial data -- gross sales and purchases -- when computing the tax amount. With far fewer accounting rules than are imposed either for generally accepted accounting principles ("GAAP") or for income tax rules, the subtraction method is relatively easy to implement. The credit method, on the other hand, would require a company to add to each sales invoice a line which states the amount of tax attributable to the sale. Then, when recording both its sales and its purchases, the company must create a new accounting category and place into that category the tax shown on each sales invoice and each purchase invoice. Although not fatal to a simple system, these steps would create some additional compliance requirements which the subtraction method would not impose.

The subtraction method's computations are also seen as being more familiar to U.S. businesses which are accustomed to the federal income tax where, simply stated, gross income minus deductions equals taxable income. Both financial and income tax accounting already require that companies record their aggregate receipts and expenses for a given accounting period. A subtraction method value-added tax would use the same basic data and procedure.

Conversely, relatively few U.S. businesses are already accustomed to tax systems that are computed and recorded on each sales invoice with a subsequent record of the tax amount. Retailers which pay state and local sales taxes have such familiarity. Manufacturers which are subject to the handful of federal excise taxes (such as on alcohol and tobacco products) and gasoline retailers have some familiarity with computations based on transactions, but these are generally based on quantities produced or sold rather than on invoice prices. So, in a sense, the American business tax "culture" is much better attuned to the subtraction method than it is to the credit method.

C. Brief Comparison to a Sales Tax

While a subtraction method value-added tax and a retail sales tax apply to the same theoretical base, the sales tax concept presents the unnecessary risk of missing all of the value-added represented by (i) the "underground economy" which sells goods and services to consumers without reporting such sales and (ii) the banking and insurance industries which are unable to identify the actual fee that is charged as part of each loan payment or insurance premium paid by consumers. When a consumer purchase is not taxable, *all* of the value-added in the goods or services are exempt. A value-added tax will at least apply to that portion created by honest businesses that are in the system.

Also, some system must be devised to prevent the "cascading" effect of taxing sales of goods and services that are used by a business in the production of its own goods and services. Exempting goods that will be resold is not sufficient. Goods and services that a business purchases to use when producing its own goods and services cannot be subject to the sales tax because their value will be taxable again at a later stage. To avoid such cascading will place a significant burden on the seller to distinguish between types of customers. Consider this issue as it affects sales of goods and services by airlines, utility companies, computer and software dealers, hotels, gasoline retailers and lawyers -- just to name a very few. The value-added tax avoids these complexities completely because a business purchaser is able to deduct the cost of its purchases when computing its own tax liability.

APPENDIX

A. The Economic Effects of a Value-Added Tax

A value-added tax is neutral in its impact on a number of economic decisions which are distorted by the current hodge-podge of federal tax systems. For example, a value-added tax does not distinguish between the use of labor services or capital services. It applies equally to payments for both in whatever proportion each is used. Thus, the decision to use either more employees or more capital to transform inputs into more valuable outputs would be driven by factors other than the value-added tax. Similarly, whether a company decides to finance its operations through debt or equity is irrelevant under the value-added tax. Interest and profits *both* are in the base and are taxed at the same rate.

A value-added tax does not distinguish between the sectors of the economy. The value-added that is created by the service sectors and the value-added that is created by manufacturers are subjected to the same rules and tax rate. Also, a value-added tax is indifferent to the origin of goods and services as long as they are purchased or consumed within the taxing country's borders. A value-added tax system eliminates the advantages currently enjoyed by foreign companies which sell in the United States while paying little of the existing income tax and none of the payroll tax on the value of their imports.

A value-added tax also treats all entities the same, regardless of the form of the business organization involved -- whether C corporations, S corporations, partnerships and sole proprietorships. These labels are irrelevant under a value-added tax system.

B. Who Bears the Burden of a Value-Added Tax?

Economic theorists will probably never settle the argument about who bears the ultimate burden or "incidence" of a value-added tax. The traditional view is that such taxes are fully passed forward to consumers in the form of higher prices. The theory is that a value-added tax can be passed along by businesses because the full cost of purchases (including taxes) is recovered when it sells its goods and services. This assumes that markets are completely inelastic, meaning that consumers will buy the same quantities of goods and services at the higher prices as they bought at lower prices before the value-added tax was enacted. In such an inelastic market, any business would be foolish *not* to pass along the value-added tax costs to its customers. But does this differ from the situations involving other taxes -- or any other costs -- paid by businesses? In other words, if markets are completely inelastic, wouldn't businesses also fully pass forward the costs of all taxes? Does the label "value-added tax" insulate this tax from consumer resistance to price increases?

The alternative economic view does not conclude that a value-added tax (or any other "consumption tax") is not passed forward to consumers. In fact, as a net addition to current taxes, a value-added probably would be passed forward to some degree. Rather, the alternative view concludes that there is no qualitative difference between the incidence of a value-added tax and that of any other business tax. The burden will be shared in part by labor, in part by owners and in part by consumers. Market forces will determine how large each part is, and mere labels will not dictate a result.

C. Inflationary Effect of a Value-Added Tax

Given the traditional view that a value-added tax is fully passed forward in higher prices, the conventional wisdom is that enactment of such a tax will have an inflationary effect. However, there is no way of predicting with certainty what effect a value-added tax will have on inflation, just as there is no certainty in predicting how other tax reforms, tax decreases or tax increases will affect inflation. That probably depends primarily on the Federal Reserve Board's response to such changes. A serious evaluation of the effects on prices and on inflation of the introduction of VATs in 35 countries was undertaken by Alan Tait at the International Monetary Fund. Tait's research found that there was little or no effect on the price index in 22 of the countries, that an acceleration of inflation followed the new tax in six countries and that a shift in prices followed in the other seven. Even though inflation did occur in a few of the countries, Tait noted that other factors -- such as government monetary and fiscal policies, the use of the new tax revenues and advance commentaries and expectations by policy makers and the public -- explain more about inflation trends than the introduction of a value-added tax. His

study is strong support for the argument that a broad-based business tax alone does not accelerate the rate of inflation, particularly when it replaces other taxes.

D. The Value-Added Tax Applies Equally to Labor Services and to Capital Services

One persistent criticism of a value-added tax is that it taxes only labor, because machinery and equipment costs are fully deducted in the year incurred while employee compensation (including all wages, salaries and benefits costs) is not deducted at all. In fact, a value-added tax applies equally to labor and to capital. More accurately, it applies equally to payments for labor services and to payments for capital services. When a company purchases machinery and equipment, it must be allowed to remove the costs of such assets from its value-added base because *the costs of such assets have been taxable to the producers of those assets*. Not allowing a deduction for these costs would result in double taxation of the same value-added.

What is generally overlooked is that the purchase (or lease) of more and/or better machines requires the use of more debt capital or more equity capital -- or probably both -- to fund the purchase or lease. When this happens, the capital services component of the value-added base will be much higher than otherwise would otherwise be the case. Interest costs will rise and profits must rise to pay the lenders and owners for the use of more of their capital (as well as to repay the lenders their capital itself). While there is a one-time reduction in value-added as the costs of machines are deducted, the capital services portion of the value-added base will be significantly increased for several years.

E. Regressivity

VATs in Europe, Canada and other countries generally either exclude sales of food, housing and medical care from the system (using a zero rate of tax) or impose a much lower rate of tax on sellers of these and other "necessities." Conventional wisdom is that such exclusions and preferences are necessary to offset the perceived "regressivity" of a value-added tax, based on the traditional view that it will always be passed forward to consumers in the form of higher prices whereas other taxes are not.

But the usual approaches to addressing regressivity are ill-advised *even if the traditional incidence analysis is correct*. Preferential treatment of necessities is wasteful, minimally effective and distortive. When exclusions or preferential rates apply to sellers of food, medical care and housing, they apply to *all* sellers and to *all* of their sales. As a result, a huge portion of the anti-regressivity "benefits" are wasted on middle and upper income households which buy more quantities -- and more expensive -- food, medical care and housing. Furthermore, such exclusions can reduce the tax base by 30 percent or more, which requires raising the tax rate on all other business sectors (whose products and services low income households also buy) to cover the revenue loss. This process destroys neutrality among business sectors, distorts economic decisions and creates a system that is very complex and costly to administer.

Perhaps this is explains the trend in other countries to reduce or eliminate the use of such preferential rates for "necessities." The New Zealand tax enacted in 1986 (and widely regarded as a model broadly-based VAT system) uses only one rate and applies it to all businesses. Even the EC countries which introduced the use of multiple rates are trying to lessen the number of rates and the categories of activities.

The better approach is to tax all businesses on value-added at a single rate which maximizes the efficiencies of the system and prevents distortions among industries. Then, a portion of the revenues that would otherwise be lost through exclusions or preferential rates can provide income and payroll tax reductions, refundable tax credits and/or income support programs that benefit only those households which are the intended beneficiaries of such assistance.

F. "Visibility" of a Value-Added Tax

Conventional wisdom holds that a value-added tax is a "hidden" or "invisible" tax and, therefore, its rates are very easy to increase. The theory is that voters will not notice a value-added tax, making it quite painless for government to raise the rate at will. Much of the commentary on the flat tax and the sale tax emphasizes a need to make taxes almost painfully visible. Whether visibility is *politically important* to restrain the size of government or not is debatable. If it is, there is no mechanical reason why each retail sales receipt cannot say "includes XX% value-added tax."

G. How the Subtraction Method Value-Added Tax Works

The Taxpayers. The value-added tax base should include the value-added by every "business" in the economy, without regard to the legal form of the entity. Profit motive and profitability are irrelevant for value-added tax purposes. All that is important is that the entity has added value to the economy through the production and sale of goods and services.

The Taxable Amount. For purposes of a subtraction method value-added tax, the "taxable amount" is simply the excess of receipts from sales of goods and services in the United States over purchases of goods and services *(i.e.*, raw materials, machinery, energy, intangibles, accounting services, pencils, *etc.)* used by the company to produce its output. A company does not have to grapple with the income tax concepts of inventory capitalization, depreciation, bad debt reserves, intangibles amortization, *etc.* These concepts are not needed in the value-added tax context. The specific tax liability is computed by applying the tax rate to the taxable amount.

Exports. Any value-added tax attributable to exported goods and services must be removed or rebated. Otherwise, the value that is created and taxable in this country would be taxable again in the destination country if that country imposes a similar tax -- and all of our major trading partners do. The simple approach under the subtraction method is to exclude export sales from gross receipts while deducting all purchases relating to the exports, thus allowing the exporter to recover the full amount of value-added tax attributable to the goods and services which it purchased as inputs for its exports. For a company which sells exports exclusively, its sales receipts for the purposes of a value-added tax will always be zero. For a company which is primarily but not exclusively an exporter, its includible receipts will be low. When there is an excess of input purchases over sales receipts, producing a "negative value-added," a refund equal to the tax rate multiplied by the negative amount is necessary.

Imported goods. The value of imported goods and services must be included in the value-added tax base to ensure that all of the economic value that is added to goods and services before they arrive in this country is taxable identically to the value-added in domestic goods and services. Because there is an identifiable entry point for imported property, the importer can be subjected to the value-added tax system by computing its value-added at the time the import enters the United States. The amount of value-added for an imported item can be defined as the total amount which the domestic purchaser pays to acquire the item and to get it to the United States (including transportation and insurance fees). Whether we collect a check at the border or simply add the amount of taxable value-added to the importer's value-added tax return is an administrative choice. Alternatively, business importers can be denied a business purchase deduction equal to those costs.

Imported services. In contrast to imported property, imported services have no "entry point" where it is possible to either impose the tax or make a record that can be cross-checked later. Telecommunications, financial services, professional services and others move electronically and via the mails and couriers with no visible border crossings. International transportation services provided to passengers and goods are also difficult to track. Nonetheless, any value-added tax in the United States can and should be applied to all foreign services. One option is to ignore such services for border adjustment purposes and then deny the importer a value-added tax deduction for the costs of the services. This would include the value of the services in the tax base without the need to monitor flows of such services across the U.S. border.

Financial intermediation services. Financial service companies add value to the economy when they serve as intermediaries to the actual parties of financial transactions, such are between depositors and lenders or among those are pooling their insurable risks. This financial intermediation has value which customers are willing to pay for, either directly or indirectly. The value of such financial intermediation must be identified for value-added tax purposes. However, because no explicit fee is charged, financial intermediation services are routinely excluded from VATs around the world due to the perceived inability to determine "value-added" on each specific transaction such as a monthly loan payment or insurance premium payment. One advantage of the subtraction method is that the value-added need *not* be computed transaction-by-transaction. Instead, the bank can compute its implicit fees (which are part of the interest rate "spread," *etc.*) for each accounting period and take the aggregate amount into account along with its other receipts from sales of services.

Small businesses. Small businesses representatives often criticize value-added taxes as imposing significant burdens on small business, based on VATs in other countries. Under these

systems, small businesses -- indeed, *all* businesses -- are definitely subjected to burdensome record-keeping requirements which track the categories of goods and services they sell in order to properly compute the tax. The problem is not the concept of a value-added tax, but how VATs have been structured. Small businesses would not face the same burdens under a single rate subtraction method value-added tax in the United States. In fact, complying with such a value-added tax would probably be much easier for small businesses than complying with our current income and payroll taxes. Some proposals present mechanisms for providing targeted relief for small businesses under a value-added tax in the United States, primarily to lessen the administrative expenses of the government with very little loss of revenue. Whether this is desirable or acceptable in the context of *replacing* taxes currently paid by small businesses is questionable.

Real property. Real property is yet another market segment that is often considered to be too difficult by many VATs that exempt at least some real estate activities. Nevertheless, real estate activities *(i.e.*, buying, selling, and leasing of land, buildings and housing) should and can be included in the base of a value-added tax in the United States in one of two ways -- as an *operational asset* or as a *financial asset.* Real estate has some characteristics of both models. For example, some land and buildings are similar to the proverbial "widgets" because they are the products sold by home builders, commercial builders and developers. Both the seller/lessor and a business purchaser/lessee could reasonably treat such real estate transactions like any other sales of goods and services for value-added purposes. But some real estate transactions have more characteristics of the financial asset model. When financial services companies or developers hold land for future use, they could be engaged in investment activities rather than business activities currently. The approach for including real property sales in a value-added tax probably should be based on some compromises between precision and administrative simplicity.

Government and non-profit entities. Governmental entities add value to the economy when they engage in activities which, if carried on in the private sector, would be considered "business" activities. Such activities would include public utility services, medical services, postal services, mass transportation services and any other activities not involving the exercise of any essential government function. The value-added generated by these activities should be subject to the value-added tax in the same manner as the corresponding activities in the private sector. Many organizations which are exempt from the federal income tax also engage in value-adding activities that can be included in the tax base. The widely accepted social policy of exempting charitable and educational functions from most taxation may dictate that a value-added tax only be applied to those activities of the organization which produce unrelated business taxable income.

Other taxes. A value-added tax should be the federal government's general revenue source. Other taxes should not be allowed as deductions or credits, no matter what purpose such taxes achieve. The practical result of allowing certain types of taxes -- *e.g.*, sales taxes, excise taxes, other *indirect* taxes -- to be excluded from gross receipts or to be deducted when paid to a government will be an erosion of the federal tax base. All jurisdictions will be pressured by businesses to push as much of their own revenue base as possible through this loophole. To allow one or more taxes to be removed from the value-added tax base will sanction a superior status for such taxes by sanctioning that tax's first claim on *that* base.

H. Administrative and Compliance Issues

The difficulties of administration and compliance under a value-added tax are largely determined by the complexity of its underlying structure. A May 1993 IRS report concluded that the cost and difficulty of administering a value-added tax would be directly dependent on the complexity of the system and urged that "it is imperative to the interests of both taxpayers and the government that [such] legislation be kept as simple as possible." A series of varying tax rates, exemptions and preferences on sales of particular goods and services naturally requires more regulations and more complicated compliance procedures than would a single-rate value-added tax applied neutrally to all sectors of the economy. This, in turn, will generate major audit and litigation controversies. In addition to such potential controversies, businesses attempting to comply with all of the varying rates and exemptions would be required to establish procedures that identify those goods and services treated preferentially versus those that are not. Such administrative and compliance problems would be substantially reduced by enactment of a single rate value-added tax that applies neutrally to all business sectors. The Government Accounting Office estimates that a system with a single-rate and virtually no preferences would reduce audit costs by 30 to 50 percent, compared to one with multiple rates and exemptions

A single rate subtraction method value-added tax system should reduce the administration and compliance burdens of the current business tax system (if used as a substitute). Only two sets of basic data that most companies already keep for various reasons -- gross sales receipts and gross purchases of goods and services -- would be required. While certain categories may need to be identified rather than grouped with other sales and purchases (*e.g.*, exports, imports, interest), this should be a one-time change to bookkeeping procedures. Once these basic sales and purchases data are computed, a company's task would essentially be complete under a value-added tax system. It would merely apply the applicable tax rate to the base to determine liability. To this extent, a value-added tax would be relatively easy to comply with in comparison to the income tax or financial statements under GAAP rules because there would be far fewer adjustments and computations required .

Because the basic information required to compute value-added is readily available in the business community, maintaining records for use by IRS audit agents will be no more onerous than current practices. The suggestion that a credit method tax will enhance compliance compared to the subtraction method seems implausible. The notation of tax amounts on invoices does not assure that the seller is properly reporting its liability to the government. The possibility that an audit agent will look through thousands of sales invoices -- hundreds of thousands for large companies -- to add up tax amount is equally implausible. The Internal Revenue Service is far more likely to assess a company's accounting practices and to take statistical samples of invoices sampling during an audit.

Businesses should be allowed to use either the accrual or cash method for recording sales and purchases, based on the method currently used for their financial reporting. For accrual taxpayers, sales and purchases would be treated as occurring in the reporting period in which title passes or services are performed. For cash basis taxpayers, actual receipt or payment dates would determine the correct reporting period.

The tax would be computed, collected and paid for each "taxable period," which probably should be a calendar quarter or a quarter of whatever year is sensible for the business. If some companies have negative value for that period because their purchases exceed their sales, that negative amount must be taken out of the total tax base. Otherwise the system is exposing some value-added to double taxation -- once in the value-added tax bases of the companies which sold the goods and services to the "negative" company and again in that company's base. Therefore, taxpayers who have business purchases in excess of gross receipts for any period would be entitled to a refund from the Treasury equal to the value-added tax multiplied by the excess.

Chairman ARCHER. Thank you.
Dr. Cnossen.

STATEMENT OF SIJBREN CNOSSEN, PH.D., PROFESSOR OF ECONOMICS, ERASMUS UNIVERSITY, ROTTERDAM, THE NETHERLANDS

Mr. CNOSSEN. Mr. Chairman, distinguished Member of the Committee. I am a professor of tax law and economics at Erasmus University, Rotterdam. I have written widely on various consumption taxes and advised 17 countries on the design of their consumption tax system.

I am honored, Mr. Chairman, to discuss today proposals for broad-based consumption taxes, which are being considered by your Committee. In the U.S. debate five options of a broad-based consumption tax are under review: A national retail sales tax, a value-added tax, a business transfer tax—all indirect approaches to taxing consumption—and two direct approaches: A flat tax and a consumed income tax.

In my written testimony, I have reviewed the pros and cons of these alternatives in some detail, generally by applying the criteria that you, Mr. Chairman, recently announced. Specifically, I have tried to find an answer to the following questions: First, what is the most robust form of consumption tax?

In other words, which form permits the broadest possible base ensuring equal treatment and which form is least susceptible to erosion through the political system?

Second, which consumption tax is the most difficult to evade and avoid? Third, which consumption tax has the lowest operational costs? Fourth, what is the most neutral form of consumption tax?

Fifth, which consumption tax is best in freeing exports of tax, in line with your call for promoting competitiveness. And finally, which consumption tax interferes least with State retail sales taxes?

Mr. Chairman, an analysis of these questions has led me to the following conclusions: One, a national retail sales tax would not seem compatible with State retail sales taxes: Bases would be different, taxpayer resistance would be great, and such a tax would add substantial complexity.

Also, a retail sales tax is not very good in taxing services, in comprehensively excluding business inputs from taxation and by extension making sure exports leave the country completely free of tax.

Two, the value-added tax seems the most robust and neutral form of consumption tax. A sizable small business exemption—I would like to emphasize—of, say, $100,000 can eliminate most of the incompatibility with State retail sales taxes because most businesses filing for the Federal value-added tax would not have to file for State retail sales taxes and vice versa.

Such an exemption would cut in half the number of taxpayers that would have to be registered under a national retail sales tax. The number of taxpayers under a retail sales tax would be about 20 million; the number of taxpayers under my VAT with a generous small business exemption of $100,000 would be 10 million. Accordingly, it would make the VAT a much less intrusive tax.

Three, the business transfer tax appears compatible with State retail sales taxes. However, it is very vulnerable to erosion through the political system. In contrast to the value-added tax, there is no penalty on being exempt from tax. The tax on value added that is not taxed is lost forever. Hence, the business transfer tax would generate relentless political pressure to exempt "worthy" products and industries.

In my opinion, the system of freeing exports from tax under the business transfer tax would not be acceptable to the international trading community.

Four, the flat tax resembles the income tax, and any tax that resembles the income tax would soon become like an income tax, riddled with exemptions and provisions for special treatment. Like the income tax, the flat tax has difficulties distinguishing business income from labor income. As an origin-based tax, moreover, that includes exports in the tax base, it would face the same kind of cross border, intercompany transfer pricing issues as the current corporation tax.

Five, the consumed income tax is the most costly and intrusive form of consumption tax. In addition to keeping records of income, taxpayers would be obliged to keep and furnish records of savings.

Mr. Chairman, I must admit to a comparative advantage in the field of value-added taxation. Even after allowing for this, however, I believe that the value-added tax is the preferred form of consumption tax. The VAT has the broadest possible base and is less susceptible to political erosion than are the other options.

Also, the value-added tax is most neutral with respect to domestic economic activities as well as foreign trade. This is an important attribute of an acceptable tax in a highly competitive and interdependent world which leaves the optimal allocation of resources to the free play of market forces. The value-added tax probably is less evasion-prone and less costly to administer than the other forms of consumption tax. To a large extent the value-added tax can be made compatible with State retail sales taxes.

Mr. Chairman, if the United States were to give serious thought to adopting a value-added tax, it should be advised to stay clear of the mistakes and shortcomings of the European value-added taxes. In particular, it would be advisable to tax all goods and services with virtually no exemptions, to impose a single rate of tax and to provide for a generous small business exemption of $100,000, eliminating 60 percent of all potential taxpayers at a revenue cost of less than 3 percent.

In conclusion, Mr. Chairman, if a value-added tax were adopted, it is crucial to get it right the first time—by simplicity and structure in operation, stability and certainty in legislation and rulings, and convenience in payment arrangements.

A broadly based value-added tax with a single rate, virtually no exemptions and a generous small business exemption would promote the acceptability of the tax and keep initial and ongoing operational costs within reasonable bounds. Mr. Chairman, distinguished Members, I would be pleased to answer any questions, and thank you for permitting me to testify before this Committee.

[The prepared statement follows:]

WHAT KIND OF CONSUMPTION TAX
By Sijbren Cnossen[1]

Mr. Chairman, Distinguished Members of the House Ways and Means Committee:

For some time, the body politic, the business community, and the tax profession in the United States have been debating the desirability of introducing a broad-based consumption tax which is absent from the American federal tax system. Various options are being considered, ranging from *in rem* consumption taxes on transactions to a personal tax on aggregate individual consumption, akin to the individual income tax. I shall comment on these options, generally by applying the criteria that you, Mr. Chairman, have announced in the Committee's Advisory of May 11, 1995. More specifically, I shall try to find an answer to the following questions:

- What is the Most Robust Form of Consumption Tax?
- Which Consumption Tax is the Most Difficult to Evade and Avoid?
- Which Consumption Tax has the Lowest Operational Costs?
- What is the Most Neutral Form of Consumption Tax?
- Which Consumption Tax Permits the Most Unambiguous Border Tax Adjustments?
- Which Consumption Tax is Best for Capital Formation and International Competitiveness?
- Which Consumption Tax Interferes Least with State RSTs?

The answers to these questions lead me to the conclusion that the value-added tax (VAT) is the preferred form of consumption tax (CT). The VAT has the broadest base and is less susceptible to political erosion than are the other options. Also, the VAT is neutral with respect to domestic economic activities, as well as foreign trade. This is an important attribute of an "acceptable" tax in a highly competitive and interdependent world, which leaves the optimal allocation of resources to the free play of market forces. The VAT probably is less evasion-prone and less costly to administer than are the other forms of consumption tax. Finally, to a large extent, the VAT can be made compatible with state retail sales taxes.

1. What are the Choices?

Five options are being considered in the current debate. These options are: the retail sales tax (RST), the value-added tax (VAT), the business transfer tax (BTT), the flat tax (FT), and the consumed-income tax (CIT).

a. The RST purports to apply the tax only to sales made by retailers to final consumers. To confine the tax to consumer sales, registered businesses are permitted to make tax-free purchases upon the presentation of a tax registration certificate. The U.S. and Canada are (the only) two countries with an RST, because it is suitable for administration by subordinate levels of governments (states and counties) in a federation. The Nordic countries and Switzerland used to levy RSTs, but they switched to VATs.

b. Economically, the VAT is identical to the RST. It also taxes retail sales in full. Instead of collecting the full tax from the retailer, however, the VAT

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disburses the collection process throughout the entire production-distribution network. Retailers, who collect the full tax from consumers, remit the tax on their value added (the difference between sales and purchases) to the Treasury, but pay the remaining amount to their suppliers who, in turn, remit the tax on their value added, and so on. At each stage of the production-distribution process, the VAT-liability is determined by permitting registered businesses a credit for the tax on purchases of business inputs (raw materials, intermediate goods and services, as well as capital goods) against the tax on sales. The VAT is the most widely imposed CT in the industrialized and developing world. More than 100 countries now have this form of CT.

c. In principle, the BTT is identical to the VAT, but instead of allowing a credit for tax on purchases, the BTT permits businesses to deduct purchases of (taxable) inputs from sales, applying the rate to the difference. Again, the whole production-distribution network is involved in the collection process, but each stage is only concerned with its own tax liability. There is no accounting for the tax of other stages. No country has a BTT, but Michigan has some experience with this form of CT.

d. In its simplest form, the FT is a modification of the BTT. If, under the BTT, purchases are deducted from sales, what remains are wages (and salaries) and "profits" (a collective name for various "capital income" items rather than accounting profits, as usually understood). In addition to permitting a deduction for purchased business inputs, the FT also allows a deduction for wages. Subsequently, wages are taxed separately at the level of the individual recipient, permitting a basic exemption (and other deductions, if desired). This introduces an element of progressivity into the tax, even if the rate on the individual's remaining wage would be flat. "Profits" are taxed at the flat rate, without a basic consumption. No country has an FT or a tax that comes anywhere close to it.

e. The CIT is a fully personalized CT. At the individual level, the CIT taxes all income (a better word would be incomings), including the proceeds from all forms of borrowing, but permits a deduction for all forms of saving (including loan repayments). The remaining base -- aggregate individual consumption -- can subsequently be subjected to the same kind of rate structure as the individual income tax. In other words, the CIT, broadly and comprehensively defined, can be levied in accordance with ability-to-pay. No country has a CIT, although it is often pointed out that the current income tax is closer to a CIT than to a true "Haig-Simons" accretion type of income tax, mainly because retirement savings are treated on a CT basis.

If the income tax is to be replaced entirely, the new tax will need to raise some $735 billion revenue. This is a very tall order that would require a rate of more than 20 percent on aggregate consumption expenditures (assuming that three-fourths of those expenditures would in fact be taxable). More modest goals, such as reducing the income tax and/or the federal deficit, could be accomplished by a broad CT levied at a uniform rate of, say, 10 percent.

2. What is the Most Robust Form of Consumption Tax?

Neutrality and fairness require that the new CT should be able to include nearly all consumer goods and services in its base. Also, it should not be susceptible to political erosion. If "worthy" goods and services can easily be exempted, the CT would soon degenerate into an excise-type of levy. In short, robustness should be one of the characteristics of the new CT.

RSTs actually in use (or previously levied in the Nordic countries and Switzerland) have never been able to integrate the taxation of services with the taxation of goods. The reason probably is that RSTs must rely on end-use

exemptions to segregate business use from private use of services (which are more often of the mixed-use type than are goods). End-use exemptions are notoriously difficult to apply and monitor, because exempt services must be defined, identified by the retailer (impossible in many cases), and separately accounted for. Whatever the case, potentially taxable services outside distribution easily comprise one-half of GDP in industrialized countries. This is too large a portion of economic activity to be ignored under a CT if equal treatment and neutrality are taken seriously. Moreover, not being able to integrate services in the RST base is itself a source of considerable administrative complexity and ambiguity, since it then becomes necessary to devise arbitrary rules for separating the service element from the sale of a good whenever the two occur in combination.

In contrast, the VAT is the first CT that successfully unifies the treatment of services with that of goods. Unfortunately, some important categories (health care, education, banking, insurance) are usually left out of the base. Nevertheless, some 70 percent of consumer spending on services is taxed in countries that use the VAT, while very little of this spending is taxed in jurisdictions that adhere to the RST. The VAT easily segregates business use from private use of services. The type of service (or for that matter, the type of product) -- business or private -- does not have to be identified, nor the type of purchaser -- business or consumer. Moreover, the VAT always collects tax on taxable inputs, even if the service or the establishment performing the service are exempt. Hence, the rate can be lower, given the yield of the CT.

Obviously, the distinction between goods and services is not relevant under the BTT, FT and CIT which, as accounts-based forms of CT, directly tax value added, wages and "profits", or consumption.

The RST base and the VAT base are both susceptible to erosion through political favoritism. Exemptions achieve this under the RST; under the VAT, a zero rate has the same effect. Clearly, the experience in the few countries that have a zero rate for "basic necessities" (Canada, the United Kingdom, Ireland) is not favorable. Zero rates achieve nothing, but add greatly to administrative and compliance costs. Prior-stage tax must be refunded and small businesses eligible for exemption will still register voluntarily to get the refund.

The VAT has the advantage that it is difficult to exempt pre-retail stages of production and distribution. Since the tax credit on inputs would then not be available, cascading would occur which induces business to register anyway. This contrasts sharply with the BTT under which intermediate stages can easily be left out of the base since the succeeding stage would be permitted a deduction for its inputs anyway. This feature of the BTT would create relentless political pressure to exempt some "worthy" industry, sector, or product. The political system could also reduce the bases of the FT and the CIT, e.g. by allowing a deduction for mortgage interest, gifts, etc.

3. Which Consumption Tax is the Most Difficult to Evade and Avoid?

In terms of the ease with which taxes can be evaded and avoided, transactions-based CTs, such as the RST and the VAT, seem to have an advantage over accounts-based CTs, such as the BTT, FT, and CIT. Under the RST, however, the whole weight of the tax is put on one stage only, i.e. the retail stage where businesses are often small and accounts not always adequately maintained. Evasion is always for the full amount of the RST. In contrast, the multistage collection feature under the VAT gives the tax authorities a lien, as it were, on suppliers for the tax they collect from their customers, including retailers. The rationale for this arrangement is that taxable businesses are less likely to default on tax invoiced by their suppliers than on tax payable directly to the tax authorities.

Furthermore, under the VAT, each invoice exchanged between registered taxpayers represents an unequivocal agreement in respect of the gross tax liability payable by the buyer to the seller and by the latter to the tax authorities. The tax is

made visible each time a taxable transaction takes place. This "public declaration" of the tax liability is an important advantage of the VAT and the RST, if quoted separately. Obviously, its effect is stronger if, as under the VAT, the invoice is used as documentary evidence for the tax credit claimed by a registered buyer. This implies that the effect is weaker at the retail stage (in particular under the RST but also under the VAT) where sales are made to consumers and users who cannot claim credit for the tax invoiced to them.

Like the VAT, the BTT is also collected fractionally throughout the production-distribution process. Unlike the VAT, however, the tax is not calculated and quoted separately with respect to each transaction. There is no "lien" on suppliers for the tax payable in succeeding stages of production and distribution. No "public declaration" of the tax liability exists. The absence of a clearly defined audit trail, as under the VAT, weakens the BTT's fractional collection mechanism. In terms of compliance control and enforcement, the BTT, as well as the FT and the CIT, are akin to the (business) income tax. Since the tax liability is not based on transactions, evasion and avoidance, as under the income tax, would probably be greater than under transactions-based CTs. Moreover, the FT, like the income tax, has difficulties in distinguishing between income from business and from labor.

4. Which Consumption Tax has the Lowest Operational Costs?

Certainty and simplicity in tax design and operation are essential characteristics of an "acceptable" tax, because they minimize compliance and administrative costs. Overall, operational costs are a function of how well the tax base has been defined, how simple the rate structure is, the complexity of taxpayer obligations (computation, filing, record keeping), the extent of tax administrative requirements (accounting and tax collection, audit and enforcement), and the number of taxpayers.

RSTs and VATs, being transactions-based, generally require sales clerks, not accountants, to perform the tax computations. The VAT is somewhat more complicated than the RST, because in addition to tax on sales, credits for tax on purchases must be identified. Basically, however, only two spikes are needed: one on which all sale invoices are pinned and another one for all purchase invoices. The difference between the total VAT shown on all sale invoices and the total VAT shown on all purchase invoices must be computed and remitted to the Treasury (or refunded by it, if the amount is negative). More formally, under VAT, registered businesses must keep a record of purchases in addition to the record of sales which they also have to maintain under the RST. If the tax base is not comprehensive, RSTs require separate accounting for exempt items. VATs do not require separate accounting for zero-rated sales, but they do for tax on items (consumer goods bought through the business) for which the tax credit is denied.

BTTs, being accounts-based, generally require accountants, not sales clerks, to perform the tax computations. In terms of compliance, the BTT although simpler, is akin to a business income tax. Presumably, as under the VAT, records of sales and purchases must be kept. In the absence of invoices showing tax, it would be difficult to ascertain which purchases had been subject to tax. If value added would be determined on an annual basis (when the balance sheet and the profit and loss statement are drawn up), presumably some form of prepayment system would have to be devised. The BTT would require separate accounting for purchases (identified by supplier) from small-businesses, if exempted. Otherwise, value added would not be taxed comprehensively. Compliance costs for the FT would be higher than for the BTT, because the number of taxpayers would be much larger. The CIT, being a personalized tax like the income tax, probably would involve a similar level of compliance costs.

Administrative costs comprise mainly the cost of auditing taxpayer accounts. It is unlikely that audit costs, as a percentage of revenue, would differ very much between various CTs. In all cases, in-depth audits would have to be based on comprehensive accounts, such as balance sheets, profit and loss statements, and

bank accounts. VAT audits might be easier, because the tax on invoices provides a clear audit trail.

Overall compliance and administrative costs would also depend on the number of taxpayers. There are approximately 25 million separate business enterprises in the U.S. Under an RST, some 20 million businesses (retailers as well as wholesalers and manufacturers selling at retail) would have to be registered. Given a small-business exemption of, say, $100,000, the number of registrants under a VAT should not exceed 10 million (including voluntary registrants). The BTT would probably involve a larger number of taxpayers, because more small businesses would have to be taxed to ensure neutrality. The number of taxpayers under the FT and CIT would be much larger than under either of the other CTs, because, in addition to business entities, individuals earning employment income would have to be registered.

On the basis of a careful evaluation of various studies on the administrative and compliance costs of a hypothetical U.S. VAT (see, Tax Notes, June 20, 1994), I concluded that the administrative costs would be on the order of $100 per registrant and the compliance costs on the order of $500 per business. Hence, with 10 million registrants, total ongoing operational costs would be some $6 billion on an annual basis. (In comparison, the operational costs of the income tax are estimated at $75 billion.) The operational costs of other CTs likely would be higher. A federal RST would have more registrants, as would the FT and the CiT. Audit costs would be somewhat higher under the BTT, because there would be no presumptive record of tax-deductible purchases.

5. What is the Most Neutral Form of Consumption Tax?

Tax policy proceeds from the assumption that the market achieves the most efficient allocation of resources. This implies that CTs should not unintendedly interfere with producer and consumer choices. Specifically, it should make no difference for the CT-liability how often a product is traded before it reaches the consumer or whether its value is added earlier rather than later in the production-distribution process. Similarly, the CT-liability should be the same whether a product is manufactured with capital-intensive technology or labor-intensive technology. Also, CTs should not influence the form in which business is conducted. It should make no difference whether a product is made in the corporate or noncorporate sector, by integrated or specialized firms.

The RST does not score highly on the neutrality list. The main reason is that RSTs have difficulty distinguishing between producer goods (that should not be taxed) and consumer goods (that should be taxed). How does a registered trader know that a computer it supplies will be used for entertainment purposes at home (taxable), for resale (exempt), or as an (exempt) capital good for (taxable) hotel services? The inability to distinguish effectively between producer and consumer goods in practice means that many producer goods are taxed. This discourages capital-intensive production and, hence, economic growth. For similar reasons, RSTs are not very effective in taxing services, again distorting economic choices, particularly of consumers who will tend to buy more (untaxed) services relative to (taxed) goods.

The VAT scores much higher on neutrality grounds. Distinctions between producer and consumer goods and services --increasingly troublesome in sophisticated markets -- are unnecessary. Registered sellers, including retailers, are simply told to always charge tax, leaving it to buyers to obtain a tax credit if they are also registered (and placing the tax unequivocally on consumers who are not registered.) Consequently, the universal tax credit for registered businesses eliminates tax on producer goods more comprehensively than does the *ad hoc* exemption approach under RSTs. By way of exception, under VAT, financial services and insurance rendered to producers are saddled with an element of VAT on taxable inputs, because their output is usually exempted. (VATs have exempted financial services and insurance, because thus far it has been difficult to separate the nontaxable interest element of a transaction from its taxable administrative cost.)

In theory BTTs, which allow a deduction of taxable purchases from taxable sales, should be as neutral as the VAT. In practice, however, it would be difficult for registered businesses to ascertain with certainty whether or not purchases have been subject to BTT. Presumably, sellers would have to show some tax registration certificate to buyers, inviting similar identification issues (albeit reversed) as under RSTs. BTTs with comprehensive coverage would mitigate, but not eliminate, this problem, particularly if a sizeable small-business exemption is introduced. This issue would also arise under an FT, but not under a personalized CIT. These forms of CT, however, would have other neutrality problems, akin to those of the income tax.

6. Which Consumption Tax Permits the Most Unambiguous Border Tax Adjustments?

The neutrality criterion is also relevant for goods and services entering international trade. As is well known, such goods and services are nearly always taxed on a destination basis, that is, in the country where they are consumed rather than the country where they are produced. The destination principle is effected by relieving exports of domestic CT and levying CT on imports at the same rate as the CT on domestically produced goods and services. These border tax adjustments (BTAs) ensure that tax distortions, if any, are not placed in producer markets (producers are faced with world market prices, free of tax), but in consumer markets (where they are probably less harmful). Other things being equal, CTs on exports would undermine the competitive position of American firms in international markets. Similarly, undertaxation of imports would give foreign firms an unfair edge in U.S. markets.

Prima facie, RSTs do not require BTAs, because, as a rule, retailers do not import or export. (Exceptions arise with respect to occasional imports (and exports) by consumers.) Although exporters do not have to pay RST, their prices (and incomes) would be affected, however, by the tax imposed on producer goods which, as argued above, cannot be comprehensively excluded from the base. This should have a detrimental effect on international competitiveness. The RST, moreover, discriminates against domestically produced goods, because the price of those goods includes an element of tax on producer goods (in addition to the RST itself), while the price of goods imported from countries without an RST does not include that tax.

The VAT has fewer difficulties meeting the requirement of unambiguous BTAs. Tax levied in previous stages of production and distribution, being shown on purchase invoices, is simply rebated at the export stage. Moreover, imports are not favored, because domestically produced goods are not burdened with an element of tax on producer goods (except banking and insurance). However, the BTA-arrangements for the VAT cannot deal effectively with non-tangible services whose location of supply or purchase is difficult to determine. Most VATs provide a workable solution by taxing services mainly rendered to final consumers in the country of purchase, which in virtually all cases is also the country of destination. On the other hand, services exported by banks, insurance companies, professional services, advertising agencies, and similar enterprises, which are rendered mainly to business, are zero-rated. By deeming the location of the purchaser as the place of supply, imports of designated services are thus taxable in the hands of receiving businesses as though they had supplied them themselves.

Under the BTT, exports would be completely freed of tax if the tax rate, which must be uniform, is applied to the value of taxable inputs used in manufacturing exports, and the resulting amount is refunded. But this approach requires proof that the inputs have indeed been taxed as sales in previous stages of production and distribution. In contrast to the VAT, invoices do not provide the presumptively correct documentary evidence that this has indeed been the case. No doubt, this would invite objections from the trading partners of the U.S. These trading partners would also argue that the BTT is not a tax on products *per se* (but rather an accounts-based tax on value added) and hence not eligible for export rebate under GATT.

The FT is an origin-based tax. In other words, exports would be taxed and imports would be free of tax. Hence, the burden of the tax is on producers rather than consumers (who face world-market prices). Under the so-called equivalence theorem, exchange rate adjustments would cancel the effect of the origin-based tax on real trade, but in practice the effect would differ from one industry to another industry. An origin basis of taxation also means that exports have to be valued for FT purposes so that no value added domestically escapes the tax. This would raise problems reminiscent of the potential for manipulating cross-border intercompany prices under the corporation tax. The CIT is also an origin tax or a source tax, to use the terminology of the income tax.

7. Which Consumption Tax Is Best for Capital Formation and International Competitiveness?

In thinking about the effect of a CT on capital formation and international competitiveness, the comparison should not be between various forms of CT, but with the income tax.

In contrast to an income tax, a CT is neutral with respect to the choice whether to consume now or to save for future consumption. Although a CT reduces the absolute return to saving (that is, the amount of future consumption), the tax does not reduce the net rate of return to saving. A comprehensive income tax, on the other hand, reduces the net rate of return to saving, because both the amount saved and the interest earned on that amount are subject to tax. Therefore, if it is assumed that saving increases as the net rate of return on saving increases, a CT is superior to an income tax in promoting saving. By the same token, a CT does not tax (new) investment or, in contrast to an income tax, (current) capital income (if not consumed). On the basis of this reasoning, a CT should be better for capital formation than a pure income tax. In practice, of course, the outcome might not be so pronounced, because the current income tax also does not tax current (institutional) saving; in addition, it has various investment promotion allowances. Also, second-order effects on interest rates and other economic variables would have to be taken into account.

Furthermore, under a uniform CT, all consumer prices would rise exactly in proportion to the CT, thus leaving all relative prices unchanged. The imposition of a CT, therefore, does not involve a change in the allocation of resources and production incentives. Moreover, international competitiveness is not affected if proper BTAs are in place. In this connection, it should be pointed out that these BTAs, particularly under the VAT, are not a tariff-cum-export subsidy. On the contrary, BTAs under VATs (and the BTT) put internationally traded goods and services on the same footing as under RSTs. In practice, as argued above, internationally traded goods and services are treated more neutrally under the VAT than under the RST. BTAs are troublesome under BTTs.

This conclusion must be modified if the VAT, RST, or BTT were substituted for the income tax. As a tax on current consumption (of domestically produced and imported goods), the CT would dampen domestic demand. By contrast, income tax is an inducement to current consumption. Substituting the CT for the income tax, therefore, improves the trade balance. Over time, however, this effect would cancel itself out, because the accumulation of foreign reserves would lead to increased imports. In short, the CT would have a positive short-run effect on the trade balance, but no such effect would occur in the long run.

Other things being equal, international competitiveness would suffer under FTs and CITs, because the tax would not be rebated at export. Since world prices facing producers would not change, the CT on exports would be borne by them, exports would decline, the U.S. dollar would depreciate, and imports would become more expensive. In effect, the nonrebatable CT would be a protectionist import tariff violating the spirit of the GATT. Presumably, little would change if the FT or the CIT were substituted for the income tax which is also levied on an origin basis.

8. Which Tax Interferes Least with State Retail Sales Taxes?

An important consideration in weighing the pros and cons of various CTs would be their relationship to the RSTs which are levied by 45 states and the District of Columbia (as well as some 7,000 local governments). With some justification, states would consider the imposition of a federal CT an intrusion into their tax domain. Obviously, much would depend on the type of CT. Moreover, a CT which would replace (part of) the federal income tax would, it might be argued, leave states with more room to use their income taxes for revenue purposes.

A federal RST would score very low in terms of compatibility with state RSTs. It would have to be computed and paid by the same traders selling at retail (probably some 20 million) that now have to comply with the requirements for state (and local) RSTs. In addition, these businesses would have to account for federal RST charged on products and services exempt under state RSTs or vice versa. The incidence of the increase in compliance costs, like the incidence of the compliance costs of the RST itself, would be regressive: as a percentage of sales, they would bear more heavily on small businesses than on large businesses. Consumers would perceive the federal RST as a double tax on their purchases. One solution might be to merge the state RSTs with the federal RST, but this would require an unprecedented consensus on a nationwide harmonization of the various RST bases.

Prima facie, the VAT would run into the same problems. After all, being levied through the retail stage, it also would seem to involve double imposition and accounting for tax. However, the VAT can be so designed that most businesses would not have to account for tax on their sales. The answer lies in a generous small-business exemption which, in contrast to a similar exemption under RSTs, can be very substantial without serious loss of revenue. Thus, a small-business exemption under a federal VAT of, say, $100,000, would reduce the number of potentially registrable businesses from 25 million to some 10 million (including voluntary registrants). Only some 2.6 percent of potential revenue would be lost, because exempt businesses would still pay tax on inputs. As a result, most VAT-liable businesses would not be subject to state RSTs and most RST-liable businesses would not have to pay federal VAT.

As an accounts-based tax, the BTT would not be as visible as the RST and the VAT and hence might be expected to run into less opposition as a double tax on consumer purchases. Consumers might even perceive the BTT as a tax on business which, of course, it is not. Unlike the VAT, however, it could not incorporate a generous small-business exemption without jeopardizing the neutrality of the tax or proper BTAs. For similar reasons, the FT and the CIT should not run into much state opposition.

9. Rating Consumption Taxes

In the table below, I compare the various CTs on the basis of the characteristics and criteria discussed above. The rankings are from poor to excellent. The table does not provide a score for capital formation and international competitiveness, because I do not think that a clear-cut answer can be provided on these issues. Generally, saving is best promoted by reducing the deficit. Effects on international competitiveness are swamped by exchange rate considerations.

Form of CT	Robustness	Evasion Proof	Compl. and Admin. Costs	Neutrality	Border Tax Adjustable	Compatibility with State RSTs
RST	Fair	Fair	Fair	Fair	Fair	Poor
VAT	Good	Good	Good	Excel.	Excel.	Fair
BTT	Poor	Fair	Fair	Fair	Poor	Excel.
FT	Poor	Fair	Fair	Fair	Poor	Excel.
CIT	Poor	Fair	Poor	Fair	Poor	Excel.

The **RST** scores very low on compatibility with state RSTs. Also, it is not very good in taxing services, excluding producer goods and, by extension, providing correct BTAs.

The **VAT** is the most robust and neutral CT. Product and factor neutrality are important attributes of a CT in increasingly integrated and competitive world markets. A sizeable small-business exemption, not feasible under the RST, can eliminate the incompatibility with state RSTs and make the VAT less intrusive.

The **BTT** appears compatible with state RSTs. However, it is very vulnerable to political erosion. BTAs can easily become indeterminate and unacceptable to the international trading community.

The **FT** also is not as robust as either the RST or the VAT. As an origin-based tax, moreover, it does not score very highly on neutrality grounds. Proper treatment of international transactions is problematic.

The **CIT** is the most costly form of CT to administer and comply with. In addition to keeping records of income, taxpayers would be obliged to keep and furnish records of savings.

Taxation probably is a risk-averse business. Accordingly, it should be pointed out that there is much experience with RSTs and VATs, but none with the BTT, FT or CIT. I find the BTT very vulnerable from a political point of view. Transitional problems with the FT and the CIT should not be ignored. In the final analysis, much would depend on how much of the income tax would be replaced. Considerations regarding the distribution of the tax burden -- between rich and poor, young and old -- would also have to be brought into the picture.

To me, the real choice seems to be between the RST and the VAT. In making that choice, it must be borne in mind that the coverage of the RSTs (excluding capital goods) actually in use is little more than half that of most VATs, and that RST rates are on average only one-half to one-third of most VAT rates. Moreover, RSTs avoid the problems of hard-to-tax groups, such as service sectors, by simply excluding them from the base, just as they avoid the enforcement problems associated with higher rates by widely taxing capital goods. The conclusion is, therefore, that the VAT is a more robust form of CT: its administrative integrity seems easier to maintain as the demands on the inherent structural and technical capacity of the tax are increased in response to greater economic complexities and cross-border integration.

10. Do's and Don'ts of a VAT

If the U.S. were to give serious thought to adopting a VAT, it should be advised to avoid the mistakes of the European VATs (see the EU's Sixth Directive on Value-Added Tax). Specifically, the following mistakes should be avoided.

1. Tax all goods and services, with the fewest possible exceptions.

2. Impose a single rate of tax and confine the zero rate to exports. Generally, European VATs have two positive rates. These rate structures have been expensive to administer and comply with. They increase definitional problems, induce misreporting, necessitate additional recordkeeping, and require more intensive audit oversight. Moreover, multiple rates do not improve the burden distribution of the VAT.

3. Provide a generous small-business exemption, eliminating 60 percent of all potential taxpayers. Instead, VAT would be collected on their inputs only. Voluntary registration should be possible. In contrast, many European VATs try to tax even the smallest business, greatly adding to compliance and administrative costs.

4. Tax agriculture, subject to the small-business exemption. Taxation provides for much more even-handed treatment of food products. In contrast, the Sixth Directive exempts agriculture, but permits purchasers of agricultural products a presumptive tax credit for the tax paid in respect of farm inputs. Even-handed treatment is not achieved.

5. Tax real estate activities in full with the only exception of rents, rental values, and sales of residential property. The Sixth Directive exempts 'immovable property', but taxes newly created real estate. This has led to much confusion.

6. Try to find a way of taxing financial services and insurance, possibly on a cash-flow basis. The Sixth Directive exempts these services on administrative grounds, although exported services are subject to a zero rate.

7. Include non-profit organizations in the VAT-base, subject to a very generous exemption of, say, double the small-business exemption. The Sixth Directive generally exempts non-profit organizations on the ground that they do not have a 'profit motive' -- a criterion which in practice has proved to be unworkable.

8. Tax specified commercial-type of activities by subordinate levels of government, but refund the VAT on major investment goods, such as buildings, roads and bridges. The Sixth Directive exempts all government activities, thus distorting competitive conditions vis-à-vis the private sector.

9. Generally, do not tax secondhand goods, but apply the VAT to the margin of a few specified secondhand goods, e.g. cars.

10. Reduce compliance costs by basing VAT reporting as much as possible on existing accounting information, including the cash basis, if used. Also, permit quick methods for the calculation of the VAT on fringe benefits and items supplied through the business for personal use. Closely related businesses should be permitted to elect "nil consideration."

In conclusion, if a VAT is adopted, it is crucial to get it right the first time, by simplicity in structure and operation, stability and certainty in legislation and rulings, and convenience in payment arrangements. A broadly-based VAT with a single rate, the fewest possible exemptions, and a generous small-business exemption should promote the acceptability of the VAT, and keep initial and ongoing operating costs within reasonable bounds.

Chairman ARCHER. Thank you, Dr. Cnossen.

Professor Schenk, welcome, you may proceed.

STATEMENT OF ALAN SCHENK, PROFESSOR OF LAW, WAYNE STATE UNIVERSITY LAW SCHOOL, DETROIT, MICH.

Mr. SCHENK. Mr. Chairman, thank you very much for the invitation to appear before this Committee to discuss the value-added tax. Mr. Chairman and Members of the Committee, these hearings provide a unique opportunity to initiate a public debate on significant tax reform and the role of a value-added tax in that reform.

I will discuss the European and subtraction VATs and I will comment briefly on the Japanese tax which no one has mentioned, a modified European VAT that does not rely on invoices. I will look at the question of whether one form of VAT is better than the others.

Thomas Hobbes, back in his "Leviathan," suggested that it is more appropriate to tax individuals on what they withdraw from community resources in the way of a tax on consumption than on what they contribute to community resources by way of a tax on income.

Any value-added tax should be broadly based in order to simplify administration and compliance and prevent distortion of consumer choices. Otherwise, we will be repeating the mistakes of the past with our income taxes.

Congress should tax some services that are not taxed under many foreign value-added taxes, such as financial intermediation services and some services provided by government and nonprofit organizations in market transactions. Even the smallest businesses ultimately should be included in the value-added tax base. Exemptions are to be avoided.

If Congress wants to tailor taxes to individual economic circumstances of families through exemptions or other special provisions, this goal is better accomplished with an individualized income tax, not a tax on sales like a VAT.

I want to cover two major points about a VAT: One, the WTO rules and our balance of trade, and the other, how a VAT would operate with State and local retail sales taxes.

The U.S. taxation of imports and exports is circumscribed somewhat by our obligations under the WTO rules. The European VAT is considered an indirect tax that is border adjustable under these rules. A pure sales subtraction VAT is economically equivalent and therefore should be border adjustable. Our trading partners, however, may question the border adjustability of the Danforth-Boren and the Domenici-Nunn-Kerrey subtraction VATs but maybe not your tax, Mr. Gibbons, because the Senators grant credits against the VAT liability for a portion or all of the employer's share of the OASDI payroll tax. Additional research is needed on this issue.

The border adjustability of a subtraction tax may be jeopardized if Congress modifies the tax so that it resembles a tax on income rather than consumption. This is my concern about a subtraction VAT. It will be modified by Congress, and if it is modified too much, it may not be border adjustable.

You have heard a lot about whether VAT tax border adjustments improve balance of trade. I just want to make one point. The Japa-

nese VAT and the proposed subtraction VATs, except for Mr. Gibbons' subtraction VAT, have features that may actually result in a negative tax on exports, sometimes called a subsidy.

I want to say a few things about how a value-added tax could be operated alongside State and local sales taxes. The value-added tax appropriate for the United States ultimately may depend upon the kind of VAT that can operate alongside the existing variety of State and local retail sales taxes.

Most foreign countries employ VAT only as a Federal or local tax, not side by side with a second sales tax at another level of government. A European VAT that is separately stated on sales invoices looks like our retail sales taxes. The imposition of two different visible sales taxes on retail sales will create complexity at the checkout counter.

A European VAT can be modified to require that the tax be buried in retail prices and merchants can be required to post signs informing consumers of the tax rate included in the prices. The Japanese VAT that does not rely on tax reported on invoices also is an alternative worth considering.

Canada to our north has experience with a visible Federal European value-added tax operating alongside provincial sales taxes. Businesses complained about substantial compliance costs. Canadian consumers have voiced strong opposition, in part because of the sticker shock that results when two sales taxes are added at the cash register. A special committee on finance studied alternatives to the Canadian GST and recommended major changes in the GST that would bury the tax and move it closer to a Japanese consumption tax.

A subtraction VAT proposed by Mr. Gibbons and others is calculated on the results of operations for each tax period. By its nature it is buried in product prices. If the experience in Michigan with a State retail sales tax and a VAT calculated on period results and buried in product prices is any guide, then if Congress adopts a subtraction VAT and States continue to rely on transactional retail sales tax, businesses and consumers may not view these taxes as two sales taxes.

In the United States, States may object to a VAT imposed on sales and added at the cash register as an intrusion into their sales tax domain. If Congress adopts a subtraction VAT or a Japanese or a European VAT that is buried in retail prices, the State opposition may be more muted.

Let me just conclude with a couple of comments. If Congress decides to enact a tax on consumption to be collected by business, it should seriously consider a VAT. Except for concerns about the coexistence of a Federal VAT and State retail sales taxes, one form of VAT does not stand out as the best VAT to adopt. Because a Federal VAT must coexist with State and local retail sales taxes, there may be administrative and compliance reasons to prefer a VAT that is buried in the prices of taxable goods and services at least at the retail stage.

The administrative and compliance costs of a VAT are significant enough to dismiss the tax unless it replaces or substantially simplifies existing taxes or raises substantial revenue for other critical needs. If Congress decides to enact the European VAT, as a transi-

tion to the VAT, I urge you to look seriously at some of the attractive features of the Japanese consumption tax.

Thank you very much, and if I could add a personal note to you, Mr. Chairman. Thanks for holding these hearings. I teach a course in value-added tax, and so far most of the material has to be self-generated. Now, you have given me a lot of material, and I thank you.

[The prepared statement follows:]

Testimony Submitted by
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For
Committee on Ways and Means
U.S. House of Representatives

Hearings on Replacing the Federal Income Tax
June 7, 1995

Mr. Chairman, thank you for the invitation to appear before this committee to discuss the value-added tax. These hearings provide a unique opportunity to initiate a public debate on significant tax reform, and the role for a value added tax in that reform. If Congress needs substantial revenue for debt reduction, to finance programs, or to replace revenue from existing taxes, Congress should seriously consider a value-added tax.

There have been several proposals in the past few years to enact a federal VAT or national sales tax. They include Senator Hollings and Congressman Dingell's proposals for a European credit-invoice VAT, Congressman Gibbons, as well as former Senators Danforth and Boren, and Senators Domenici, Nunn and Kerrey's proposals for a sales-subtraction form of VAT, and Majority leader Armey and Senator Specter's adaptation of the Hall-Rabushka two part tax on a consumption base. Senator Lugar proposed a national sales tax to be administered by the states. I will discuss the credit-invoice and subtraction VATs, and comment briefly on the Japanese tax, a modified form of European VAT that does not rely on invoices.

The credit-invoice and subtraction VAT proposals tax the sales price of taxable goods and services and grant credits or deductions for purchases from outside suppliers. Tax liability therefore is based on value added at each stage. Under the European credit-invoice VAT, a business credits tax on purchases against tax on taxable sales to calculate tax due (a tax against tax calculation). Under a sales-subtraction VAT like the Danforth-Boren Business Activities Tax, a business multiplies the tax base (taxable sales less deductible purchases) by the tax rate to calculate tax due. The sum of the tax collected at all stages is equal to a tax on the retail prices of taxed goods and services sold to consumers. Appendix A contains an illustration of why these two forms of VAT and the retail sales tax are economic equivalents if they are imposed on the same base.

There are many issues raised by these proposals, especially the proposals to replace the corporate income tax and some of the OASDI payroll tax with a VAT. With the hearings at an early stage, I will concentrate on only a few of the issues. If Congress decides to replace the corporate income tax with a VAT, is one form of VAT better than the others?

I. Shifting From an Income Tax to a Tax on Value Added

Our major trading partners balance their tax systems by relying both on taxes collected at the source (income and payroll taxes) and taxes collected at the point of use of funds (consumption taxes -- mostly VATs). We rely very little on consumption taxes for federal revenue.

Thomas Hobbes, in Leviathan, suggested that with limited community resources, it is more appropriate to collect taxes on what individuals withdraw from community resources (taxes on consumption) rather than on what they contribute to those resources (taxes on returns to labor and capital, or income).

A switch from the corporate income tax to a VAT would represent a major shift in tax from a tax imposed only on profitable companies doing business in corporate form to a broader-based tax on sales measured by value added by all firms, whether or not the firms earn a profit. The economic implications may be

substantial. I will touch on only a few in the succeeding sections.

II. Scope of the Tax

A. Broadly define the base and minimize special treatment

A VAT should be broadly based in order to simplify administration and compliance and prevent distortion of consumer choices. The VAT base should include at least personal consumption expenditures. Unlike the familiar state retail sales taxes that are imposed mainly on retail sales of goods, a VAT should be imposed on services as well. Congress should tax some services that are not taxed under many foreign VATs. For example, a VAT should apply to financial intermediation services, real property transactions and, except for essential government services, services of units of government and non-profit organizations that are provided in market transactions. Politically, it may be easier to tax at least purchases by nonprofit organizations and government entities if the tax is a subtraction VAT included in product prices than if the tax is a separately-stated credit-invoice VAT listed on sales invoices.

Possible models for broadly-based European credit-invoice VATs are the ABA Tax Section VAT Committee's model VAT statute and the New Zealand Goods and Services Tax. The latter has been successful in taxing many transactions that are exempt elsewhere.

A VAT base can be altered by granting exemptions or zero rating to particular businesses (small business exemption), to particular sectors (governmental entities), or particular goods or services (education).

If sales are zero rated, they are completely free of tax. There is no tax on the sales and the seller can recover the tax paid on purchases. If Congress taxes international transactions under the destination principle (discussed later), exports will be zero rated.

If sales are exempt, there is no tax on the sales, but the seller can not recover tax paid on purchases attributable to the exempt sales. If government-provided services are exempt from VAT, the governmental entity bears tax on purchases but does not charge VAT on its services. Exemptions, however, may encourage vertical integration. For example, if education is exempt, a university that purchased stationery and forms from an outside printer before VAT becomes effective may establish a print shop in-house in order to avoid the new VAT on the purchases from the outside printer. Rules are needed to prevent this incentive to vertically integrate.

Exemptions also complicate the tax by requiring businesses to identify noncreditable tax on purchases attributable to exempt sales and by requiring line drawing between taxable and exempt transactions. The latter breeds litigation. Whether it chooses a credit-invoice or a subtraction VAT, Congress should minimize exemptions and zero rating.

If Congress wants to tailor taxes to economic circumstances of families, it is easier and more appropriate to accomplish this goal under an income tax, not a tax on sales like the VAT.

B. Businesses subject to tax

A person generally is subject to VAT on business activity. Who is a taxable person and what constitutes business activity? Congress should draw these lines broadly.

Most foreign VAT systems exempt small businesses from the tax, although the threshold for exemption varies substantially. At one extreme, only the smallest businesses and street vendors are exempt. Japan is at the other extreme. Assuming an exchange rate of 85 yen to the dollar, Japan totally or partially exempts businesses with annual sales up to about $600,000, and allows businesses with annual sales up to about $4.7 million to calculate tax liability under a simplified scheme. Only about 10 percent of Japanese businesses calculate tax liability under the normal statutory method.

U.S. experience with state and local retail sales taxes indicates that even the smallest businesses can be included in a sales tax base. The question of whether to grant any small business exemption requires a balancing of the administrative and compliance costs of granting exemption against the fairness and competitive inequities of exempting some businesses and taxing others.

What kind of activity is covered by the VAT? The trade or business, income-producing activity, and hobby distinctions under the income tax must be addressed under a VAT. Most VATs do not cover casual sales by individuals. Some high-priced casual sales, such as sales of planes, yachts, or real property, should be taxed. Rules must define the person who must file a return. For example, divisions of a single company may be required to file a single return or be permitted to file separately. Similar options may apply to businesses under common ownership or affiliated corporations.

A credit-invoice VAT generally handles exemptions better than a subtraction VAT. Revenue lost through an intermediate stage exemption under a credit-invoice VAT can be recovered at the next stage. The same generally does not occur under a subtraction VAT. If the revenue loss and complications caused by exemptions will result in Congress granting no exemptions or fewer exemptions under a subtraction VAT, a subtraction VAT may be better. If exemptions will be granted under either form, the credit-invoice VAT is preferable.

III. Balance of Trade Implications of a VAT

A. Apply the destination principle to international transactions

Congress can adopt either the origin or the destination principle to define the jurisdictional reach of a VAT. Except for House majority leader Armey's proposal (and possibly Senator Specter's as well), all of the proposals made recently are destination principle taxes. Under the destination principle, tax is imposed only on goods and services consumed in the United States. Imports are taxed and exports are relieved of tax. In contrast, under the origin principle, tax is imposed only on value added within the United States. Imports are not taxed and exports bear tax.

Other countries with VATs rely on the destination principle to tax international transactions. To place American companies in a comparable position, Congress should zero rate exports (and refund excess credits), so that the VAT does not enter into the sales prices of our exports. Congress should tax imports at the rate applicable to domestic sales. As discussed below, precise border tax adjustments may be easier with a European credit-invoice VAT than the proposed subtraction VATs or the Japanese Consumption tax in its present form.

International trade has become an increasingly important aspect of our domestic economy. The U.S. taxation of imports and exports is circumscribed somewhat by our obligations under the World Trade Organization rules (formerly the General Agreement on Tariffs and Trade, or GATT). Under these rules, a member country can rebate indirect taxes on export (but can not subsidize exports) and can impose on imports taxes no greater than those borne by domestically-produced items. A European credit-invoice VAT is considered an indirect tax that is border adjustable under these rules. Senator Hollings and Congressman Dingell's destination principle credit-invoice VATs comply with our obligations under these agreements.

A pure destination principle sales-subtraction VAT is economically equivalent to a credit-invoice VAT and therefore should be border adjustable. It should not matter what method is utilized to calculate tax liability on value added at each stage of production or distribution. Our trading partners, however, may question the border adjustability of the Danforth-Boren or the Domenici-Nunn-Kerrey subtraction VATs that grant credits against the VAT liability for a portion or all of the employer's share of

the OASDI payroll tax. If it is permissible to use VAT revenue to reduce payroll tax rates, as it should be, then the payroll tax credit feature in these proposals may be permissible. Additional research may be needed on this issue.

The border adjustability of a subtraction VAT may be jeopardized if Congress modifies a subtraction VAT so that it resembles a tax on income rather than consumption, such as by granting deductions for compensation paid.

B. Will border tax adjustments improve the balance of trade?

If Congress adopts a destination principle VAT to replace existing federal taxes included in export prices, the VAT may improve the U.S. balance of trade in the short term. The long term effects are less predictable.

If a VAT is introduced as an additional revenue source, the VAT will not alter the balance of trade. For example, assume that a vehicle, before VAT, sold for export at $15,000. With the introduction of a 10 percent VAT, the same vehicle will sell domestically for $16,500. If the vehicle is exported, there is no VAT on the sale and the vehicle will sell for the same $15,000 price it carried before the VAT was introduced.

If a VAT replaces a federal tax that is included in the price of American exports, the replacement should reduce the price of the exports. For example, assume that the VAT replaces the corporate income tax and assume further (it is not clear that this assumption is realistic) that the corporate income tax caused the price of the exported vehicle to increase from $14,500 to $15,000. The switch from the corporate income tax to a VAT should lower the export price of the vehicle to $14,500 and the export sales should increase. Even if these assumptions are correct, in the long run, the exchange rate of the U.S. dollar may adjust so that the vehicle will cost the equivalent of $15,000 in foreign markets. The exchange rate of the U.S. dollar is affected by many factors other than our balance of trade. It therefore is not clear if the increase in American exports prompted by a switch to a VAT will provide a long-term balance of trade advantage, or will be negated by an adjustment in the exchange rate.

The trade effects of a credit-invoice and subtraction VAT may be similar, but not necessarily the same. The difference results mainly from the fact that the proposed subtraction VATs allow deductions for purchases from exempt sellers (such as exempt small businesses). As a result, exports may bear negative tax to the extent that the exports contain purchased components or services that were exempt from VAT. The Japanese Consumption Tax provides treatment comparable to the subtraction VAT proposals.

IV. Coordination of a Federal VAT With State Sales Taxes

The VAT appropriate for the United States ultimately may depend upon the kind of VAT that can operate alongside the existing myriad of state and local retail sales taxes (RSTs). With any kind of federal VAT that operates with RSTs that are not harmonized, businesses face increased costs when they are subjected to different federal and state rules on the administration, audit, collection and assessment of the taxes. Government costs to administer the tax may increase as well.

Most foreign countries employ VAT only as a federal or a local tax, not side-by-side with a second sales tax at another level of government. This is one area where it is important to address European credit-invoice VATs and sales-subtraction VATs separately. The method of calculating VAT liability and the visibility of the VAT at the retail stage may be important.

A. Credit-invoice VAT and State Sales Taxes

A credit-invoice VAT that is separately stated on sales invoices looks like the more familiar RSTs. With a credit-invoice VAT, businesses must comply with two different sales taxes imposed on individual transactions. This will create complexity at the

check-out counter, especially if the seller does not use automated cash registers.

A credit-invoice VAT can be buried in selling prices, rather than separately stated on retail sales. The merchants could be required to post signs informing consumers of the tax rate included in the prices. If the VAT is buried in retail prices, consumers subjected to both taxes may not be confronted with sticker shock, but businesses still must calculate the VAT and RST on each transaction.

Japan has a credit method VAT that does not rely on invoices and that permits businesses to calculate tax from sales and purchase records for each tax period. The Japanese tax is an alternative worth considering.

Canada, with its Goods and Services Tax (GST), imposes a national credit-invoice VAT alongside provincial sales taxes (PSTs) imposed by all provinces except Alberta. Businesses subject to the GST and PST complain about the substantial compliance costs associated with the variety of sales taxes imposed on different tax bases and including different rules governing such obligations as the filing of returns and the submission to audits. Canadian consumers also have voiced strong opposition to the GST, in part because of the sticker shock resulting from the addition of two sales taxes at the cash register. While Quebec has harmonized (in large part) its sales tax with the federal GST, Quebec's provincial tax base and rules governing input credits differ somewhat from the federal GST rules.

In large part due to business and consumer opposition to the GST, a special Committee on Finance studied alternatives to the GST. The committee report recommended major changes in the GST, including a simplified system to allow taxpayers with annual revenue of Can. $200,000 or less (80% of the taxpayers) to report sales and purchases on a tax-inclusive basis. The tax could be buried in retail prices. It also urged the government to seek harmonization of the federal GST and provincial sales taxes. The recommended system would move closer to the Japanese Consumption Tax system.

No U.S. state opted to piggyback its state income tax on the federal income tax, even though, without charge, the IRS would have collected and remitted the state portion back to participating states. It therefore is unlikely that most or all of the states will give up their power to define their sales tax bases and hire their own agents in order to harmonize their RST with a federal VAT.

While it is possible for states to administer a harmonized federal-state sales tax or VAT (see Senator Lugar's proposal), the German experience with states (landers) administering the federal VAT suggests that the American states may seek to attract business by claiming that they are more lenient in administering the single harmonized tax.

B. Sales-Subtraction VATs and State Sales Taxes

Notwithstanding the advantages of a separately-stated, transactional credit-invoice VAT, an accounts-based subtraction VAT has one significant advantage over that kind of credit-invoice VAT. A sales-subtraction VAT, a period tax, is calculated on the results of operations for each tax period and is included in the prices of taxable goods and services.

Relying on the experience in Michigan with addition and subtraction forms of VAT, if Congress adopts a subtraction VAT (a period tax) and states continue to rely on transactional RSTs, businesses and consumers may not view these taxes as two sales taxes that require harmonization to reduce compliance burdens.

In the U.S., states may object to the credit-invoice VAT imposed on sales and added at the cash register as an intrusion into their sales tax domain. If Congress adopts a subtraction VAT (or a Japanese or even a credit-invoice form of VAT) that is buried in the retail prices of taxable goods and services, the state opposition may be more muted.

V. Administrative and Compliance Issues

Our piece of the global economy is complex. A tax on consumption will be complex, even if Congress keeps the base broad, imposes a single rate, and minimizes exemptions.

A. Single rate tax

A VAT should be imposed at a single positive rate, with a zero rate only for exports under a destination principle tax. Multiple rates increase administration and compliance costs. Businesses must identify sales that come within each rate group and have clerks trained and registers programmed for sales at different rates. The IRS also must verify the rate for reported sales.

A European credit-invoice VAT can accommodate multiple rates. With a subtraction VAT, it is difficult, if not impossible, to impose multiple rates.

B. Separately stated tax and the audit trail

A perceived advantage of a credit-invoice VAT is that the tax listed separately on each sales invoice provides an audit trail for the IRS to verify the seller's reported sales and the buyer's claimed input credits. The requirement for buyers to retain invoices to document claimed input credits is designed to encourage buyers to demand tax invoices from their suppliers. These invoices can be cross-checked with the suppliers' reported sales.

The "audit trail" advantage of a credit-invoice VAT may be overstated. The foreign experience indicates that taxpayers cheat under a credit-invoice VAT. The sales and purchase data required on VAT returns prepared under the Japanese CT or the proposed subtraction VATs can be verified by checking a business's sales and purchase invoices, even if VAT is not separately stated on the invoices.

There are other advantages if the VAT must be separately stated on sales invoices and purchasers can claim credit only for VAT listed on invoices. For example, businesses that are exempt from VAT or that sell exempt services can not list VAT on their sales invoices. Purchasers therefore can not claim input credits on these exempt transactions. The IRS auditor can verify allowable input credits by checking invoices on which VAT is listed. The Japanese CT and the proposed subtraction VATs allow credits or deductions for purchases from exempt small businesses. In part, this exception was made because it is so difficult to identify purchases from exempt small businesses under these VATs.

C. Accommodation to rate changes

A federal tax on consumption can be used as a tool to fine tune the economy. A change in the tax rate, coupled with consistent monetary policy, can encourage or discourage consumption. A credit-invoice VAT accommodates better than a subtraction VAT to rate changes.

A change in rate under a credit-invoice VAT will be reflected in prices and revenue immediately. A seller claims credit for the actual tax listed on purchase invoices, whether the purchase was taxed at the old or new rate. The goods or services acquired therefore are free of tax in the hands of that seller. Beginning on the effective date of the rate change, the seller will charge tax on sales at the new rate, whether a higher or lower rate. Buyers, including final consumers, should bear tax at the new rate.

With a subtraction VAT that is buried in product prices, there may be a time lag before the full effect of a rate change is phased in. If the tax rate is increased from five to 10 percent, the seller likely will include the new 10 percent rate in prices. Unless complicated rules are used to phase in the value of deductions for purchases, the rate hike may increase government revenue by only the value added after the effective date of the rate change. If the subtraction VAT is reduced from 10 to five percent, unless there are complicated rules to adjust the value of

deductions for purchases after the effective date that still may carry some of the old 10 percent rate, sellers may not reduce tax-inclusive prices charged on sales made immediately after the effective date to five percent. The tax revenue may reflect a five percent rate only on value added after the effective date.

D. Administrative and Compliance Costs

The General Accounting Office examined the cost of administering a European credit-invoice VAT with a single rate and minimal exemptions. The GAO report acknowledges that the addition of exemptions will substantially increase the costs. The GAO report estimates the administrative cost at between 1.22 and 1.83 billion annually, once the tax is fully phased in. The cost differential reflects different assumptions about the level of the small business exemption threshold and therefore the number of businesses that are included in the system. Based on these cost estimates, Congress should not enact a VAT unless it is to raise substantial revenue -- at least $100 - $150 billion annually.

The estimates of costs of complying with a credit-invoice VAT vary widely. The compliance costs depend on such factors as the number of returns required each year, the amount of information required to be filed or maintained, and the number of rates and items given special treatment. Estimates under a British study place compliance costs at 0.003% to 1.94% of taxable sales. These costs are offset in part by the cash flow benefits that accrue to firms that receive VAT from their customers before they must remit the tax to the government. It appears that compliance costs tend to be regressive, when measured as a percentage of sales, placing the heaviest burden on the smallest firms.

There is no reliable data available on the administrative and compliance costs of a subtraction method VAT. It is reasonable to assume that the compliance costs will be lower if businesses can take the data for the VAT returns from existing records of sales and purchases and the tax is not separately stated on invoices. The administrative costs may not change much, if at all.

In estimating the costs to administer or comply with a VAT, Congress should consider the savings that will result if existing federal taxes either are substantially simplified or replaced entirely.

The amount of VAT litigation and its attendant costs will depend in large part on the nature of the VAT base. If Congress grants exemptions and zero rating to particular sales or entities, it is predictable that there will be substantial litigation. In the United Kingdom, for example, Parliament created value added tax tribunals to handle anticipated disputes under their VAT that contained numerous exemptions and zero rating.

E. Tax issues that exist under the income tax arise under a VAT

Many issues that exist under the income tax apply under a VAT. For example, the definition of a taxable person and the proper reporting unit must be resolved under a VAT. A business can reduce its VAT liability by making purchases from outside suppliers but not by paying compensation to employees. It is necessary to make the familiar distinction between employees and independent contractors. To determine who is engaged in business, it may be necessary to make the income tax distinction among business under section 162, income-producing activities under section 212, and hobbies under section 183. Related party rules may be needed.

VI. Transition issues

A. Transition rules for purchases made between the dates the tax is enacted and becomes effective

The transition to a VAT could disrupt markets for business inputs as well as for consumer goods. If a VAT replaces the corporate tax and the purchase of capital goods qualifies for input

credit, then if a business can not recover the cost of capital goods under the expiring corporate tax, it may defer discretionary purchases until the VAT becomes effective.

If consumers anticipate that the introduction of the VAT will increase prices, they may accelerate purchases before the VAT becomes effective. This increased demand for goods and services may result in inflationary pressures that will increase when the VAT becomes effective.

B. Transition period needed to prepare for VAT

If Congress enacts a credit-invoice VAT, Congress should provide an effective date of approximately 18 months after the date the tax is adopted. The following represent some of the preparation work necessary to implement this VAT. Businesses must purchase new invoices to provide the data required for VAT purposes, train employees, and purchase or modify computerized cash registers and other record keeping equipment. The government must train personnel, issue guidance, educate businesses and consumers, the Federal Reserve must prepare to receive and process payments, and the IRS must purchase equipment and prepare to process and audit returns. The Customs Service must prepare for the collection of the tax at the borders and for the maintenance of records of export sales.

If Congress enacts a subtraction VAT that is broadly-based and that can rely on records already prepared by business, the required transition period may be somewhat less. The cash register adjustments and other preparations required to list VAT on sales invoices would not be necessary, but much of the training and education of employees of businesses and the government still must be done. The preparation required by the Federal Reserve, the Customs Office, and IRS under a credit-invoice VAT will exist under a subtraction VAT.

VII. Conclusion

If Congress decides to enact a tax on consumption to be collected by business, it should seriously consider a VAT. If a VAT replaces the corporate income tax, except for concerns about the co-existence of a federal VAT and state RSTs, one form of VAT does not stand out as the best VAT to adopt.

If Congress decides to add a VAT to the federal tax system, keep it simple and free from distorting and complicating exemptions or other special treatment. If it is necessary to reduce the regressive effects of a tax on consumption, Congress should do so outside the VAT system, such as through direct grant programs, cash rebates to low income households, or through the individual income tax that can be tailored to individual circumstances.

Congress should include as many businesses as possible in the tax system. It should apply the destination principle to tax imports and free exports from the tax. Make sure that the tax, whatever its form, is border adjustable. Do not adopt a VAT just to improve our competitive position in world markets in the long term. It is not clear that it will produce that result.

The European VAT should not be adopted just to achieve the benefits from its "audit trail." These benefits may have been overstated. Address transition issues and allow an adequate period for government and businesses to gear up for the tax.

In principle, a federal VAT should be separately stated and visible to consumers. However, if a federal VAT must co-exist with state and local retail sales taxes, there may be administrative and compliance reasons to prefer a VAT that is buried in the prices of taxable goods and services, at least at the retail stage. The goal can be accomplished with adjustments to a European credit-invoice VAT. The Japanese VAT or the subtraction VAT provides these results without any tinkering.

The European VAT handles rate changes better than a subtraction VAT. While the compliance costs of a subtraction VAT may be somewhat lower than a European credit-invoice VAT, the administrative and compliance costs of both are significant enough

to dismiss the tax unless it replaces existing taxes or raises substantial revenue for other critical needs.

If Congress decides to enact a European credit-invoice VAT, as a transition to the VAT, Congress should look seriously at the Japanese Consumption Tax, with its simplified method for smaller businesses, as the first stage of a credit-invoice VAT.

Appendix A

European Credit-Invoice VAT, the Sales-Subtraction VAT and the Retail Sales Tax

The following example is used to illustrate the European-style VAT, the subtraction VAT, and the retail sales tax.

Under the European-style credit-invoice VAT, a business's tax on purchases is credited against tax on taxable sales. Assume that a lumber mill sells lumber to a carpenter who fashions the lumber into tables and sells the tables to a retailer who resells them to consumers. Assume that the lumber mill sells the lumber for a pre-tax price of $1,000. With a 10 percent VAT, the mill would add $100 tax for a tax-inclusive price of $1,100. The carpenter sells the tables to a retailer for a pre-tax price of $5,000 (not including the $100 tax on the lumber). The carpenter adds $500 tax, for a tax-inclusive price of $5,500. The carpenter recoups the $100 tax on his purchases in calculating the tax that he remits to the government. The retailer sells the tables to consumers for a pre-tax price of $10,000. The retailer adds $1,000 tax, for a tax-inclusive price of $11,000, and recoups the $500 tax paid on her purchases. At each stage, tax is remitted only on value added by each business. This VAT is illustrated in Table 1.

Table 1

	Tax Liability of Each Seller	Tax Remitted to Government
Mill sale to carpenter		
Taxable sale $1,000 x 10%	$ 100	
Purchases 00	00	
Tax Payable by Mill	$ 100	$ 100
Carpenter sale to retailer		
Taxable sale $5,000[1] x 10%	$ 500	
Credit for tax on purchases	(100)	
Tax Payable by Carpenter	$ 400	400
Retailer sales to consumers		
Taxable sale $10,000[2] x 10%	$1,000	
Credit for tax on purchases	(500)	
Tax Payable by Retailer	$ 500	500
Total tax collected by government and paid by consumer		$1,000

Tax liability under a sales-subtraction VAT like the Danforth-Boren Business Activities Tax is calculated by multiplying the tax base (taxable sales less deductible purchases) by the tax rate. The data will be taken from company records and it therefore is more convenient to calculate the tax using tax-inclusive figures. To raise the same revenue as the above 10% rate applied to tax-exclusive data, the rate should be 9.0909%. In Table 2, the tax

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[1] The price would be $5,000 instead of $5,100 because the carpenter recovers the $100 tax on his taxable purchases.

[2] The pre-tax sales prices would total $10,000 because the carpenter would charge the retailer $5,000 + $500 tax, and the retailer would recover that $500 tax.

payable by each business, the revenue to the government, and the tax imposed on consumers are identical to the amounts listed under the European-style VAT in Table 1.

Table 2

	Tax Liability of Each Seller	Tax Remitted to Government
Mill sale to carpenter		
Taxable sale	$1,100	
Deduction for purchases	00	
Tax Base	$1,100	
Tax Rate	9.0909%	
Tax Payable by Mill	$ 100	$ 100
Carpenter sale to retailer		
Taxable sales	$5,500	
Deduction for purchases	$1,100	
Tax Base	$4,400	
Tax Rate	9.0909%	
Tax Payable by Carpenter	$ 400	400
Retailer sales to consumers		
Taxable sales	$11,000	
Deduction for purchases	(5,500)	
Tax Base	$ 5,500	
Tax Rate	9.0909%	
Tax Payable by Retailer	$ 500	500
Total tax collected by government and paid by consumer		$1,000

Under a federal retail sales tax, tax is collected only on sales to consumers. In the above example, the retailer will charge $1,000 tax on taxable sales of $10,000, producing the same revenue and the same tax-inclusive consumer prices as under the European VAT or the subtraction method VAT.

Chairman ARCHER. Thank you, Professor Schenk. I want to thank all of you. I am particularly grateful for your testimony, and I also must say because I think it is very much in line with my colleague and my friend Sam Gibbons, that I am very grateful to him because he has been plowing this ground for some time, and he understands the big picture and what is at stake, and I am hopeful that in some way or another we can reach a resolution of this issue that is going to help this country in years to come.

I am curious as to what differences there might be between you, Professor Schenk, and you, Dr. Cnossen, and whether those can be resolved.

Mr. SCHENK. Do you want to start, Sijbren?

Mr. CNOSSEN. Yes, Alan, no difficulty. I think I have come down, Mr. Chairman, fairly strongly in favor of the tax credit method, value-added tax. Professor Schenk has left the door open for a modified tax credit value-added tax with some elements of the subtraction method, which is currently imposed in Japan. I hope that sums it up reasonably well. So I guess we agree that a full subtraction method VAT probably would not be preferable.

In this respect we disagree with Cliff Massa. I think the Japanese value-added tax does well at the low rate of 3 percent that it is currently being levied. If you were thinking of a consumption tax that would replace the entire income tax, I guess you would have to impose it at a rate of some 20 percent. Aggregate consumption expenditure is $4.8 trillion. If for one reason or another about one-fourth of that expenditure is exempted, then you would have to tax the remaining expenditures at 20 percent to raise some $735 billion in revenue. That is a very high rate.

I believe that a high-rate subtraction method VAT would leave quite a bit of value added untaxed and would raise much stronger objections from your trading partners than the low-rate Japanese tax does. Although the rate is low, the Japanese tax nevertheless is a subsidy on exports and at the same time is an extra tax on imports. You didn't mention that, Alan, but I think you agree with that aspect as well. I think both features would be problematic.

Besides, I believe that the GATT arrangements for border tax adjustments require that taxes should be imposed on specific products to be eligible for rebate at the time of export. In other words, they should be transactions-based taxes, not accounts-based taxes as is the subtraction method, business transfer tax. Furthermore, it should be possible to calculate border tax adjustments unambiguously: There should be full certainty how much tax on exports has to be rebated and how much tax is imposed on imports, equivalent to the tax on domestically produced goods and services. Now, I would like to yield to Professor Schenk.

Chairman ARCHER. Professor Schenk.

Mr. SCHENK. Mr. Chairman, I don't think there is one right answer about the VAT. There are good and bad points of the subtraction method. There are good and bad points about the European style. I have one major concern about the subtraction method, and you are certainly in a better position than I to know how to evaluate this concern.

My concern is that your colleagues in the House and Senate will look at a tax that is based on sales minus purchases and think of

it—as they have been thinking about taxation in this country for decades—as a tax on income, and therefore be tempted to approach it that way and grant deductions, and enact other complications to the tax that would just destroy its nature.

Why do I say this? Because in Michigan we have experience with value-added taxes. We used to have a subtraction VAT and now we have an addition VAT. Think of the businesses that come in to the State legislature and would come in here. For example, a real estate construction company or a service company may claim that under an income tax there were years that they hired a lot of people, did not earn a profit, and did not have to pay any income tax.

Now, Congress is saying that even though we do not have any profit, but we are hiring employees, we have to pay a tax under this subtraction VAT. Michigan responded to this pressure by granting a special deduction for labor-intensive businesses. There were other special provisions like that that really changed the nature of the tax. That is my concern about the subtraction tax. If Congress could enact a pure subtraction tax, as Mr. Gibbons is trying to develop, I would not have those concerns. My question is whether or not that can get through Congress.

Chairman ARCHER. So basically what I hear you saying is that you have a degree of flexibility in your own mind that might accommodate what Dr. Cnossen is recommending as a viable alternative?

Mr. SCHENK. Yes.

Chairman ARCHER. Let me ask all of you, if I can, three quick questions. First, let me say as a foundationpiece for my own views that I personally will not support any consumption tax as an addition to the current income tax. It must be as a replacement for the entire income tax.

I just want to make that very clear. I have tried to over the months, but perhaps you need to restate these things. But having said that, if we are to move from the current income tax structure to a type of VAT, which all three of you propose, can we do that, in effect, cold turkey? And if not, why?

Mr. SCHENK. From which tax, Mr. Chairman? From the corporate income tax or from both?

Chairman ARCHER. From the corporate and personal income tax. Let's say, hypothetically, let those cease on December 31 and on January 1 go to one of your forms of value-added tax.

Mr. SCHENK. Speaking for myself, I think the transition issues would just be horrendous. I do not think that you can go cold turkey. I think if you announce today that the change will become effective December 31, you would probably have businesses defer purchases of capital goods, and you would have consumers stock up on consumer goods before the new tax goes into effect. I think you need a transition period.

Mr. MASSA. I am not sure, Mr. Chairman. It seems to me that either path, once you decide where we are going to end up, the path from here to there, whether long or short, is not going to please everybody. There are going to be dislocations. We have to decide is the end result worth the trip.

I am sure that if there is an extended transition period, this Committee will be busy like it has never been busy before with a

line of people, I would be included, I am sure, up here on behalf of people saying, but you have got to take this one into account and you have got to take that one into account.

As I recall the Canadians, as they began to move to the goods and services tax, at least were coming to a conclusion that cold turkey wasn't going to be any worse than anything else. I am not sure I have the answer for you, but I certainly wouldn't dismiss it out of hand because I am not sure that the answer cold turkey is going to be any worse than 3, 5, 7 years' worth of transition rules which actually increase complexity and increase costs in the process.

Chairman ARCHER. Dr. Cnossen.

Mr. CNOSSEN. Mr. Chairman, I think I would not like to be in the driver's seat—$735 billion in revenue, a rate of at least 20 percent in my view, possibly higher if Congress accepted some exemptions of the very broad base; enormous announcement effects; and very serious economic relocation issues, also because of the abolition of the income tax itself. These relocations of economic activity, economic decisions, and so forth, in my view, at a 20 percent rate consumption tax that would fully replace the income tax might be called dislocations.

Chairman ARCHER. So how would you do it?

Mr. CNOSSEN. I would phase it in. I would start with a value-added tax of 5 percent and reduce the income tax accordingly, Mr. Chairman, by the revenue that a broad-based consumption tax would yield, be it a national retail sales tax, a tax credit value-added tax, or a subtraction method value-added tax.

Chairman ARCHER. OK, thank you. On two other quick issues, what would you do about education and medical services?

Mr. CNOSSEN. I would tax them, Mr. Chairman, and I will explain why. I think there used to be a time when we thought that food should be exempted and now we know that the rich spend twice as much on food as the poor do and we also know that a consumption tax is not the appropriate tax to affect the income redistribution, or I should say try to impart some degree of progressivity to the tax system. Income distribution issues should be dealt with by the expenditure side of the budget.

I think that this argument also applies to medical services. Moreover, we have tremendous problems exempting medical services proper, because hospitals also do work for pharmaceutical companies in the form of research, and so forth, for which they want to be taxed in order to be able to get the tax credit on inputs. By and large, the same argument, perhaps to a somewhat lesser extent, applies to education.

Mr. MASSA. Every sale of goods and services in the economy, whether it is currently a tax-exempt organization or not, let's apply the system to it. Let the market sort out where the burdens go instead of trying to distinguish whether this business activity of selling education or selling medical care or selling legal services or selling food is worthy of not being taxed. Let's not start down that path. Let's put everything in the system. Let the market sort out where the burden goes, and then attempt to deal on a much more directed basis with the households that you conclude need some offsets to those effects.

Chairman ARCHER. In other words, there would be no tax-exempt entity?

Mr. MASSA. If they sold goods or services, I would recommend that they be in the system.

Chairman ARCHER. Well, is a State university selling a service?

Mr. MASSA. Arguably, they are selling services in exchange for tuition.

Chairman ARCHER. OK. Professor Schenk.

Mr. SCHENK. I would agree. My dean and president might not like it, but I think that it is very important not to distort consumption, and obviously you have problems even with that simple answer, and you raised one, Mr. Chairman. When somebody at my law school pays $5,000 a year tuition at the law school, he or she is not paying the full cost. The State is paying part of that cost, and so if you only tax the $5,000, you are not really taxing the full value. I think it should all be taxed whether it is the football game or it is the tuition.

Chairman ARCHER. All right. Then finally, do you have any concern about the problems in border areas in conjunction with Mexico or Canada, that if we convert our income tax completely to a value-added tax, will people simply go across the border and buy the products and services in a foreign country?

Mr. MASSA. Our two border countries currently have value-added taxes of their own, both Canada and Mexico. We are, in fact, the only major trading nation that does not have one. Perhaps the relative rates would make a difference, and Dr. Cnossen's experience in the European Community may help to answer that, but it would not seem to me to be either a large or an insurmountable problem.

If somebody decided that the Canadian tax rate was lower and I will buy it over there, we probably would end up with some kind of modest exemption on tourist-imported goods anyway, so it would not seem to me to be a major problem.

Mr. SCHENK. Mr. Chairman, I think it is a problem. It is a problem that Canada faced when it adopted a VAT and the United States did not have one. I live on the Detroit-Windsor border and people came over by the vanloads, and as a result the government had to do something in order to try to stem that flow.

Chairman ARCHER. Were they able to do so?

Mr. SCHENK. I must confess I forgot exactly what they did.

Chairman ARCHER. Dr. Cnossen.

Mr. CNOSSEN. Mr. Chairman, I think that cross-border shopping would not be a serious problem. You have a long contiguous border with Canada, but not really that many people are living along the border. If I go by European experience, politicians and businessmen make a lot of hay about cross-border shopping, but in fact the quantitative significance of it is very, very low.

Germans come and shop in Dutch towns even though the value-added tax is higher in Holland. The reasons are that parking facilities or movies are better, the cultural climate is freer, or whatever. Rate differentials do not significantly influence cross-border shopping in European countries, although in the European Community some 10 percent of the population lives along borders within 25 kilometers on either side.

Mr. SCHENK. Mr. Chairman, I remember what resolved the cross-border shopping problem. The exchange rate of the dollar in Canada versus the United States changed and therefore it was no longer profitable for Canadians to shop in the United States.

Chairman ARCHER. I see. I would like to explore your ideas of how we handle the regressivity argument, but I have already overused my time, so if I could get each of you to submit in writing, or if someone else wants to inquire about that, it would help the Committee a great deal to get specificity as to how you think we could best handle the regressivity argument.

[The following was subsequently received:]

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June 7, 1995

The Honorable Bill Archer
Chairman
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

I very much appreciated the opportunity to testify before the Ways and Means Committee earlier today on the critical issue of choosing between various consumption tax alternatives. During my testimony, you asked that I provide the Committee additional materials concerning my views with respect to the potential regressivity of a consumption tax. I have examined this issue closely, and indeed, I published an article in Tax Notes in which I specifically addressed the regressivity issue. I thought it would be most efficient to provide you a copy of that article.

Once again, I appreciated the opportunity to testify, and I look forward to providing the Committee any additional information you may require to address this important issue.

Sincerely,

Sijbren Cnossen

Enclosure

Sijbren Cnossen is a professor in the economics faculty at Erasmus University, Rotterdam, the Netherlands. He has written widely on the value-added tax (VAT) and advised international organizations and several countries on the design and implementation of a VAT. This article is based on his testimony on consumption taxes and international competitiveness before the Committee on Ways and Means of the U.S. House of Representatives on June 20, 1991.

Professor Cnossen points out that a VAT is the most product-neutral and factor-neutral tax which exists. This is an important attribute of a "good" tax in a world that leaves the optimal allocation of resources to the free play of market forces. In theory, a VAT is equivalent to a national sales tax, a business transfer tax, or a uniform business tax of equal base and rate, but a VAT has greater feasibility and versatility. Also, it is more certain to be neutral and to effect correct border tax adjustments. He points out that the integrity of a VAT is safeguarded best if it is applied to all goods and services. Moreover, a single rate with no exemptions is strongly recommended. Professor Cnossen explains that a VAT is not a tariff-cum-export subsidy. Instead, the rebate at the export stage ensures that exporters are not disadvantaged vis-a-vis their foreign competitors. A VAT per se would have no favorable effect on the trade balance, but it is superior to an income tax in promoting saving, capital formation, and economic growth.

I. INTRODUCTION

In considering a consumption tax, such as a value-added tax (VAT), the United States is following the same pattern in tax development as many other countries in Europe and the rest of the world. Twenty-one of the 24 member countries of the Organization for Economic Co-operation and Development (OECD) have accepted the VAT as their main consumption tax. Recent converts to the VAT include Canada and Japan. The United States, Switzerland, and Australia are the only OECD countries that have not yet done so. Outside the OECD area, the VAT is levied by approximately 35 countries in Latin America, Asia, and Africa.

CONSUMPTION TAXES AND INTERNATIONAL COMPETITIVENESS: THE OECD EXPERIENCE

by Siljbren Cnossen

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The VAT was pioneered in the European Community (EC). From the beginning the EC has attached great importance to the VAT, because it is very successful in treating intra-community trade, as well as trade with third countries, according to the destination principle. A VAT enables precise identification and rebate of the tax on exports so that they can leave a country free of tax, while imports can be taxed on exactly the same footing as domestically produced commodities. Obviously, this form of neutrality is essential for the proper functioning of a common market. More generally, the border tax adjustments under a VAT are consonant with the tax provisions of the General Agreement on Tariffs and Trade (GATT).

In addition to being neutral with respect to foreign trade, a VAT does not distort domestic production and distribution. Thus, under a VAT, it makes no difference how often a product is traded before it reaches the consumer or whether its value is added earlier rather than later in the production-distribution process. A VAT is neutral regarding the production technique that a business adopts. In other words, it makes no difference for tax liability whether a product is manufactured with capital-intensive technology or labor-intensive technology. Also, a VAT is not influenced by the forms in which business is conducted. Other things being equal, the tax bill is the same whether a product is made in the corporate sector or by unincorporated businesses, or whether it is produced by integrated or specialized firms.

It will be appreciated that the VAT's neutrality with respect to domestic economic activities, as well as foreign trade, is an important attribute of a "good" tax in a highly competitive and interdependent world, which leaves the optimal allocation of resources to the free play of market forces.

II. APPROACHES TO TAXING 'VALUE ADDED'

The type of VAT used in the EC and nearly all other countries is a multistage, destination-based, net consumption VAT that includes all goods and services in its base (except those explicitly exempted). It covers retailers, and it permits registered firms a credit or "deduction" against the tax payable on their own sales for tax paid on their purchases from registered suppliers. For any tax reporting period, the net VAT liability is simply the difference between the total amount of VAT shown on all sale invoices and the total amount of VAT shown on all purchase invoices.

This method, which is used in all OECD countries, is called the indirect subtraction technique or tax credit method. Since the tax on sales must be stated on invoices to provide documentary evidence for the credit claimed by registered buyers, the tax credit technique is also referred to as the invoice method. It should be emphasized that the net consumption VAT is levied according to a cash flow (invoice) basis of accounting, instead of according to an accrual basis by which transactions are recorded in a firm's profit and loss account. Thus, under VAT, no correction needs to be made for a change in inventory value, and the tax paid on the purchase of capital goods is credited immediately against the VAT payable on sales.

Under a VAT, . . . the same value added is never taxed twice; that is, cumulative effects do not occur.

Under a VAT, the sum of a firm's purchases (the value added at earlier stages) and the value added by the firm itself equals, by definition, the value of the purchases (which have a full tax credit attached to them) by the next firm in the production-distribution process. As a result, the same value added is never taxed twice; that is, cumulative effects do not occur. Moreover, at the final retail stage, the sum of all values added throughout the process equals the consumer price, excluding tax. In other words, the total tax collected piecemeal under the

VAT from all stages of production and distribution is e· actly equal to a tax collected on the sale by the retaile to the final consumer or user: that is, a retail tax : national sales tax (NST).

The net VAT liability can also be ascertained by de ducting the aggregate value of purchases from the ag gregate value of sales and taxing the difference betwee them. This approach to computing value added is calle the direct subtraction technique or accounts method. i the United States, it is known as "the business transfe tax" (BTT) or "uniform business tax" (UBT). The BTT wa proposed by Sen. William V. Roth, Jr., R-Del., in 1986 Sen. Roth proposed using the revenues to make possibl· lower income tax rates, super saving accounts, and mor rapid depreciation allowances. A UBT bill was introduce. recently by Rep. Richard T. Schulze, R-Pa. Its revenues in turn, would be used to replace the corporation incom tax and the employer-paid portion of the FICA payroll tax

In industrial countries, services comprise up to 50 percent of national product, too large a portion of economic activity to be excluded from a broadly based consumption tax.

Finally, value added can be computed as the sum o factor rewards: wages, depreciation, interest, and ne profits. In the literature, this approach is referred to as the addition method. This approach is more complicatec than either of the subtraction methods, because it requires inventory accounting as well as adjustments fo investment income and capital goods purchases. Hence no country applies the addition method. However, Argentina and Israel apply this method to selected economic activities, such as banking, in which the value of inputs and outputs is difficult to measure.

III. DIFFERENCES BETWEEN A VAT AND AN NST

If a VAT is identical to an NST, why not collect the ful tax at the retail stage, that is, impose an NST? A VAT is preferred for four reasons: (i) potential coverage; (ii ability to distinguish producer goods from consume goods; (iii) ability to effect correct border tax adjustments and (iv) administrative feasibility.

First, NSTs are less effective in taxing services tha are rendered primarily by small business establishments Not taxing services means that services are favored ove goods. This distorts the economic choices of both consumers and producers, and it unnecessarily accentuates the regressive impact of the tax, because the demand fo services is generally more income-elastic than is the demand for goods. In industrial countries, services comprise up to 50 percent of national product, too large a portion of economic activity to be excluded from a broadly based consumption tax.

Second, NSTs have difficulty distinguishing between producer and consumer goods. How does a registerec firm know that a shovel it supplies tax free is not usec for (taxable) gardening purposes instead of as an (exempt) input for factory work? Who knows whether sugar is used to sweeten tea at home (taxable) or as an (exempt) ingredient for (taxable) bakery products? Similarly,

an NST has difficulty distinguishing taxable consumer services from exempt services rendered to business. A VAT has no such difficulty, because the seller is simply told always to charge tax, leaving it to the purchaser to obtain a tax credit if it also is a registered taxpayer.

Third, because NSTs are unable to distinguish effectively between producer and consumer goods, in practice many producer goods (e.g., fuel, office furniture, and computers) are taxed. This discourages capital-intensive production and, hence, economic growth. Also, it means that the NST enters into the cost of exports, with detrimental effects on international competitiveness. Similarly, because the price of domestic goods includes the NST on those goods and incorporates an element of tax on producer goods, whereas the price of goods imported from countries with a VAT that is rebated for exports does not, the NST artificially discriminates against domestic goods.

Fourth, a VAT is a more robust form of consumption tax. It disperses the collection process over the whole of industry and commerce. It transfers part of the burden of proof concerning tax liability to taxpayers (who must prove that they are entitled to the tax credit on purchases). It penalizes dishonesty more than does an NST, because every invoice throughout the production-distribution process is a "public declaration" with respect to tax liability.

IV. DIFFERENCES BETWEEN A VAT AND A UBT

If a VAT is identical to a UBT, why not collect the tax on the difference between the aggregate value of sales and the aggregate value of purchases, rather than as the difference between the tax on each of these two categories? The VAT is preferred for three reasons: (i) it is a more obvious and robust form of tax; (ii) it has fewer difficulties with exemptions and differentiated rates, if desired; and (iii) the border tax adjustments under VAT are more precise and sure to be accepted under GATT.

First, the VAT is a transactions-based tax, i.e., VAT is charged each time a product is sold or a service is rendered. The UBT, on the other hand, is an accounts-based tax under which the tax liability is calculated after, rather than at the time, sales are made. This means that the UBT is more of a hidden tax, that no "audit trail" is provided, and that the UBT is more susceptible to evasion. It is not true that the VAT requires separate business accounts. Both taxes have to be ascertained from records of sales and purchases, but only in the case of the VAT would the entries be backed up by tax invoices.

An exemption creates an arbitrary and indeterminable benefit for favored products. Once lost, the tax cannot be recouped.

Second, under the VAT, an exemption in the middle of the production-distribution process means that the tax on purchases cannot be passed on. As a result, the tax load on the affected product will ultimately be higher than in the absence of an exemption. This feature creates a strong inducement for business firms to register for VAT purposes. No such inducement exists under the UBT. An exemption creates an arbitrary and indeterminable benefit for favored products. Once lost, the tax cannot be

recouped. This means that the UBT will be subject to relentless political pressure to exempt certain products, activities, and sectors. Fairness and neutrality would suffer. Furthermore, a UBT cannot accommodate differentiated rates which, although not to be recommended, may be desired for technical reasons or to mitigate the regressive burden distribution of the tax.

Third, under the VAT, the accurate valuation of imports is of no great concern, because if less tax is paid due to undervaluation, there will be less tax to credit in the next stage. Under the UBT, on the other hand, valuation inaccuracies upon import do not simply wash out in succeeding stages. Similarly, under the VAT, the tax shown on purchase invoices is simply rebated at export. Under the UBT, on the other hand, there is no certainty that the inputs, which, incidentally, have to be valued accurately, have borne tax in stages prior to export. In short, border tax adjustments under a UBT are likely to be much less accurate than under the VAT. If so, they would invite objections from the trading partners of the United States.

Not surprisingly, no OECD country has a UBT. Until recently, the Finnish VAT had some features akin to a UBT, but these have now been abolished. Also, the Japanese VAT has an optional subtraction method, but it is confined to small firms. Obviously, the ments of a VAT versus a UBT must be viewed separately from the use of the proceeds. If desired, a VAT, like a UBT, can also be used to replace the corporate income tax and/or phase out the employer-paid portion of the FICA payroll tax.

V. DESIGN OF A VAT

The integrity of a VAT is safeguarded best if it is applied to *all* final goods and services. Taxing one commodity but not another distorts consumer choices and reduces the tax intake at a given rate, although some concessions must be made for social policy considerations and on administrative grounds.

A. Exemptions

No OECD country taxes free or governmentally subsidized services in the areas of health and education, nor does any OECD country tax social, charitable, or religious services. In the OECD, these "public interest activities" are exempted. This means that no credit is given to the "exempt organizations" for the tax they pay on purchases. Given the nature of the exempt services, which are rendered directly to consumers and which often are subsidized, distortions of consumer choices should be small. On the other hand, commercially provided education and health services generally are taxed.

A second group of activities exempted in the OECD includes financial transactions and insurance. There are various problems in trying to tax financial services. Should the tax be imposed on the full price—the interest—of the financial service, or should the tax be confined to the gross margin of the intermediary as measured by the difference between its loan revenue and its cost of borrowing? Because of these conceptual difficulties, as well as practical problems in measuring inputs and outputs, all OECD countries have opted for the exemption approach.

For similar reasons, OECD countries exempt all forms of life insurance from the VAT. Nonterm life insurance premiums, for instance, have a savings element that is difficult to separate from the portion attributable to the costs of administering the insurance scheme. Other

forms of insurance are also exempted, except in New Zealand, which taxes fire, general, and accident insurance premiums. To confine the tax to the gross margin, insurers are allowed a credit for the tax fraction of any indemnity payments. Nearly all countries zero rate financial and insurance services which are exported.

B. Real Estate

The treatment of real estate, that is, the lease and sale of land and the construction, lease, and sale of buildings, is one of the more complicated issues under the VAT. It warrants careful consideration. In most industrial countries, housing services, comprising rents and rental values of owner-occupied property, constitute 15 percent or more of total annual consumption expenditures. This is too large a portion of the potential tax base to be ignored under a VAT. Moreover, once an essential part of the tax base has been excluded, it becomes exceedingly difficult to recoup.

Nearly all countries in the OECD area tax building materials, as well as repair and maintenance services, at the standard rate. Logically, these materials and services, broadly interpreted as construction activities, add up to a new building. Most countries recognize this, and under their VATs, newly created buildings are subject to the standard rate as well. This means that a nonregistered individual who buys a new dwelling pays the full VAT on it. In effect, in that case, the VAT on new residential property is viewed as the capitalized value of the tax that would have been payable in respect of current housing services had the VAT been applicable to rents and imputed rental values. Basically, commercial buildings, which can be close substitutes, are accorded the same treatment. Potential cascading effects are eliminated by permitting commercial lessors to apply for registration and payment of VAT.

Countries that follow this approach also exempt the sale of real estate other than new buildings. This is logical, although it means that increases in the value of the stock of building services are not taxed, nor is a tax credit provided for decreases in that value. Taxing the transfer of (exempt) real estate would imply that a (presumptive) tax credit would have to be given for the tax, if any, paid on the earlier purchase of the property, a choice that no country has elected. Again, owners of industrial and commercial real estate could become registered taxpayers and receive the usual VAT treatment. The sale of their property then would be taxable, but any subsequent registered owner would be able to claim a tax credit if it, in turn, were to lease or sell the property to a registered taxpayer.

C. Small Traders and Farmers

Generally, small traders and farmers face relatively higher costs in complying with the obligations imposed under the VAT than do other taxpayers. Similarly, the tax administration's cost of enforcing the tax on them is relatively higher. For these and other reasons, most OECD countries with a VAT exclude small-scale traders and producers with an annual turnover below a specified amount (the "registration threshold") from the obligations to register, furnish returns, pay tax, and keep prescribed records. The VAT paid by small firms is confined to the tax invoiced to them by their registered suppliers. While small firms benefit from not being taxed on their own value added, they suffer from not being able to pass the VAT on to their customers, because, as nonregistered

users, they are not allowed to issue tax invoices. Also, they cannot obtain a refund when exporting their output or when purchasing expensive machinery. For these reasons, the small-firm exemption generally is optional.

The VAT treatment of farmers requires special attention. If taxed, farmers would have to comply with the usual VAT obligations. If they were exempted, however, although they would not incur compliance costs, they nonetheless would have to pay VAT on their inputs of feed, seed, fertilizer, equipment, and machinery for which credits cannot be provided. Because farmers are situated at the beginning of the production-distribution process, this element of tax would cascade down through the process. Clearly, therefore, a straightforward exemption of primary sectors, without compensatory measures, would be neither fair nor good social policy.

New Zealand, Sweden, and the United Kingdom treat farmers in the same manner as all other producers of taxable products, that is, they must comply with the same requirements for furnishing returns and making payments. Generally, modifications of these requirements can be obtained only under the small-firm exemption. Other OECD countries do not require farmers to register, and they compensate them for the tax borne on the purchases of VAT-liable inputs. In some countries, a purchaser of agricultural products receives a presumptive tax credit approximately equal to the tax borne by the farmer on his inputs. Obviously, the purchaser is expected to pass that benefit on to the farmer. In some other countries, the primary producer is taxed at a rate (different from the normal VAT rate) approximately equal to the rate of tax (expressed as a percentage of sales) he bears on his inputs. As a result, no tax needs to be paid nor a return furnished, but the farmer is able to invoice the tax to the purchaser of his products, who subsequently can take a credit for it. In all of these countries, the agricultural exemption is optional.

The most appropriate approach to the VAT treatment of farmers depends to a large extent on the size of production units.

The most appropriate approach to the VAT treatment of farmers depends to a large extent on the size of production units. Compared to most other OECD countries, in the United States, the agricultural sector is organized primarily as large production units. The only sensible VAT treatment of these units is registration and payment of tax, which would ensure that agricultural products bear a more even VAT burden than they would if they were exempted. The small-firm exemption would then apply to small production units.

D. Public Sector Bodies and Nonprofit Institutions

Under the VAT, public sector bodies may be either exempted or taxable. Obviously, it does not make sense to tax the Department of Defense, if for no other reason than that it would be impossible to value its services. On the other hand, a good case could be made for taxing telecommunications and the Postal Service, which charge for their services through telephone bills and the sale of postage stamps.

Under the VAT, public sector bodies must register for VAT purposes if they generate goods and services that

are used by or benefit businesses and individuals (except, of course, goods and services explicitly exempted by legislation) and for which a price is charged. In other countries, such chargeable services include all public utilities. Exempt, as well as taxable public sector bodies, always pay VAT on their purchases of taxable supplies, even if this means that they pay tax that is collected simultaneously by another government agency. This approach safeguards the VAT's integrity in that taxable suppliers need not distinguish between taxable and nontaxable goods and services, and consumers cannot find illegitimate access to untaxed supplies. Obviously, for exempt government agencies which are financed out of general revenue, there is no net budget effect, since both the VAT receipts and the appropriations to pay the VAT are higher. Usually, arrangements are made to compensate subordinate units of government for the increase in the cost of their purchases upon the introduction of the VAT.

The costs of VAT administration can be greatly reduced by introducing an appropriate small-firm exemption.

Broadly, nonprofit institutions and government entities are treated in a similar fashion; sales of goods and services that would be taxable if supplied by business are also taxable if supplied for a price by nonprofit institutions, for example, canteens and gift shops. However, the VAT is not applied to services that are supplied without compensation, for example, by churches and charitable institutions. After all, there is no basis on which to calculate the tax. Even if nonprofit institutions are not taxable on services rendered, their purchases are taxed on the ground that suppliers should not be required to differentiate their sales according to the end user.

E. Administrative Costs

The administrative litmus test of a "good" tax is its ease of collection and compliance. In OECD countries, administrative costs as a percentage of VAT revenue range from 0.35 percent in Sweden to 1.09 percent in Belgium. Measuring administrative costs in this way is misleading, because a simple rate change would affect the apparent efficiency of the VAT administration even though there would be little or no change in absolute costs. A better yardstick would be to measure administrative costs per registered trader or per tax office staff member. Although figures are difficult to compare properly, they clearly show that the cost of administering the broadly based, single rate New Zealand VAT is only a fraction of the cost of administering the U.K. VAT, which zero rates 40 percent of the potential tax base and has complicated schemes for real estate and small traders.

The costs of VAT administration can be greatly reduced by introducing an appropriate small-firm exemption. In 1985, approximately 60 percent of all agricultural and nonagricultural firms in the United States had business receipts of less than $25,000. These small firms accounted for less than one percent of total business receipts. Thus, exempting these firms would hardly affect tax revenues, but the number of taxable firms would be reduced from 20 million to 7.5 million. The costs of VAT

administration also can be reduced by applying a single rate, providing for less frequent returns, and by close integration with the administration of the federal income tax.

Although international data on administrative and compliance costs of the VAT must be treated with caution, it is clear that a VAT can be collected at a significantly lower average cost than can income taxes for a similar amount of revenue. Data on compliance costs are even more sketchy, but a simple rule of thumb (the ratio of VAT lawyers to income tax lawyers) indicates that VAT compliance costs are far lower than income tax compliance costs. In terms of administration and compliance, the VAT emerges rather well from a comparison with the income tax.

VI. THE REGRESSIVITY ISSUE

The most pointed criticism of a VAT is that its burden is distributed regressively with respect to income. Since consumption as a share of income falls as income rises, a VAT levied at a uniform rate falls more heavily on the poor than on the rich. While the criticism is valid, it is true only if VAT payments are expressed as a percentage of income. If, instead, consumption is used as the denominator, then, by definition, the impact would be proportional. The burden of a VAT levied at a uniform rate also would be largely proportional if the denominator were lifetime income rather than annual income, because many income recipients are only temporarily in lower-income brackets. They move into the middle- or upper-income brackets as their earnings increase. A lifetime income concept takes account of this phenomenon.

Whatever the case, in the political arena, the burden distribution of the VAT is usually measured against annual income. The question in this context is whether the regressivity issue should be addressed through the VAT itself or through other tax and expenditure measures. The VAT itself might be used to tax at a lower-than-standard rate (or even at a zero rate) essential consumer items that are disproportionately consumed by the poor and, conversely, to tax at a higher-than-standard rate luxury commodities that are disproportionately consumed by the rich. Corrections outside the VAT system might include higher income tax exemptions, lower basic rates, or increases in transfer payments to the poor.

Strong arguments have been advanced against the use of multiple rates under a VAT. Rate graduation is a very blunt and expensive instrument to mitigate regressivity.

However, strong arguments have been advanced against the use of multiple rates under a VAT. Rate graduation is a very blunt and expensive instrument to mitigate regressivity. As household budget expenditure surveys indicate, with rate graduation, the rich generally benefit twice as much as the poor in absolute amounts. This is because, for VAT purposes, it is nearly impossible to distinguish expensive higher-quality food products bought by the rich from less expensive ordinary food products purchased by the poor. If such a distinction is

not feasible, lower rates become less effective in mitigating the regressivity of the VAT. This is confirmed by the findings of four recent country studies, which indicate that the impact of a VAT does not differ significantly whether necessities are zero rated (as in the United Kingdom), taxed at a lower rate (as in the Netherlands), or taxed at the standard rate (as in Denmark and Norway).

Furthermore, the costs of administering a VAT are inevitably increased by a differentiated rate structure, because it brings in its train problems of delineating products and interpreting the rules regarding which rate should be applied. Even with careful design, anomalies cannot be avoided. Differentiated rates also involve a significant increase in compliance costs, particularly of small firms. Usually, it is not possible for them to keep separate accounts for the sales of differentially taxed products. The tax liability must then be determined by applying presumptive methods, an approach that increases the difficulty of monitoring the taxpayer's compliance. Also, there is evidence that the increase in compliance costs attributable to differentiated rates is distributed regressively with respect to income. Smaller firms with lower incomes bear proportionately more of the burden than do larger firms.

It should also be emphasized that, given the amount of revenue to be raised, applying a lower or zero rate to essential commodities means that the standard rate must be higher than it would be in the absence of rate differentiation. This higher standard rate would magnify the distortion of consumer and producer choices. This defect should be taken seriously because, as a rule, the severity of tax distortions increases progressively with the tax rate that causes them. It has also been shown that high *ad valorem* rates have detrimental effects on product quality. The higher the standard rate required to maintain revenue, the more serious are these effects.

Normally, the introduction of a VAT would be accompanied by a general price increase of some 0.7 percent for each percentage point of tax if its introduction were accommodated by the monetary authorities, as is ordinarily the case.

Similarly, increased rates make little sense. To the extent that they cover expenditures for drinking, smoking, and driving, increases in the related excises or user charges are indicated. Also, higher rates are difficult to enforce with respect to small high-value items, such as jewelry, perfume, and cameras, which easily can be smuggled in from abroad. In practice, the part of the VAT base that can be taxed at a higher rate is extremely small, at most five percent of total consumption expenditures. This is to be expected. As noted above, higher-income groups usually buy varieties of particular commodities that are more expensive than the varieties bought by lower-income groups, but it is nearly always impossible to distinguish between them in a way that is relevant for VAT purposes. The rich also spend proportionately more than the poor for foreign vacations and on education, but these expenditures either cannot be taxed or must be excluded on merit grounds. Overall, higher-than-standard

rates impart little progressivity to the distribution of the VAT burden.

Nonetheless, 15 of the 21 OECD countries with a VAT address the regressivity issue within the context of the VAT by applying one or more lower rates to essential items. However, this picture owes much to the situation in the original EC member states, which adopted the VAT in the late 1960s and early 1970s. These countries were concerned with staying as close as possible to the tax burden distribution of the previous turnover tax so as not to jeopardize the acceptance of a completely novel levy. (Lately, these countries have begun to reduce the number of VAT rates.) Not surprisingly, later converts to the VAT, not constrained by these considerations, adopted a uniform rate and adjusted the resultant regressive distribution of burden more effectively elsewhere in the tax and income transfer system.

In the United States, the regressivity of a VAT could be offset by (i) adjustments in food stamp payments and AFDC benefits to compensate low-income families with children, (ii) adjustments in Social Security benefits and SSI payments to compensate the elderly, (iii) the provision of a refundable vanishing VAT credit against personal income tax liability, and (iv) an increase in the earned income tax credit to compensate low-income workers. A highly imaginative approach would be to use part of the VAT revenues to reduce the payroll taxes that are highly regressive, distortionary, and which cannot be rebated on exports.

VII. EFFECTS ON PRICES, SAVING, AND CAPITAL FORMATION

An often-voiced concern in countries without a VAT is that the introduction of the tax would set in motion a spiral in which the tax, prices, and wages would feed on each other, i.e., a VAT would be inflationary. Normally, the introduction of a VAT would be accompanied by a general price increase of some 0.7 percent for each percentage point of tax if its introduction were accommodated by the monetary authorities, as is ordinarily the case. The crucial question, however, is whether this one-time increase would lead to further price escalations. Empirical evidence suggests that in 11 of the 13 OECD countries surveyed, considering all circumstances, the introduction of the VAT either had little or no effect on retail prices or simply resulted in a shift of the CPI trend line (one-time effect). The answer to the question raised above, therefore, almost categorically, is that VAT introduction does not lead to a price escalation spiral.

If approximately 70 to 80 percent of consumption expenditures would be taxed, a five-percent VAT would lead to a three- to four-percent increase in the CPI. In the absence of compensating wage adjustments, disposable incomes would be reduced correspondingly. It should be pointed out, however, that this reduction in take-home pay also would occur under an equal-yield increase in the personal income tax or in excise taxes.

A VAT is neutral with respect to the choice whether to consume now or to save for future consumption. Although a VAT reduces the absolute return on saving (that is, the amount of future consumption), the tax does not reduce the net rate of return on saving. In contrast, an income tax reduces the net rate of return on saving, because both the amount saved and the interest earned on that amount are subject to tax. Therefore, if it is assumed that saving increases as the net rate of return on saving

increases, a VAT is superior to an income tax in promoting capital formation and economic growth.

VIII. INTERNATIONAL COMPETITIVENESS

Since a VAT is levied on imports but rebated on exports, it is often contended that the tax promotes international competitiveness. The country's trading partners, the argument goes, "subsidize" exports to the United States and "discriminate" against imports from the United States. In a more sophisticated version of the argument, it is pointed out that since the United States relies relatively more heavily on income taxes, which are not rebatable under GATT, in terms of international trade, the country is disadvantaged *vis-a-vis* its trading partners, which collect relatively more revenue from indirect taxes less harmful to trade.

Emphatically, the argument that a VAT is a tariff-cum-export subsidy is wrong. However, there is some ground for assuming that the heavy reliance on income taxes hampers exports. In thinking about these two issues, it is useful to compare the international trade effects of a VAT on the one hand to its equivalent—the NST, and on the other hand to a substituting personal income tax. The latter comparison is appropriate if it is assumed that additional revenues must be raised through either a VAT or an income tax increase. Alternatively, the proceeds of a VAT could be used to lower the income tax.

It is well known that exports are not taxed under an NST because they do not constitute retail sales. For the same reason, imports are not taxed until sold at retail. Exactly the same happens under a VAT. Exports must be "detaxed" by rebating the tax collected in earlier stages of production and distribution so that exporters are not disadvantaged *vis-a-vis* their foreign competitors. Imports are taxed, but the tax that is imposed at the import stage under the VAT mechanism can be credited by the first taxable inland user, resulting in equivalent treatment *vis-a-vis* domestically produced goods. Under VAT, exports and imports end up bearing exactly the same tax as under an NST of equal rate.

The imposition of a VAT . . . does not involve a change in the allocation of resources, production incentives, or international competitiveness.

Under a uniform VAT, all consumer prices rise exactly in proportion to the VAT, thus leaving all relative prices unchanged. The imposition of a VAT, therefore, does not involve a change in the allocation of resources, production incentives, or international competitiveness. Indeed, contrary to popular belief, international competitiveness would suffer if the VAT would not be rebated at export. Since world prices facing producers would not change,

the VAT on exports would be borne by them, exports would decline, the U.S. dollar would depreciate, and imports would become more expensive. In effect, the nonrebatable portion of the VAT would be a protectionist import tariff violating the spirit, if not the letter, of the GATT.

This conclusion must be modified if the VAT were substituted for (an increase in) the personal income tax. As a tax on current consumption (of domestically produced and imported goods), the VAT would dampen domestic demand. By contrast, income tax is an inducement to current consumption and discourages saving because it taxes savings as well as income from savings. Substituting the VAT for (part of) the income tax, therefore, promotes saving and improves the trade balance. Over time, of course, this effect would cancel itself out, because the accumulation of foreign reserves would lead to increased imports. In short, the VAT would have a positive short-run effect on the trade balance, but no such effect would occur in the long run. What is plausible, however, is that compared to an income tax, a VAT is more conducive to promoting saving, capital formation, and economic growth.

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June 22, 1995

The Hon. Bill Archer
Chairman
Committee on Ways and Means
1102 Longworth House Office Building
Washington, DC 20515

Dear Mr. Chairman:

During the Committee's June 7 hearing on tax reform, you asked me and the other members of the value-added tax panel to submit for the record our recommendations regarding regressivity offsets. This letter provides my comments on three issues -- (1) the nature of the regressivity problem of a value-added tax, (2) whether the tax system itself should be structured to address regressivity and (3) how the problem should be addressed outside the value-added tax.

My general conclusions are that regressivity is not a fundamentally different problem under a value-added tax than it is under any other tax paid by businesses and that any problem which does exist must be addressed *outside* the value-added tax system itself.

1. The Nature of "Regressivity" in a Value-Added Tax

All forms of taxes applied to economic value-added (*e.g.*, a retail sales tax, the European VAT, the subtraction method business activities tax) are widely assumed to be regressive. This is based on the belief that the tax burden is fully passed forward to the ultimate consumer who pays the tax as a part of the total cost of purchased goods and services. Lower income households generally consume larger portions of their incomes than do middle and upper income households, so the burden of the tax is believed to fall disproportionately on them.

Two fundamental questions need to be considered -- is the assumption correct, and is this result unique to the various taxes on value-added?

a. Is the tax fully passed forward?

I have long been troubled by the assumption that a tax on value-added is always fully passed forward to the consumer. This phrase -- "fully passed forward to the consumer" -- cannot mean simply that prices go up. Prices could rise by the full percentage of the tax rate, and sales certainly will continue to occur at the higher prices. Instead, "fully passed forward to the consumer" must mean that the full burden of the tax -- or the *economic incidence* of the tax -- falls on people in our role as consumers because we buy the same quantities of goods and services at the higher prices that we bought at the lower prices. If that occurs, the tax is fully passed forward because neither the profits of the sellers of goods and services nor the wages and salaries of the sellers' employees are reduced. But if consumers purchase somewhat lower quantities of the same goods and services at the higher prices, they are not bearing the full burden. Instead, as sales volumes fall, some portion of the burden of the tax is actually being paid by the business owners (because their profits also fall) or by employees (because wages are reduced or people are fired) or some combination of the two.

Both common sense and my experience as a partner in my own business tell me that *any* cost of doing business is included in prices to the maximum extent possible. When customers resist by buying fewer goods or by shifting to lower-priced goods, the business looks for ways to maximize its sales volume and profitability. A principal way is to scale back the price increase. In that case, the business owners bear a portion of that tax. Unless the market place is literate and can distinguish between taxes and other costs of operating a business, there is no apparent reason for concluding that a tax on value-added in any form is inherently more likely to be borne fully by consumers than is any other cost.

b. Is the pass forward unique to taxes on value-added?

If taxes on economic value-added are passed forward to some unknown degree from business to business, is this result unique to these taxes? Aren't the taxes that a business pays on its profits, payroll and property passed forward, too? What about the individual income tax that is paid by employees from their gross wages -- isn't this included to some degree in what the business collects from customers in order to pay gross amounts of wages and salaries?

Looked at another way, what would happen to market prices if all taxes paid out of business receipts (including income taxes on employees' wages) were suddenly repealed? Is it likely that businesses could sustain current price levels for an extended period of time? How long would it take for enterprising companies to begin reducing prices -- and to gain market shares -- while retaining their desired level of profitability after the expense of taxes

had been removed? I believe that the process would begin very quickly and would continue until a new level of equilibrium is found in all markets. If so, that is at least intuitive proof that current taxes paid by businesses are also included in prices to some significant degree.

My view is not that a tax on value-added would not be passed forward to consumers to the maximum extent possible. In fact, I believe that it would. Rather, my proposition is that a tax on value-added will be passed forward to the same degree that any tax or other cost of doing business is passed forward. This requires that the regressivity issue be assessed in terms of what effect, *if any,* will arise from the substitution of a tax on value-added for direct taxes on profits and/or payroll.

This also suggests that federal policy makers and others should not encourage the conventional wisdom about price increases following enactment of any of the taxes on value-added, unless the conventional widsom can be proven. A prolonged period of telling people that prices will go up when one tax is substituted for another is likely to encourage that initial reaction and to delay the efficient work of market forces that will sort out the longer-term effects of substituting one tax for another.

2. Addressing Regressivity Within a Tax on Value-Added

Even if a one-time increase in prices can be proven, efforts to offset regressivity should not become part of the value-added tax itself. One approach to lessening regressivity is to exclude the sales of food, medical care and housing from the gross receipts of businesses under the subtraction method tax. This is the equivalent of the zero rate under the credit method VAT, and it is the chief source of the problems presented by VATs in other countries (and by state and local sales taxes in this country). This approach is wasteful, inefficient and complicated.

First, such exclusions waste enormous amounts of foregone revenue on unintended beneficiaries. To provide the intended assistance for, perhaps, the 20 percent of households with the lowest incomes, exclusions also forego revenues from sales of food, medical care and housing to the other 80 percent. These middle and upper income households are very likely to buy more and higher priced necessities. So, to get the intended benefit to 20 percent of households, *at least four times as much revenue is lost from everyone else.*

Second, the exclusion of food, medical care and housing cuts the tax base dramatically. Based on national income accounts data, a 15 percent tax rate on a universal tax base must be increased to about 21 percent to recover the revenues lost because of the exclusions. Lower income households also purchase the goods and services that would now be taxable at the much higher rate. Thus, the already wasteful effort to provide a benefit to

such households becomes even more inefficient by taking back a large portion of the intended benefit.

Third, the preferential rules set the stage for complexities and controversies that will swirl around the definitions of "food" and "medical care" and "housing" and anything else that is left out. These are the source of numerous controversies in the countries in which they are used.

Fourth, many of the goods and services that would receive preferential treatment do not enter international trade. Housing, medical care and much of the food sector of the economy are purely domestic in nature. Absent the same tax burden as other sectors, these sectors will enjoy an artificial tax-induced cost advantage relative to export-intensive businesses and to those that compete with imports. This tax preference will encourage a shifting of resources to the untaxed sectors and away from trade-related sectors of the economy. Our trade-related sectors could contract, and competitiveness could deteriorate as an unintended but real consequence of the preferential treatment.

For these reasons, it is clear that a system which taxes value-added should not be shot full of multiple rates and preferences in an effort to deal with regressivity issues. All businesses should be taxable at the same rate on their business activities.

3. **Addressing Regressivity Outside of the Value-Added Tax System**

If it can be determined that a tax on value-added is certain to be passed forward to consumers to a greater degree than the taxes which it replaces, that issue should be addressed outside the value-added tax itself, for the reasons noted above. After quantifying the magnitude of the greater pass forward, the next step is to determine how much of this effect is offset by current government programs. A number of existing transfer payment and income support programs will be adjusted upward by their COLAs to reflect any price increases. These will include Social Security, military/government/railroad retiree pensions and various other specific benefits programs for certain employment categories and for food and housing support. Entitlement programs for medical care such as Medicare and Medicaid cover some additional portion of the effect, too.

To the extent that there is a price effect that is not offset by these programs, a direct transfer payment can be used. If the income tax is repealed, perhaps a simplified refundable credit based on household income (including government programs) and dependents can be fashioned. The current review in Congress of the earned income tax credit should provide a basis on which to construct any direct transfer payment mechanism that is necessary, based on total receipts of the household and the number of persons living there.

Summary

I urge the Committee to undertake first a serious assessment of the regressivity issue with a reconsideration of the "full pass forward" premise itself and then a reconsideration of how current taxes are passed on to consumers. Only after a problem is confirmed will it be possible to assess its magnitude, the ability of existing government programs to address it and the possible need for even more targeted relief.

Sincerely,

Cliff Massa III

Response by Alan Schenk to Chairman Archer's Request for Information on Regressivity

Mr. Chairman: You asked our panel to send you our comments on how to handle the regressivity issue under a value-added tax. I will quote in part from an article I wrote in 7 Virginia Tax Review 207, 270 (1987), where I wrote:

"Broad-based sales taxes are considered regressive because they impose a higher tax burden, as a percentage of income, on lower income groups (especially those below the poverty level) than on higher income groups.... [t]he regressivity of one tax may be accommodated by making adjustments in the progressive taxes if, as a result, the overall federal system possesses an acceptable degree of progressivity."

If Congress is concerned about the regressivity of a VAT, it should look both at the distribution of the VAT burden and the distribution of the benefits financed by the tax.

If a consumption tax like a VAT, that is collected by business, replaces all federal income taxes, there is little opportunity to make adjustments for regressivity under remaining progressive federal taxes. A VAT is not adaptable to differing economic situations of individuals or households.

If it is desirable to have a tax on consumption, it should be imposed on the broadest possible base in order to keep the tax neutral. The tax should not distort choices that consumers make about the products and services that they want to buy. It is undesirable to accommodate for regressivity within the VAT system, such as by granting exemption or zero rating to necessities like food, housing and medical care. These adjustments in the tax

base complicate the tax and grant benefits to high income households as well as the low income households that need targeting to resolve the regressivity issue.

If Congress retains the individual income tax or converts that tax to a progressive consumption tax like that proposed by Senators Domenici, Nunn & Kerrey, regressivity of the VAT could be addressed through credits like the earned income credit and increases in the standard deduction. Alternatively, the regressivity of a VAT could be accommodated through changes in direct grant programs to low income families, such as the food stamp program. Canada accommodates for regressivity by issuing a check quarterly to lower income households that were adversely affected by the introduction of the Canadian Goods and Services Tax. Unfortunately, Canada also complicates its tax by granting special treatment to food and other items.

Some economists claim that if a VAT or other tax on consumption is tested over a lifetime, the tax is not regressive. Even if the data supports this conclusion, this claim is not responsive to the problem. We historically have measured fairness of federal taxes, particularly the individual income tax, by using a year as the period of measurement. It seems inappropriate to use a different period of measurement to evaluate a consumption tax. As Dr. Carl Shoup wrote almost 50 years ago, a nation's "tax system must satisfy the deep, widespread feelings of the people as to what is fair." (Gen. Headquarters, Supreme Commander for Allied Powers, Tokyo, 1 Report on Japanese Taxation 17 (1949)). Ultimately, the question is whether the American public will view a VAT as a replacement tax, without any adjustment for the impact of the tax on low income households, as a "fair" tax.

Chairman ARCHER. Mr. Gibbons.

Mr. GIBBONS. First, I want to thank you, Mr. Chairman, for calling these witnesses and calling these hearings, and I want to thank the witnesses for their contribution that they have made to the whole understanding of taxation. I met and listened and read from each one of them and tried to profit by what they have thought.

I am familiar with the Canadian experience. I have talked to the Canadian taxwriters, and they suggest that the best transition is to go cold turkey, but don't write a law like their goods and services tax, write a law very similar to the one that I call my proposal, which is a simple subtraction method VAT. They think that their system as conceived was overly complicated. They also think that you ought to do it as a replacement tax, not as an add-on tax. I realize they were both adding on and replacing at the same time.

I think that is the experience that you have had in Europe, too, is you were adding on and inventing a tax system and you came up with a credit voucher system, subtraction system, and I think as you go through the evolution, Europe will sooner or later just go to a simple subtraction method VAT. That is what it looks like to me as you replace more and more of your income tax and your other systems of taxation with a value-added tax. That is the reason I try to just make the jump all at one time.

Now, I am concerned about the crediting at the border, the adjustment at the border. Under my system, the tax is embedded in the price of the goods and services. You don't have to keep displaying it on every individual voucher, but we could require it to be displayed on every voucher, although I think that would be a waste of time. It may make it difficult if we ever have to change the rate if we have it embedded in all those vouchers, too.

So tell me, what do you think is the danger of us getting in a trade squabble with our world trade partners if we go to the simple subtraction method of the tax? Would any of you want to fight that one?

Mr. SCHENK. I would be happy to start. As I said during my comments, Mr. Gibbons, it seems to me that if, in fact, Congress adopted your very broad-based sales subtraction VAT, it is economically equivalent to what the Europeans imposed. Therefore it would be a bit disingenuous if our trading partners said the Europeans can do it, anybody that follows the Europeans can do it, but you can't do it if you choose a different method of calculating the tax of value added.

Now, there are some concerns, and your colleagues in the Senate want to provide a payroll tax credit, not just repeal the payroll tax. The credit may be quite different when it comes to border adjustability. That is where we are going to get into trouble.

I am not saying that the answer is clear, but certainly our trading partners can argue that a payroll tax credit has the effect of not taxing some compensation. If you are really not taxing some compensation, maybe you are not taxing value added any longer. It then becomes an income tax and therefore not border adjustable. It really depends. Sorry for an academic answer.

Mr. GIBBONS. That is all right.

Mr. MASSA. The problem, the potential problem that Alan just raised, I think, needs to be emphasized is not related to the struc-

ture of the value-added tax. It is how an additional tax relates to it. I would hope that our trading partners are not disingenuous enough to say if we are taxing value added this way it is different than if we are taxing value added that way.

It is often observed that the credit method tax is a tax on products or on transactions and that the subtraction method is a tax on books of account or on the period. But I would recommend very strongly that you consider the fact that your tax and the subtraction method tax, in fact, compute a tax on the value of every good sold and every service sold. You simply accumulate it at the end of the period.

It doesn't seem to me that there is any fundamental difference, any difference except a mechanical one, so aside from the fact that perhaps our trading partners might not like our wising up and stepping into a border adjustable tax, I would hope we would not have real difficulty telling them that this is an apple and this is an apple, and we are going to treat them both the same way at the border.

Mr. CNOSSEN. Mr. Chairman, I have two very distinguished lawyers here on my left side, and it is the first time I hear two distinguished lawyers say that something which is economically equivalent is also legally equivalent. As I understand, lawyers go by what the law says and what the treaty says, and the GATT treaty or the WTO treaty says that the tax must be imposed on specific products and it must be possible to calculate the rebate unambiguously.

I would like to say here that income, of course, is also value added. Under the flat tax, value added is the sum of wages and capital income, and yet income taxes, under the General Agreement on Tariffs and Trade, are not rebatable at borders. We have agreed to this provision, even though revenues and value added are the same thing. So I would tend to be more pessimistic about the chances that border tax adjustments for a subtraction method VAT would be accepted without a fight.

I would like to add that the eligibility for export rebate also is in doubt because there is no presumptively correct record of the tax that has been paid in previous stages of production and distribution.

Mr. GIBBONS. Well, we could just, each voucher that would support the transactions, and there has to be vouchers somewhere, you know, people have some kind of record of what they did, you can simply put on each one of those vouchers, this includes x percent value-added tax. It would seem to me that would be the paper trail that you need. That is about all you really get with the European-style tax.

Mr. MASSA. It doesn't prove it has been paid.

Mr. GIBBONS. It doesn't prove it has been paid, that is right. I don't want to take any more time. Other Members ought to have more time. I have talked to these gentlemen so much over the years, I want to commend you again, though, each of you, for your thinking that has gone into all this, and I know that you realize I have stolen valuable material from you to include in my writings, and I thank you for it, and in my thinking, and so I will yield back the balance of my time.

Mr. SCHENK. Mr. Gibbons, could I make a personal comment.

Mr. GIBBONS. Certainly.

Mr. SCHENK. I testified before this Committee for the first time in 1970. I was the 17th witness out of 17, and it was a very long day for me and for all Members of the Committee, and at the end of the day there were only three Members left, and thank you, Mr. Gibbons, you were one of them.

Mr. GIBBONS. Well, thank you. Thank you. I sort of recall that. My memory gets a little dull going that far back, but thank you very much for remembering that.

Mr. COLLINS [presiding]. Thank you, Mr. Gibbons.

Mr. Portman.

Mr. PORTMAN. Thank you, Mr. Chairman. Just a brief followup to Mr. Gibbons' questions. I have one specific issue as to services. Let's assume the proposed tax system is border adjustable. How would you deal with the imported services?

Mr. MASSA. Well, services are a good deal tougher to deal with because they are not tangible. They don't cross the border. They don't come through a customs point and say here it is, let's levy the tax. I believe what you will find in the various subtraction method proposals that are out there, a business importer of services is simply not allowed to deduct the services in computing value added and therefore they get into the base.

One of the areas on which more creative work needs to be done is telecommunications and professional services that are imported. There simply is no way to say, well, it crossed the border, therefore it goes into the base. The principal approach in the subtraction method is to say you do not treat it as a business purchase if you bought it from a foreign service supplier, therefore your own base is increased and the tax gets paid on it that way.

Mr. CNOSSEN. Services cannot be imported or exported. Services are not mentioned under the General Agreement on Tariffs and Trade, so what all value-added taxes do is make the recipient of a foreign service liable for reporting and paying the tax on the imported service, and eligible for the subsequent tax credit.

Mr. PORTMAN. Mr. Massa, I enjoyed reading your testimony, particularly your suggested principles for tax reform. In looking at them, it seems to me that they might apply equally, at least in most cases, to a national sales tax, and yet you come out strongly in favor of a VAT tax in your statement and your testimony.

Can you talk a little about that, the tax base of a national sales tax as an example as compared to the tax base of a VAT tax, and Professor Schenk and Dr. Cnossen, feel free to chime in.

Mr. MASSA. The tax base is the same, it is value added. It is the value of all goods and services consumed. The national sales tax simply applies at one stage to what a value-added tax does in increments along the way, so at least in theory the tax bases are the same.

There are some issues which sales tax proponents need to address and I think are addressing, one of which is if you miss a sale at the retail level, that entire tax base is gone. Therefore, in the underground economy which continues to operate, I assume, any goods and services that are sold when somebody is doing your roofing off the back of a truck or some such thing, that entire tax base is just missing. You miss it all.

Another major problem, certainly from the business perspective, is making sure that a business which buys goods and services for use in its own business doesn't pay the tax. That is a troubling issue that I think still has to be dealt with. The multistage value-added tax does not have those problems, and that is why I think it is a simpler system to deal with and more efficient than a sales tax, but in the ideal world they reach exactly the same conclusion.

Mr. PORTMAN. Professor Schenk, any thoughts on that?

Mr. SCHENK. Yes, Mr. Portman, what I would add is experience from Louisiana. Maybe Mr. McCrery could confirm this. Louisiana had a single stage retail sales tax, and many years ago they added a wholesale level to that tax and gave a credit to retailers so that it wasn't a double tax. The State estimated what the revenue should have been raised just by adding this wholesale tax. They were amazed that revenue went up dramatically more than they expected. Well, it is not surprising. What they found is that with a multistage tax, people subject to the retail sales tax who previously cheated, now paid the tax.

Mr. PORTMAN. So retail taxes, as well as wholesale taxes, were probably increased, and people were identifying the taxable amount at both levels?

Mr. SCHENK. Yes.

Mr. PORTMAN. Dr. Cnossen.

Mr. CNOSSEN. Yes, I think a retail sales tax would put too much weight on the weakest chain in the production distribution network. Moreover, I think a value-added tax, and I think that is an important feature, particularly in the United States, would enable you to exempt 15 out of 25 million businesses if you had a small firm exemption of $100,000 with a loss of revenue of only 3 percent; 2.6 percent, to be exact, to quote the GAO's report.

Of course, a retail sales tax, because the whole tax is collected at the retail stage, not at previous stages of production and distribution, could not accommodate that kind of exemption without very serious loss of revenue.

Mr. PORTMAN. Thank you, Mr. Chairman. Thank you gentlemen.

Mr. COLLINS. Mr. Hancock.

Mr. HANCOCK. Thank you, Mr. Chairman.

We are talking about primarily at this hearing about a total replacement of the income tax. Have you gentlemen ever given any thought to—or is there any credence in the possibilities of, for instance, a value-added tax replacing the income tax? You still got a whole bunch of other taxes, sales tax to replace the income tax.

You still got a whole bunch of other taxes built in, excise taxes, what have you. Would it be even feasible to consider replacing the entire tax structure of the U.S. Government with a value-added tax, giving them back every tax except a value-added tax or a sales tax?

Mr. MASSA. I think Mr. Gibbons certainly believes so because that is the thrust of his package. It would seem to me that setting aside for the moment the issues of how much money you are going to accumulate to put into or earmark for Social Security or the highway trust fund or anything else, I don't see any reason why things wouldn't get more and more efficient if we had one uniform

neutral tax that was the government's entire source of funding. Can it be done? I don't know, but in theory it certainly could.

Mr. HANCOCK. Is there any country that you know of that operates on that basis, even a small country?

Mr. MASSA. None that I know of.

Mr. CNOSSEN. No country has ever gone down the way that Chairman Archer is proposing, replacing the income tax by a value-added tax. If you did replace the whole tax system in the United States by a consumption tax, that probably would require a rate around 40 percent on all consumption expenditures.

I think that would raise very serious compliance and administrative problems, very serious taxpayer resistance; moreover, I guess we all know, intuitively know, that the higher the tax rate gets, the greater the distortions of the tax system become. That is why we have more than one tax, because we can keep the rates low and distortions generally are less than if we had one unique tax. Besides, there are other taxes, excises, and so forth, with which you want to achieve goals other than simply raising revenue.

Mr. HANCOCK. Thank you, sir.

Mr. COLLINS. Mr. Ford.

Mr. FORD. Thank you very much, Mr. Chairman. I will try to be very brief. Let me ask the members of this panel whether we should look at some of the other countries and whether they have an income tax as well as a VAT tax. Should we focus on changing the existing income tax system rather than change the whole Tax Code itself. If changing the system as we know it is advisable, should we implement a VAT tax with the subtraction method?

Mr. SCHENK. Well, Mr. Ford, it makes me a little nervous to go cold turkey, as the Chairman suggested, from one to the other. We have no experience, no country in the world has that kind of experience. As Professor Cnossen just pointed out, a balance of taxes is maybe one way to move so that some of the taxes are collected at the source on income and some of the taxes are collected at the point of consumption. I agree with you, we don't have experience.

Mr. FORD. So, when choosing a new tax system, you favor the VAT tax. But it is your opinion that we don't have the experience with this new system and we should gradually move into the area of a consumption tax or whatever new system that might be proposed.

Is that an accurate representation of your testimony?

Mr. SCHENK. Well, as I said in my testimony, I think that if Congress decides—and you know better than I—if Congress decides that it is valuable to impose a tax on consumption to be collected by business, then I would favor a value-added tax. I think that is the best tax to use. But it is that initial political judgment about which I have no judgment.

Mr. FORD. Could I hear from you, Mr. Massa?

Mr. MASSA. I would be perhaps a little less cautious and more concerned that if we put a new system in place and kept what we have, the odds are in a few years we would be talking about an even messier and more complex set of taxes.

I would encourage the Committee and your colleagues to at least consider the variable step of saying, we are going to change the entire system. If we find that the price is too high to pay to get from

here to there, then we won't do it. But rather than put in place a new system and leave some substantial portion of the income tax, I would hope we would try to find a bold way of saying, we really want to change the whole system, and let's do it. If we have to phase it in, fine; if we can do it cold turkey, fine.

Mr. FORD. But what would make the consumption tax so attractive? What makes it so attractive that you would proceed cold turkey without regard to unforeseen consequences of the VAT system?

Mr. MASSA. For me, again as a lay economist, it is that a value-added tax taxes payments for labor, services and payments for capital services; and by that I mean, wages, salaries and benefits on the one hand, profits and interest on the other. At the business level, they are all taxed once, all taxed at the same rate, so that businesses are no longer pushed and pulled between uses of labor and capital services. To me, it seems that that is a much more neutral, less distortive, more efficient tax system than sort of the various pieces we have got now.

Corporate income tax, I think it is generally agreed, is a tax on capital services. The individual income tax is a labor/service tax; it is also a capital tax, when you get capital gains, interest and dividends. We have the payroll tax that adds more taxes to labor/services. To a value-added tax, as I understand, it says we will tax returns to all factors of production, I think they are called, labor and capital once, and at the same rate; and that would be much better than what we do now.

Mr. FORD. Should we focus on exempting certain small businesses?

Mr. MASSA. I wouldn't exempt them—I share Professor Schenk's view—lest every law firm, accounting firm, doctor firm and everything else in the country all of a sudden breaks up, becomes a series of individual businesses. Dr. Cnossen's view about efficiency I understand, but I just think if you have a business level tax, every business ought to be in it unless there is some compelling reason to remove them.

[The following was subsequently received:]

Hearings on Replacing the Federal Income Tax
June 7, 1995

Response to Representative Ford's Request for Information on a Small Business Exemption

Mr. Ford. In many countries with VATs, small retailers do not maintain good records. Many of these countries also have a history of tax evasion at the retail stage. Typically, only a small percentage of the total value added in an economy is added by small businesses. It is not surprising that most countries with VATs grant exemption to small businesses with annual sales below a prescribed threshold. Taiwan, at one extreme, taxes even the smallest businesses, but these very small businesses are taxed under a different scheme administered by government auditors who visit these businesses. At the other extreme is the Japanese Consumption Tax (CT). I will assume an exchange rate of 85 yen to the dollar. Japan completely exempts businesses with annual taxable sales below about US$350,000. It partially exempts businesses with annual taxable sales below almost US$600,000. In addition, Japan provides a simplified scheme for businesses with annual sales below US$4.7 million. Only about 10 percent of Japanese businesses must use the regular method to calculate CT liability.

The states in the U.S. have been very successful in including small businesses in the retail sales tax (RST) bases. Small businesses keep records adequate to account for a broad-based federal VAT, although compliance by small retailers will become more complex if the VAT must be separately stated on sales invoices and the VAT will imposed on a base that differs from the RST bases. If Congress decides to enact a European-style VAT, I urge Congress to study the Japanese CT, a good first stage toward a European VAT that ultimately should cover all businesses, regardless of size.

Mr. FORD. I yield back.

Mr. COLLINS [presiding]. Mr. Ensign for a quick comment.

Mr. ENSIGN. Thank you, Mr. Chairman.

In the interests of time, I just want to make a quick comment and also I would like to receive your comments on regressivity as well. But you mentioned in hiding them in the price of goods, the taxes would be in the best interest of the States, helping get them onboard.

The one caution that I have on that is that one of the drawbacks to the VAT tax is that in the future it is easy to raise the VAT tax rate and if you hide that tax into the price of a good, at that point it is even easier and easier to hide tax increases. And as we are growing, the size and the scope of government over the last umpteen years, one of the reasons I think we now have a chance to downsize government is because people are sick of paying the amount of taxes, and that is a caution that I would add.

Thank you for the time, Mr. Chairman.

Mr. COLLINS. Thank you, Mr. Ensign.

We appreciate you gentlemen testifying before the Committee today. We excuse this panel and call the two gentlemen from the other end of the hall, Mr. Nunn and Mr. Domenici. Thank you, gentlemen.

We thank you two gentlemen for visiting with us at this end of the hall. We apologize. We have a vote on the floor and we understand that you have some votes coming up in just a few minutes. So we are going to go ahead. Mr. Domenici, would you like to lead off?

Senator DOMENICI. Mr. Chairman, I am going to let Senator Nunn lead off and follow him.

Mr. FORD. Mr. Chairman, let me say before the two Senators begin their testimony, I will have to leave the hearing because there is a vote on the floor. I will return, but I did not want my absence to be mistaken for rudeness.

Senator NUNN. We understand that better than anybody, you know.

Mr. COLLINS. It is a pleasure to welcome my colleague from Georgia to testify in front of the Committee.

STATEMENT OF HON. SAM NUNN, A U.S. SENATOR FROM THE STATE OF GEORGIA

Senator NUNN. You have taken over this Committee even sooner than I predicted.

Mr. COLLINS. We move fast.

Senator NUNN. I have just come from a hearing all morning on Bosnia and we have the President's and Senator Dole's terrorism bill on the floor, and now I am shifting to the IRS Code, and the only common denominator among those three subjects I think is terror. But I think all three probably fit in that category.

It is a pleasure to appear before the Ways and Means Committee as part of your hearings on tax reform, and I thank you and Chairman Archer, Congressman Gibbons and all of the Members for holding these hearings. Senator Domenici and I appreciate the opportunity to discuss our tax bill that we have introduced, which is

called the U.S.A. tax, which stands for unlimited savings allowance.

I would like to summarize my prepared remarks, and I would put the rest of my remarks in the record. We can't cover the whole subject today, and we know that, so I am just going to hit a few highlights. And then Senator Domenici is going to go into more detail on both the business and the individual side of the Tax Code.

The most important fundamental principle of the unlimited savings allowance proposal is the removal of the current bias in our Tax Code against the savings and investment that are the key to the higher living standards in this country in the future. In my view, higher savings lead to more investment, more investment means that we will have more productive American workers, the more productive our workers are, the more competitive we are in the international arena, and the more competitive we are in the international arena, the better jobs we have, and of course the better jobs we have, the higher income we have. So there is a direct connection between savings, more savings and higher income. If we can make that connection with the American people, I think we have got an excellent chance for real fundamental tax reform. If we don't make that connection, if people don't understand that, if they don't buy it, if they disagree with it, then I think it is going to be very hard to reform the Internal Revenue Code in a significant and fundamental way.

To efficiently use our time, Mr. Chairman, I am just going tc highlight four parts of our proposal that I think are very important, without getting into the details of the proposal, and then Senator Domenici will fill in the very large gaps here and have his own comments.

First, the question of fairness. I think that question has to be addressed. We have heard a lot about simplicity; we want our Code to be much simpler, and we think it is much simpler, but we do not want to withdraw the question of fairness in the process.

There are four main elements that we believe that make our U.S.A. tax on individuals fair: First, we retain progressive rates; second, we have a family living allowance that exempts from taxation the first several thousands of consumption for necessities. Everybody has to have certain necessities. We have added a family living allowance and, of course, we retained the individual exemptions. For a single person, the standard family deduction would be $4,000; for a married couple, it would be $7,000. The bottom line is for a family of four, if you have a family living allowance plus the current exemptions, they would pay no tax on the first $17,600 of income.

The third part of fairness, we retain certain key elements of the current Code. We enhance the earned income tax credit—we increase that; we think that is essential—and we retain the tax exempt status of certain safety net benefits.

Fourth, and most importantly, and we think this is fundamental and should be part of any tax proposal that comes forth into fruition as law, we have a new payroll tax credit to offset the most regressive part of the current Tax Code. This is a very significant and very important change. I will say more about that in a moment.

Finally, on the question of fairness, the U.S.A. tax system reflects a fundamentally different philosophy in that we do not focus on where the income comes from. We do not have different rates for wage income or dividends or capital gains. If our proposal is adopted, the debate about rich and poor on capital gains will be over because the wage earner will be able to save their money and defer taxes just as capital gains will be deferred if the gains are reinvested. So it will be the same principle.

Under the U.S.A. tax, the point is not where the income comes from, it is what you do with it, and we think that is very important.

The second point I would like to address is the payroll tax credit. Under the U.S.A. system, you would subtract from your income tax the amount withheld from your salary for the employee's share of the Social Security payroll tax or the FICA tax. Now, this is a tax credit; it is not a deduction. It credits directly against taxes. That would also be true of the employer; they would get a full 7.65 percent credit back against income taxes. We think this is a very important feature. It would reduce the regressive nature of the current payroll tax that is today the most regressive part of our tax system. There are literally millions of Americans today that pay more on FICA tax than they do on income tax, and these are primarily low-income working Americans.

The U.S.A. payroll tax would be refundable. Any worker with earned income can in effect subtract 7.65 percent, that is, the amount of the Medicare and the Social Security tax. Our proposal does not abolish the payroll tax or affect the operation of the Social Security system in any way. We know that revenue has to continue to come in; it will be collected as it is now, and the system would have just as much soundness as it does now.

Senator Domenici and I both believe that some of those fundamentals have to be addressed later, but not in terms of diminishing the revenue. So this is an important process for fairness. I think it will also eliminate one of the major impediments to people who have low skills, who now find themselves with a very large tax to the employer every time he hires a new individual. In effect, we have a tax on jobs in the name of the FICA tax that I think poses a tremendous problem to people with low income and low skills.

The third major point I want to make is the U.S.A. tax promotes U.S. competitiveness. This is very important. Our tax would put us on the same footing as our competitors. The U.S.A. business tax is territorial, meaning it applies to all sales on U.S. soil, no matter where the business is headquartered, and it is border adjustable.

Now, what that means is, we exclude, Mr. Chairman, from the tax base on business export sales. We do not include that in the tax base. Products made in America and exported would not be taxed. When a company, foreign- or U.S.-owned, manufactures abroad and sells in the American market, the company is subject to a new import tax, the same as if the factory were located in the United States. That is what we call border adjustability. Exports are excluded from the business tax and the business tax is added to imports, which means that foreign products sold in this market would have the same tax as American products made here. There would no longer be any incentive for a company to locate out of

America and export back into America because those goods would have the same tax.

Now, this is crucial because our share of economic output that is exported and imported has changed dramatically over the last 15, 20 years, yet the current Tax Code has not kept pace. In effect, this is what our competitors do. They have value-added tax for large parts of their revenue. They tax goods coming in and add to our products and then they rebate on taxes going out. We believe this is GATT-compliant, because it is very similar to what happens in Europe and what happens in Japan.

Fourth and finally, the one new deduction that we add into this Code is the deduction for human capital. That is a deduction for tuition expenses for postsecondary education, whether it is college, trade or vocational school or remedial education. Under the U.S.A. proposal, we provide a deduction for up to $2,000 per person for the taxpayer and for the dependents. We feel this is enormously important because we are addressing the capital side of the equation with our individual and business taxes; and we also think we ought to address the human capital side because the education and skills that our people have will have just as much effect on the future of our economy, if not more, than the actual savings and the investment.

Mr. Chairman, I won't even summarize because I know everyone is on a tight schedule today, but I would ask that my entire statement be put in the record, and I will turn it over to my colleague, Senator Domenici.

[The prepared statement follows:]

Prepared Statement of Senator Sam Nunn
Testimony before the Ways and Means Committee
June 7, 1995

Mr. Chairman, it is a pleasure to appear before the Ways and Means Committee as part of your hearings on tax reform for the 21st Century. Senator Domenici and I appreciate the opportunity to discuss S. 722, the USA Tax Act of 1995, with you and the other members of this distinguished Committee.

As you know, six weeks ago we introduced, along with Senators Kerrey and Bennett, the USA Tax Act of 1995, a comprehensive tax reform proposal that we believe represents the best way to achieve the goals we all share -- increased national savings and investment, higher economic growth, and improved competitiveness. We welcome debate, comments, suggestions, and constructive criticism on this legislation.

Mr. Chairman, as you and others on this Committee have suggested, our tax system needs more than a Band-Aid. It needs a transplant. If we are serious about our Nation's future, we have to scrap the current tax system and put in its place a system that will work for our people and for our country.

Senator Domenici and I believe we have such a system. We call our proposal the USA tax system. USA stands for Unlimited Savings Allowance, which is the key, fundamental part of this proposal. We believe it represents fundamental change in the way America taxes itself, the way America saves, and the way America invests.

What do we mean by a tax system that works? We mean a system that encourages savings and investment. We mean a system that is perceived to be fair and is fair. We mean a system that is understandable. We mean a system that reduces the complexity of paying taxes for ordinary Americans by taking less time, fewer forms, and fewer dollars to comply with. We mean a system that is attuned to the international competitive realities and gives U.S. companies and their employees a chance to compete fairly in the global marketplace, which we do not have today.

We mean a tax system that is fiscally responsible. There is no point in creating a system that increases the private sector component of the national savings with one hand, while further reducing the public sector component of national savings, by increasing the deficit, with the other hand. Our proposal is designed to be revenue neutral. We do not have an official revenue estimate from the Joint Committee on Taxation yet, but we have designed this legislation with the intention of being revenue neutral. We are not proposing a tax cut or a tax increase. In our view, that debate is best kept separate from

the issue of the what the proper structure of our tax system should be, which is the issue we are addressing in this bill.

Members of this Committee are well aware of the daunting task that lies ahead in order to fulfill the reconciliation instructions in the Budget Resolution. To find over a trillion dollars in savings over seven years will involve many painful decisions, some of which may not be sustainable over time. I believe it is counterproductive to increase that burden by simultaneously cutting taxes. To me that is like an alcoholic announcing that he was going on the wagon while chug-a-lugging a couple more bottles of whiskey.

When Senator Domenici and I began advocating our concept of a complete overhaul of the Tax Code three years ago, the prospect of fundamental reform appeared to be several years off at best. Today, however, the clock has moved up. It is clear that, while we are just beginning the process of debating how to change the Tax Code, there is already a broad consensus in this country and in this Congress that fundamental reform is necessary.

Mr. Chairman, I believe the central goal of any reform of our tax system should be to raise the level of national savings. Senator Domenici and I are proposing the unlimited savings allowance tax system because we believe it is better for taxpayers and for our economy, because it removes the current bias in our Tax Code against the saving and investment that are the key to higher living standards. Higher savings lead to more investment. More investment means that we have more productivity from American workers. The more productivity we have from our workers, the more competitive we are in the international arena. The more competitive we are in the international arena, the better jobs we have. The better jobs we have, the higher income we have as Americans.

That is a very important chain. That is the bottom line. The bottom line is what happens to the real income of the American people in the future. There is a direct connection between how much we save and the real income of Americans. That is the direct connection that we have to make sure people understand. If we cannot make that connection in the American mind, there is no point in talking about a fundamental reform of the tax system. If most Americans agree that this proposition is true, then I think there is a tremendous opportunity here to make the fundamental changes we are proposing.

The national savings rate in the United States is lower than that of any of our major competitors. In the 1980s, our savings rate dropped to an average of 3.6 percent, half the level of the 1960s and 1970s, and far below the comparable figures of 10 percent in Germany and 18 percent in Japan. In the first five years of this decade, 1990 to 1994, the U.S. savings rate has

fallen almost 50 percent from the already low levels of the 1980s, to just 2.1 percent.

Without increased savings and investment, we cannot raise our long-term standard of living, meet our financial obligations, and build a better society for today and for the generations that follow. The United States cannot continue to be the major competitive force in the world if other countries continue outsaving us and outinvesting us. It simply cannot happen over a long period of time. That is fundamental.

As Josef Joffe pointed out in a recent editorial in the New York Times,

> "... the U.S. has a big problem. America has lived like a person who writes checks at will. For almost a generation, it has bought more abroad than it sold -- hence, the zillions of dollars in global circulation. What happens when there is too much money? It buys less. Hence, no more four marks to the dollar.
>
> "Again, the external value of one's currency does not really matter as long as the fundamentals are sound. But the unstoppable fall of the dollar says that the fundamentals at home are askew. It virtually screams that America is consuming too much while saving and investing too little. The Government is living on borrowed money; so is the consumer."

It is often said that the best way to increase national saving is to reduce the federal budget deficit. I agree with that proposition. We not only need to reduce the share of our national savings being soaked up by the federal budget deficit -- we also need more savings. And we believe our proposal can turn the tax code from a major roadblock to higher savings into an important tool to promote higher savings.

As the members of this Committee know better than anyone, the tax code has been and will continue to be used to encourage or discourage certain behavior through such provisions as the deductibility of home mortgage interest or taxes on cigarettes. Yet the current tax code not only fails to encourage private saving, which is vital to our future, it actually discourages it. Yet there is no doubt that future generations will not have the same level of entitlement benefits from the government that we have today. Our present entitlement programs are not sustainable at their current growth rates. That means that Americans are going to have to save more, to take more personal responsibility for their own futures.

So we need to get the tax code working for us, not against us, to get people to once again adopt the mentality of savers who

think about tomorrow as well as today. We need to start an education process in this country to make saving a national issue -- not just a tax issue. People need to understand the fundamental importance of saving, both for their own future and for America's future. We literally and figuratively must "save America".

The USA Tax System is a Single Tax in Two Parts

The USA proposal consists of a single, integrated tax in two parts: a progressive tax on individual incomes, and a low, flat rate tax on all businesses. These two parts are meant to work together. It is important that people not try to consider the two parts separately, because if they do they will not grasp the significance of the whole concept. It is a single tax levied in two places: at the business level where wealth is created and at the individual level where wealth is received.

This proposal allows an unlimited deduction at the business level for capital investment and, more important, it permits all citizens an unlimited deduction for the amount of their annual income they save and invest. The USA Tax System directly and systematically addresses our saving and investment problems.

To the individual, our system says, "If you choose to defer some of your consumption in favor of saving income for your future and the future of your children, the Tax Code will not penalize you for doing so."

And to the business enterprise, whether very small or very large, manufacturing, service, or agricultural, the USA tax system says, "If you choose to invest your profits in a new machine or a new process that will help you grow and put more people to work, the Tax Code will help you." The USA Tax System, by its very nature, would align the way we tax with our common desire to provide our children with a better tomorrow.

Mr. Chairman, the details of this proposal are contained in the text of the bill we have introduced, and I hope the members and staff of this Committee will take the time to study it. Certainly Senator Domenici and I would value your views and suggestions. There are several major elements of this proposal that I think need some emphasis this afternoon.

The Individual Tax

Let me describe the key features of the individual part of our proposal first. The individual tax would function in a manner similar to that of the current income tax. Gross income would include wages, salaries, interest, dividends, earnings withdrawn from unincorporated businesses, proceeds from asset sales -- basically the same concept of income we have today.

From your gross income, you would make subtractions before you figure your tax, just as you do now. You would subtract personal exemptions, a new Family Living Allowance, a new savings allowance, and a limited number of itemized deductions.

First, the USA proposal contains a family living allowance that is similar to the current standard deduction except that it is in addition to any itemized deductions, not an alternative to itemized deductions. This family living allowance exempts the first dollars spent on consumption from taxation, because we know that people in low income brackets spend a higher proportion of their incomes on necessities than people in high income brackets.

In addition to the Family Living Allowance, you would have personal exemptions just as you do under current law. A family of four filing a joint return would have its first $17,600 of income exempt from taxation by adding this Family Living Allowance to its four personal exemptions.

The Unlimited Savings Allowance

In addition to these deductions, there would be a new deduction for the amount of income that is saved called the Unlimited Savings Allowance. We define savings in this proposal as net new savings. That is key. If you add to the national savings pool, you would deduct that money before you pay taxes. In other words, to make it simple, if someone makes $40,000 a year and saves $5,000, they would pay taxes on $35,000, instead of today paying taxes before the savings on the entire $40,000. That is fundamental. We encourage people to save.

The Unlimited Savings Allowance is similar to the IRA concept, but it is unlimited. It is not limited to $2000 or any other dollar amount. It is not limited to saving for retirement. But it is for net new savings. We do not give a deduction for merely shifting savings around. That has always been one of the problems with the IRA.

The USA Tax System is fundamentally different from the current tax code, which penalizes savings. Under the present tax code, savings are taxed twice, once when you earn the income that you save, and again when you receive a return on those savings; consumption is taxed only once.

The USA Tax System also reflects a fundamentally different philosophy in that we do not focus on where your income came from. We do not have different rates for wage income or dividends or capital gains. Under the USA Tax System, the point is not where the income comes from, it's what you do with it. The portion of your income you save, whether you're rich or poor, you defer paying tax on it. The portion you spend, above the level for basic necessities, is subject to tax at progressive

rates.

The deduction for individual saving also permits a new perspective toward designing a business tax. Because our proposal defers taxes on individual saving until they are spent, we can eliminate enormous complexities in today's tax code. There is no reason to be concerned about people sheltering their saving in corporations, which creates a huge portion of the complexity in today's the tax code. We do not need elaborate rules to force businesses to distribute "sheltered" saving.

Other Deductions for Individuals

In addition to the Family Living Allowance, the personal exemptions and the savings allowance, we propose a limited number of additional itemized deductions. The higher the number of deductions, as we all know, the higher the marginal tax rates would have to be. So, there is a trade-off. We are proposing to retain a deduction for home mortgage interest and charitable deductions. We could have more deductions, of course, and certainly we welcome debate on which deductions people think should be added to, or subtracted from, our proposal -- with one word of caution. The higher the number of deductions, the higher the rates will have to be to avoid increasing the deficit. There is a direct tradeoff between the number of deductions and the tax rate.

Our proposal does have one such additional deduction which I feel very strongly about, and that is a deduction for tuition expenses for post-secondary education, whether it is college, trade or vocational school, or remedial education. We feel it is important that the tax system provide a deduction for investment in human capital that parallels the deductions on the business side for investments in physical capital, since both investments raise the productivity and real incomes of workers.

The USA Tax System is Fair

The USA Tax System is a progressive tax. Our system will have three graduated rates. We are proposing a progressive system, not a flat tax. We do not believe it is necessary to abandon the principles of fairness and progressive taxation in order to get a simpler, more efficient, growth-oriented tax code. It is important to keep in mind that the graduated rates in the USA Tax System will not create the same disincentives for saving and growth as today's tax system, since taxes will be deferred on income that is saved and invested.

There are four main elements that make the USA tax on individuals fair. First, we have three progressive rates. Second, we have a Family Living Allowance that does not tax the first several thousand dollars of consumption for basic

necessities. Third, we retain some progressive elements of the current code, such as the Earned Income Tax Credit -- which we increase -- and the tax exempt status of food stamps and other safety-net benefits. Finally, we have a new payroll tax credit which I will discuss in a moment.

We would apply progressive tax rates to the amount of income that is consumed, after subtracting the Family Living Allowance, personal exemptions, and deductions for mortgage interest, charitable contributions, and education expenses.

The tax rates in the USA system are not directly comparable to the rates in the current income tax code, however. I know people are going to find that a little hard to understand at first, but the reason why they are not comparable is very important, and that is our payroll tax credit.

The Payroll Tax Credit

Under the USA system, after you determine the amount of tax resulting from applying graduated rates to your taxable income, as I have just described, you would subtract from that income tax the amount withheld from your salary for the employee share of your Social Security payroll, or FICA, tax. We think that is a very important feature of the USA system that would reduce the regressive nature of the present payroll tax. The payroll tax, which is absolutely essential to fund Social Security and Medicare, has also become the most regressive part of our Tax Code. The Social Security portion of the payroll tax does not apply above the first $60,000 of earnings. Higher-income people above that level pay only a limited portion for Medicare. But low-income people, medium-income people, are paying a very large percentage of their overall taxes on FICA tax. In fact, there are literally millions of Americans today that pay more FICA tax than they do income tax.

Our payroll tax credit would be refundable so that if you had more withheld in payroll taxes than you owed in taxes, as is the case for many people, the difference would be refunded to you. Therefore, people with earned income can, in effect, subtract 7.65 percent, the amount of pay withheld for the employee's share of the Social Security and Medicare payroll taxes, from our tax rates.

It is very important for people to understand this. To compare a tax rate under the USA proposal to current rates, you have to subtract the 7.65 percent credit. A 20 percent rate under the USA system would be, in effect, equal to a marginal rate of 12.35 percent under today's system after you take the payroll tax credit.

The payroll tax is a perfect example of why fundamental tax

reform is needed. While it was designed with the best of intentions, the payroll tax is a very regressive tax. It discourages hiring additional workers, especially lower-wage workers.

Our proposal does not abolish the payroll tax or affect the operation of the Social Security System in any way. But what it does try to do is offset the negative side effects of the payroll tax by crediting the payroll tax against an individual's or business's tax liability under the USA tax. The employer would also get the 7.65 percent credit against their taxes -- not a deduction, but a tax credit. Employees get a credit for the FICA taxes against the individual income tax, and employers get a credit for the employer share against the business tax.

So the same amount of revenue will continue to be deposited in the Social Security trust fund, but the payroll tax will be integrated into the income tax in a way that offsets its regressive nature. This is important for fairness purposes. It is also important so that we eliminate one of the major impediments to people with low skills being hired. Now people with low skills, minimum-wage-type jobs, the employer has to look very, very carefully before they hire because they are not only paying for the minimum wage, or whatever the wage is, they are also paying another, in effect, 15.3 percent because of these very high payroll taxes.

The Business Tax

Mr. Chairman, I will take just a few moments to describe the business side of our proposal.

The second component of our new tax code is the business tax. The business tax would work like this: Under the USA Tax System the business would add up its sales receipts during the year, then add up the cost of the goods and services it purchased for use in its business. The cost of these business purchases would be subtracted from the sales receipts. The difference would be subject to a business tax at a flat rate of 11 percent.

I am sure many people will wonder why the business rate seems so much lower than current law. The answer is that the two rates are really not comparable, because our tax would not be applied to corporate income as currently defined, but rather to a company's gross profits. It is a fundamentally different concept from what we have today, and it applies to all businesses, not just those that are incorporated.

I think everyone who studies this business tax needs to understand we have a fundamentally broader base for the business tax so we are dramatically lowering the rate but we are producing the same amount of revenue. We are not lowering the overall

proportion that businesses are paying. They are paying the same proportion. But we are able to lower the rate because we are greatly broadening the base, and that needs to be understood.

It is also important to understand that under the USA Tax System, the cost of investment in plant and equipment and inventory would be fully deductible when spent. There would be no need for complicated depreciation schedules. Investment would be deducted up front. Investment creates jobs. New plant and equipment increases productivity and that increases the income of our people. So that is the behavior we should be encouraging rather than discouraging.

Investment in plant and equipment is what we need in this country, and yet the amortization of these investments over a long period of time under current law discourages businesses from investing as much as they would otherwise.

The USA Tax Promotes U.S. Competitiveness

Another very important feature is that our USA Tax System puts U.S. companies on the same footing with our competitors. The USA business tax is territorial -- meaning it applies to all sales on U.S. soil no matter where the business is headquartered -- and it is border adjustable.

We want to encourage exports, and we do so in this proposal. We exclude the proceeds from export sales from taxation by rebating the tax on goods exported for sale abroad. And when a company, foreign or U.S. owned, manufactures abroad and sells to the United States market, the company is, through the operations of a new import tax, taxed essentially the same as if the factory were located in the U.S. That is border adjustability -- the tax is rebated on exports and added to imports, which is exactly the situation American exporters to Europe and Japan face today. We believe our business tax will place American companies and workers on an equal and level international playing field.

This is no small matter. The share of our economic output that is exported, and the share of our national income that we spend on imports, have both doubled over the past twenty five years. Yet the current U.S. tax code has not kept pace with the rapidly changing face of international competition. While our economy has shifted dramatically over the past 30 or 40 years, we have not made a comparable shift in our tax code. We have simply tinkered with it year in and year out.

Our current tax system is a holdover from another era, when international trade was a small component of our economy, when having a tax rule that applied to all American corporations equally was enough. But today American companies do not just compete with each other, they compete globally. And the current

U.S. tax code puts our companies at a disadvantage.

Under the rules of the General Agreement on Tariffs and Trade, or GATT, certain types of taxes can be levied on imports and rebated on exports -- border adjustability -- while other types of taxes cannot. Our competitors in Europe and Japan have business taxes that can be rebated under GATT, while we do not. We believe the USA business tax is legal under the GATT, since it would work essentially the same way as European and Japanese value-added taxes, which are GATT-legal, although without the complexity that adding a VAT to our current income tax would have.

Let me give a simple example of how our business tax applies to exports and imports. If a company has $2.5 million in sales, of which $500 thousand are export sales, for purposes of the business tax its receipts would be only the $2 million it had in domestic sales, not $2.5 million. But it will not have to go through a lot of complicated calculations to allocate its production costs between its domestic and foreign sales. All domestic input costs will be deductible regardless of whether the sales are domestic or export sales. Under our proposal there will no longer be a tax incentive to move production overseas.

Conversely, if the facilities used for the production of the $2 million in domestic sales are moved overseas and the $2 million of goods are imported into the U.S., an 11% import tax of $220,000 will be collected on those goods; the same as the domestic company I mentioned earlier.

In order to comply with the requirements of the GATT, businesses would not deduct wages. This is a key point, and I know there will be concern about this. But there are two important things to remember. First, our rates are much lower -- 11 percent -- than the rates currently imposed on corporate profits.

The second thing that we need to remember is that under our proposal, the deduction for wages would be replaced by the credit for the employer's share of the Social Security payroll tax -- which is 7.65% of its payroll -- which is the other half of the credit that employees get under the individual tax that I have already described. Businesses would get a credit back on that tax up to the maximum Social Security wage.

The USA Tax Is Designed to Be Deficit-Neutral

Under our proposal, the individual and the corporate shares of our total revenue would remain the same. We are not trying to shift the tax burden from businesses to individuals, or vice versa. We are not trying to shift the burden from the rich to the poor, or from the poor to the rich. We are not looking for

the fellow behind the tree to tax that my friend from Louisiana Russell Long often mentioned. We are designing this system to produce the same amount of revenue as the current tax code. It is not a proposal to cut taxes or raise taxes.

Because of the comprehensive nature of our proposal, and the enormous workload the Joint Committee on Taxation has had this year, they have not been yet been able to perform an official revenue analysis or a distributional analysis of this proposal. It is our intention that this system retain the progressivity of the current system, and that it be revenue neutral compared to the current system. Should the official estimates indicate that the bill we have introduced fails to completely meet either of those goals, we intend to work with the Joint Committee to refine this proposal so that we meet both, because we think they are very important.

The USA Tax Is Simpler and More Efficient

Although it is certainly possible to design a "simpler" tax system than the one we are proposing, I think the USA tax system also makes great strides in making our current tax code simpler and more economically efficient. The USA tax eliminates the need to calculate depreciation year after year, because investments are expensed immediately. We also eliminate the complicated, and in many cases counterproductive, Alternative Minimum Tax, or AMT.

The USA business tax puts debt and equity financing on an equal footing. We treat all forms of businesses the same - corporations, partnerships, and proprietorships.

One of the greatest contributions the USA system will make to simplification is that no longer will people have any reason to seek out unproductive, economically wasteful tax shelters in order to cut their taxes. If you want to lower your taxes, put your money in savings where it can work for all of us -- buy a CD, invest in a mutual fund. It might take a few minutes to do your net savings calculation once a year, but the net savings calculation should result more efficient use of our national income, as well as higher economic growth as saving and investment increase.

In an economy with a gross domestic product of over $6 trillion, taxation will never be a completely simple affair, and I do not think it is the only standard by which tax reform should be judged. But because the USA Tax System eliminates the need for rules against sheltering income in corporations, and because it is based on cash rather than accrual accounting, it promises major advances in simplicity and clarity.

Under the USA system, we believe whole volumes of tax code complications would fall away into welcome oblivion. The tax

shelter industry would shrink and compliance costs would plummet. All income would be treated alike. The key is what people do with their income. If it is reinvested, then the tax on it would be deferred. It is not reinvested, if it is consumed, then ordinary tax rates would apply. Those rules would be the same for everyone, for the factory worker, for the capitalist, for the miser, and for the wealthy conspicuous consumer.

There would be no more need for fights over capital gains, investment tax credits, Individual Retirement Accounts, and other targeted incentives for saving. The USA Tax System eliminates these issues because it offers a blanket deduction for personal saving and business investment.

And under the USA system, taxpayers will not have to keep track of the basis of their newly purchased savings assets such as stocks and mutual funds, the way they do now, and most taxpayers will not have to worry about the basis of savings assets they already hold. Finally, the USA tax system will not take a whole new bureaucracy to administer.

The USA Tax System is a Revolutionary Concept

In a way, the USA tax system could be described as simply taking the current tax system and adding a deduction for savings. That may be the major change most people would notice. But the USA Tax System represents a much more profound change in its effects than in its form.

For any given level of income, those who save and invest more will pay lower taxes. The taxpayers in the top bracket would pay roughly the same total amount of taxes they do now. But within that bracket, there will be those who pay less and those who pay more. The same will hold true whether you are in a higher or a lower tax bracket. That is the essence of our proposal. Those who help our economy, help create jobs, and boost productivity by saving and investing, will pay less than their neighbors with similar incomes who do not.

We are basically going to tax people on what they take out of the economy -- above a tax free level for necessities -- rather than what they put into the economy by working and saving. Our proposal represents a revolution in the philosophy of the income tax system. But we don't have to make major changes to the system already in place to administer the tax system to make our proposal work.

By contrast, a consumption or expenditure tax, such as a value-added tax, would impose enormous administrative expenses on American businesses, without the progressivity, and without creating the same explicit incentive to save and invest, that the USA tax system has.

Conclusion

Mr. Chairman, the USA tax proposal is a revolutionary concept with important advantages for our country.

The first advantage: This proposal will increase national savings by eliminating the bias in the current tax code against savings, without increasing the budget deficit. Increasing the pool of private savings will in turn allow increased investment at lower cost, which will increase the productivity of our workers.

Second, it will level the international playing field for U.S. companies, and promote U.S. exports of domestically produced goods, by rebating the business tax on goods sold for export. It will equalize the tax treatment of American-made and imported goods by having foreign companies pay their fair share of taxes on goods sold in America, just as American exports are taxed when they are sold in foreign markets.

Third, it will make our tax code more understandable and more efficient which will save both billions of dollars and millions of hours preparing individual and business tax returns. It will do so without sacrificing the principle of fairness in allocating the tax burden.

Fourth, the USA tax credit for the employer share of payroll taxes will help create jobs for workers who might not otherwise be hired by reducing the current disincentive to hire low skill workers that results from the regressive payroll tax which applies to the entire wage of lower-paid workers but to only part of the wage of higher-paid workers.

Finally, we believe it will foster greater personal responsibility by clearly showing the costs and benefits of saving versus consuming.

The current tax system is broken and, in my opinion, it cannot be fixed. In a very real way, it has aided and abetted our irresponsible tendency to live beyond our means. Our current tax code must be abolished and replaced.

We must being anew. The USA tax system provides a way to eliminate the complexities, the special subsidies, and the crippling biases present in the current code. By enacting real reform of the tax system, this Congress can take a giant step toward securing our nation's future.

Mr. CHRISTENSEN [presiding]. Thank you, Senator Nunn.

We would be pleased to hear your testimony, Senator Domenici.

STATEMENT OF HON. PETE V. DOMENICI, A U.S. SENATOR FROM THE STATE OF NEW MEXICO

Senator DOMENICI. Thank you very much, Mr. Chairman. I have a detailed statement and I have asked that it be made a part of the record.

Mr. Chairman and Members of the Committee, it seems to me that what we are trying to determine is what it is we ought to tax. And so the central focus of this set of hearings, as I understand it, is to determine what is the best tax base; or said another way, is it better to tax income that is earned or income that is spent?

We believe the better system is the latter, to tax income that is spent, not income that is earned. Our Tax Code is more neutral than the income tax in its treatment of present versus future consumption; it is neutral regarding the choice of savings or spending. It would be easier to administer than the income tax. Our tax base can be measured more accurately and simply than an income tax base.

Now, you will be looking at a number of proposals, and Senator Nunn and I submit that we don't just have an idea or a thought or a theme or a philosophy; we have actually put together an entire new Tax Code. It took a long time. So as you proceed through your deliberations, people will ask very specific questions about the U.S.A. tax, the Domenici-Nunn bill, because we have done away with the entire individual and corporate Internal Revenue Code, and substituted a brandnew Tax Code for it. In the process, we set some specific things that we wanted to make sure would happen in this Code, and frankly, we have spent a great deal of time, effort, and resources in modeling it so we know precisely where the tax burden lies. We know how it comes out vis-a-vis today's taxes, and as a consequence, clearly we can, in due course, have all of these details at your staff's disposal. We don't intend to do that today, obviously. But I would just talk about several quick things and then go through two tax returns, an individual return and a corporate return.

We create a system in which wages, if saved, and interest earned from those savings would be deferred from taxation until spent. Now, let me just make that very simple.

If in the United States anyone who is a taxpayer has income—and that is all kinds of income—if they have disposable income, they can, under this bill, make a conscious decision to lower their taxes by either saving the money or investing the money, in which event they pay no tax on it until they take it out of the savings pool or out of the investment pool of America, bring it back to their own and spend it.

Now, that concept is fundamental to changing American's culture and the way they treat their income and other financial resources. Because many will now be able to say, "why don't I start regular savings and investment, because I don't pay any tax on that until I cash it in and spend it."

Dividends received and saved would be deferred from taxation until the proceeds are spent. Tax on capital gains could be indefi-

nitely deferred as long as the proceeds are rolled over into other qualified investments, so the debate about capital gains is gone under the U.S.A. tax. And then, I would say, there is no bias—and this was one of our criteria—no bias in favor of either debt or equity financing.

The export competitiveness of the United States would be enhanced by providing border adjustability in terms of meeting the requirements of GATT. And we think we have done that.

The expensing of costs would replace other cost recovery systems; and seventh, dividends would be taxed only at the corporate level if the recipient invests or otherwise saves the dividends.

Now, obviously there will still be two kinds of tax returns filed. One will be for businesses and one will be for individuals. Let me quickly go through the individual and the business and then we will be ready to answer questions or to proceed however you would like.

First, individuals in the future, once this is adopted, would figure their total income by adding up wages, salaries, interest, dividends, royalties, whatever, wherever they would get money. They would add that all up, and then there would be a family living allowance, which recognizes that every family budget includes necessities, as Senator Nunn has indicated, and then there is the unlimited savings allowance.

So you take those earnings that I have just described, and determine how much of it was invested or saved. The total amount that you saved or invested is deducted from that total income that we just told you about. No difference as to sources. This deduction for personal savings parallels the business tax expense deduction for capital investment, and we will talk about that in 1 minute. This encourages people to save for whatever purpose they deem worthwhile, not to save pursuant through some government-concocted list—save it for whatever purpose you want, invest it in whatever you would like to invest it in.

It puts no time constraints on savings or investments, so that individuals can move from investment to investment without tax consequences so long as they don't take the proceeds, put them in their income and spend them. Not only is it an expanded universal IRA, it is a new and improved capital gains mechanism which allows taxpayers a series of investments and rollovers without incurring tax liability, so long as they leave it in the investment pool of our country or the savings pool of our country. We believe that investing in a home is a worthwhile investment. Therefore, we would keep the home mortgage deduction as in current law, and we would keep the charitable deduction as in current law.

Senator Nunn has indicated we have a new postsecondary education deduction, and that was to create some symmetry since we have investments in stocks and bonds and other things, which is, to provide capital for our country to grow and prosper, we thought we ought to encourage secondary education and have an incentive for investment in human capital. It is not large, $2,000 per year per student.

The employee payroll tax, or FICA payroll tax are often a larger tax burden on American families, than the current Federal income tax. It is a flat rate tax and it is regressive. Our system would ad-

dress both of these problems by providing a tax credit for FICA taxes paid both to the employer and the employee. The employee credit is refundable.

The FICA tax credit changes the way Americans should think about rates. We should think about rates as a combination of the U.S.A. tax and the FICA tax rate. We will have a combination rate structure for you to look at. We think that is very innovative, we think it is very progressive. Or put it another way, it rids the system of one of the most regressive taxes we have, the FICA tax on working men and women in the country.

The rate structure contained in our bill as we now have them figured out were modeled with one idea in mind, no new taxes. Our objective is to raise the same amount of tax we are collecting today. Our tax system is a replacement tax.

The business tax rate will be a flat rate. We think it will be about 11.5 percent on all businesses. Note that the business tax does not just tax corporations. You know that subchapter S corporations and partnerships continually have problems about how do they accumulate resources in their business so it can grow and prosper? We treat all businesses alike from a farm to a major corporation to a family partnership. There is a flat tax on those businesses of 11.5 percent. The base is very broad, and therefore, the tax rate is quite low. The business tax includes an unlimited deduction for capital investment, in the form of unrestricted expensing. The expensing deduction allows businesses to recover capital before they pay tax.

One of the worst challenges facing American businesses is the complexity of filing a Federal corporate tax return. I don't know if you have talked to any American companies' tax counsel, but there are some who have the IRS agents permanently officed in living quarters in their company headquarters. These live in IRA agents would get an eviction notice under the U.S.A. tax. Business taxpayers would be on a cash basis. They would expense what they buy as they pay for it, and if they don't, if they don't have enough resources that year, they carry the deduction over. The U.S.A. tax system puts American business on a cash basis instead of an accrual basis. Utterly simple.

Small firms favor expensing for several reasons. It is simple, it helps cash flow, it permits them to accumulate without paying income taxes on what they leave in there, again until they take it out and spend it.

Now, let me describe the nuts and bolts of the U.S.A. business tax. Businesses would add up all of their receipts from sales of goods and services excluding sales of American-made products to foreign markets. Let me repeat. We would put our American corporations on the same footing that foreign competitors are. Whatever exports American firms sell overseas would be deducted from their gross income. This makes the system border adjustable. A firm deducts foreign sales. Even with this export-enhancing feature, the 11.5 percent modeled into this system will still yield you the same amount of corporate tax because the U.S.A. tax base is much broader. The business deducts the cost of purchases from other businesses, the cost of plant and equipment, parts, components—and no depreciation, it is on a cash basis with unlimited

expensing. After subtracting purchases from U.S. sales, the remainder is gross profit or the tax base to which this flat business tax is applied.

Out of these gross profits, the business may pay a business tax, wages and salaries to workers, and dividends and interest to shareholders. The businesses would also continue to pay their share of Social Security taxes into the trust fund just as they are now.

There is a FICA credit which would then be available to the businesses and individuals. We replace the wage and salary deduction with a payroll tax credit—not deduction, but credit—to make our exports more competitive by achieving border adjustability. We did this so that we comply with GATT, which permits us to have border adjustability with reference to American sales overseas. Foreign companies or American companies producing goods outside America but selling inside America, would pay an import tax equal to the flat business tax paid by U.S. firms.

Now, there are a lot of other technical aspects on banks; there is a major transition section, and I call the transition section to your attention only because you are going to have a transition problem in all of the different tax systems that have been suggested.

Example: A sales tax, 20 percent. Many, many millions of seniors have already paid a tax on their savings. Now we are going to say, when you spend your savings, you pay 20 percent sales tax. That is obviously going to be very hard to sell.

The U.S.A. tax provides a mechanism whereby savings acquired with aftertax dollars under current law would not be taxed again under the U.S.A. tax system. While there will have to be some accounting during that transition period, we think we treat the "old savings" fairly. We are not going to tax them again, since they paid taxes as they saved.

So let me close by saying, we believe that it is time to do two things in America; and I am very proud to be part of both of them, and I hope you are. We need to balance the Federal budget, stop spending more than we take in, because the biggest user of our savings is the Federal deficit and its accumulated debt; and second, we should abolish our current Income Tax Code—a Tax Code which is antigrowth, anti-investment, antisavings—we should turn it into the opposite, and let it be an instrument and tool for business growth and job creation that is fair. The current tax system does not help individuals who might not be able to save and invest even though it is in their best interests to save and invest. The U.S.A. tax system would help individuals save and invest because it allows people to get a tax deferral for whatever they save or invest. They can save with pretax dollars.

Thank you very much. It is a pleasure to be with you.

[The prepared statement and attachments follow:]

TESTIMONY OF SENATOR PETE V. DOMENICI

S. 722–THE USA TAX

BEFORE THE COMMITTEE ON WAYS AND MEANS

June 7, 1995

The tax code determines our standard of living. The rise and fall of the American families' standard of living is tied to the amount of capital their employers are able to invest in them. To have access to investment capital, we, as a nation, need to increase the national savings rate.

We will be addressing two-thirds of the decline in the national savings rate (which has taken place since the 1950's) when we enact a balanced budget plan. With the enactment of this year's budget plan we will, for the first time in three decades, stop deficit spending and stop adding to the national debt. That debt is increasing at $335,000 a minute; $20 million an hour; $482 million a day. Government. Deficit spending and adding to the national debt is a form of dissavings that lowers our national savings rate. Out of shape individual savings habits are responsible for the other one third of the decline in our national savings rate.

We have to balance the budget and enact a new tax code in order to increase our savings rate so we can increase the national savings pool. A higher savings rate permits more investment in plant and equipment, R&D, improvements in technology education and training. A higher savings rate means more, better-paying, jobs, a higher standard of living and brighter future for our families.

The USA Tax, or the Unlimited Savings Allowance Tax System, S. 722 introduced by Senator Nunn and me would achieve those objectives. We could call it the "Family Standard of Living Improvement Act of 1995" because that is what it would accomplish. It would accomplish much more.

Before explaining our proposal, I want to commend the Chairman of the Ways and Means Committee for holding these hearings. It has been too long since the Congress engaged in a serious examination of how our current tax system is working. We have never, in a systematic way, examined alternative tax systems.

With a new century only five years away it is an opportune time to stop and determine what our tax system should do and how to best accomplish it.

There are some startling facts that emphasize how badly our current income tax system is serving us and the urgency of reform.

The U.S. ranks dead last among industrial nations in the fraction of GDP devoted to investment. More ominously, since 1986, our investment rate has fallen. U.S. tax policy explains much of this. And the investments our companies have been making are at a higher price. According to Professor John Shovan of Stanford, the tax code adds one-third to the cost of capital.

Economists proclaim that the nation's savings rate is the lowest among industrialized nations, and as a result, America is risking a bright economic future to pay for the present. These trends are unlikely to reverse themselves without a major tax policy change.

But, how do we encourage more savings among individuals? When Americans save they are really investing in America and our tax code should reflect that national priority. Our major trading partners encourage saving in their tax codes, and so should we.

The philosophy of the USA tax is to tax income that is not saved or invested rather than to tax all income that is earned. It should vastly expand the pool of savings, and achieve significant simplicity in the bargain.

The USA Tax base is total Gross Domestic Product (GDP). The Business Tax and the Individual Tax are two parts of a single tax on a single tax base. The Business Tax is intended to be the first in a two-step tax collection process. The Business Tax base would begin with Gross Domestic Product (GDP)--the sum of all goods and services produced and sold by all businesses together-- **minus,** in order to avoid double taxation, those goods and services they have bought from one another. The first taxable event would take place when businesses create income by producing and selling goods and services. The second taxable event takes place when individuals receive that income, net of the Business Tax, in the form of wages, salaries, interest, dividends and similar distributions to the owners of a business.

The Unlimited Savings Allowance Tax System described in the Act would replace the current progressive-rate income tax system with a simplified, progressive-rate tax on gross income which provides that income saved or invested by individuals, and the income generated by those investments would not be taxed, until the financial resources are spent on non-qualified purposes.

The bill replaces the current corporate income tax code with a simplified cash flow tax on business gross income (sales minus cost of goods sold) which would allow a deduction for savings reinvested in plant and equipment used for business purposes.

Our system recognizes that saving and investing is good for the economy and that people shouldn't be called upon to pay taxes on income that they are dedicating to the savings pool.

This deduction for personal saving parallels the business expensing deduction for capital investment. The former allows individuals to defer tax on that portion of income that is saved, and ultimately, converted into capital. The latter allows a business to recover capital costs before paying taxes.

The "Unlimited Savings Allowance" is the central feature of the individual tax. The objective is to raise the level of national savings because there is a direct relationship between how much we save and the real income of working Americans. If we increase savings and investment we can raise our long- term standard of living, meet our financial obligations and build a better society for today and for generations who will follow.

The aging of America adds a new sense of urgency for saving. The next century will see many Americans spending as much time in retirement as they did working. Adding to the savings pool is in the national interest but saving is also in the taxpayers' best interest because it will insure a better retirement life as well.

With that general introduction, let me go through the description of the individual USA tax:

Individuals calculate their total income by adding wages, salaries, interest, dividends, earnings withdrawn from unincorporated businesses, proceed from asset

sales, rents, royalties, annuities, withdrawals from savings accounts, taxable transfer payments and other similar cash inflows. The bill assumes that there will be a transition period, during which some withdrawals from savings acquired prior to enactment of the USA tax would be excluded from income.

The taxpayer would then subtract:

THE FAMILY LIVING ALLOWANCE

A standard deduction, personal exemptions similar to current law, and together are known as the "family living allowance." The family living allowance recognizes that every family's budget includes necessities and that the federal government should not tax that portion of a family's monthly bills. For a family of four, the annual "family living allowance" would be about $17,600. There would be bigger family living allowances for bigger families. This ensures equitable treatment of larger families because who typically spend more and save less than smaller families with the same incomes.

THE UNLIMITED SAVINGS ALLOWANCE

The "Unlimited Savings Allowance" is an important feature of the individual tax. For those who want to expand IRAs, this is the ultimate expansion. It will give all Americans, including those of modest means, more control over how much of their income is taxed each year. As a consequence, it empowers taxpayers to have some say in how large their tax bill will be.

The Unlimited Savings Allowance combines the best tax policy of the Individual Retirement Accounts (IRAs) and the Capital Gains differential. It maximizes taxpayer choice and flexibility. It encourages people to save for whatever purpose they deem worthwhile--not some government concocted list. It puts no time constraints on the savings or investment so that individuals can move from investment to investment without tax consequences as long as they continue to save and invest the proceeds from the preceding investment. In this respect the "Unlimited Savings Allowance" is not only an expanded, universal IRA, it is a new, and improved capital gains mechanism which allows taxpayers a series of investments and roll-overs without incurring tax liability.

The Unlimited Savings Allowance works like a zero rate on capital gains as long as the proceeds are reinvested. However, mere portfolio shuffling without a net addition to saving does not result in a deduction.

From adjusted income, the taxpayer then subtracts what he or she saved, including net increases in bank accounts, purchases of financial assets, other investment purchases, and life and casualty insurance payments.

HOME MORTGAGE DEDUCTION

Families think of their home as an important investment in their financial portfolios . Our tax proposal thinks like most American families think. Our new system would retain the current law home mortgage deduction. A taxpayer would, therefore, deduct his/her mortgage interest.

POST SECONDARY EDUCATION DEDUCTION

The USA tax system recognizes the importance of investment in human capital as well as the investment in productivity-enhancing plant and equipment. Investment in the education and training of taxpayers and their children will produce a significant, long lasting return on investment which will benefit the entire nation. Greater future earnings generated by those attending college and post secondary technical schools would eventually be taxed.

Therefore, the taxpayer would also be allowed to subtract an education allowance or deduction of $2,000 per year, per student, with an $8,000 per tax return limit.

PHILANTHROPIC TRANSFER DEDUCTION

This is the same as the charitable deduction under current law.

ASSETS ACQUIRED WITH AFTER-TAX DOLLARS UNDER THE CURRENT CODE--TRANSITION BASIS DEDUCTION

The USA tax recognizes that many taxpayers have accumulated savings assets with after tax dollars under the current tax system. It would not be fair to tax

those assets again when we switch to the USA Tax system. The USA Tax provides that if the basis does not exceed $50,000, one-third of it is added to the savings deduction in each of the first three years after enactment . If the basis exceeds $50,000 and the taxpayer has spent more than he saved or as the economists would say, if the taxpayer's savings are negative, the basis is used to offset the negative savings so that it does not become taxable. This continues each year until the original basis is used up.

If the basis exceeds $50,000 and the taxpayer added to the savings pool during the taxable year, there are additional transition rules.

RATE STRUCTURE--Joint Returns.

The taxable income under the USA Tax is very different from the current concept of taxable income. The rate structure looks similar--three brackets 15, 20 and 40 percent-- but they are applied to a very different tax base and need to be viewed in conjunction with the payroll tax credit. In addition, people have to change their thinking about rates because they have a great deal more control over the size of their tax bill as a result of the Unlimited Savings Allowance. It is progressive, a goal achieved through a combination of graduated rates, exemptions, personal deductions, a family living allowance and for lower income individuals, the earned income tax credit.

EMPLOYEE PAYROLL TAX CREDIT

The USA Tax recognizes that for lower and middle-income Americans who work for salaries and wages, the existing FICA payroll tax withheld from their paychecks is a often a larger tax burden on American families than is the current income tax code. Since the FICA tax is a flat tax, it is also inherently regressive. The USA Tax System would address both of these problems by providing a refundable tax credit.

The lowest bracket is 15 percent (or a 7.35 percent combined USA tax and FICA tax after the payroll tax credit is taken) for taxable income up to $5,400. After a transition period and beginning in 2000 that rate can be lowered to 10 percent (2.35 percent combined USA tax and FICA tax, after the payroll tax credit is taken). After the transition period the second bracket rate of 20 percent (12.35

percent combined USA tax and FICA tax, after the payroll tax credit is taken) for taxable income up to $24,000 in 1996 dollars.

EARNED INCOME TAX CREDIT

The current law Earned Income Tax Credit is reformed. The current law rate is retained, but the maximum amount is essentially doubled.

LOW INCOME FAMILIES FREED FROM USA AND FICA TAX

The family living allowance combined with a refundable payroll tax credit would free the lowest income families from both USA tax and employee payroll taxes.

Those not exempt would pay USA tax on the remainder--his or her "taxable income." The marginal rate of taxation is progressive and increases with taxable income.

These are but a few of the features of our new individual tax system.

THE USA BUSINESS TAX

The USA business tax is a flat tax on all businesses including corporations, partnerships, sole proprietorships and other forms of business organization. The base is very broad so that the rate can be quite low.

THE EXPENSING DEDUCTION

The business tax includes an unlimited deduction for capital investment--unrestricted expensing. The expensing deduction allows a business to recover capital before being taxed. Small firms favor expensing for several reasons: it is simple, it helps cash flow and it encourages capital formation. Expensing allows businesses to escape the complexity associated with calculating and tracking the depreciation schedules for every piece of equipment. Expensing is good for all businesses, but it is particularly attractive to small businesses because it helps them with the day-to-day cash flow problems that they face. It allows them to deduct more up front --putting resources back in the hands of the entrepreneur faster

instead of keeping it in the hands of the federal government.

Expensing facilitates firms who need working capital, as well as the entrepreneur who wants to expand his business through the purchase of an important piece of productivity-enhancing equipment. Finally, expensing is good for the economy. If businesses are allowed to write-off their investments in the year they are purchased, businesses are much more likely to make such investments, thereby, increasing jobs and economic growth.

Now let me briefly describe how the USA Business Tax would work:

First, the business would add up its receipts from sales of goods and services made during the year, excluding sales of American-made products to foreign markets. The business would deduct the costs of purchases from other businesses: the cost of plant and equipment (equivalent to expensing), parts, components, and contracted services.

After subtracting purchases from U.S. sales, the remainder is "gross profit," or the tax base to which the business tax rate is applied. Out of "gross profit" the business must pay the business tax, wages and salaries to workers, and dividends and interest to shareholders and debtholders.

FICA CREDIT REPLACES WAGE DEDUCTION TO ACHIEVE BORDER ADJUSTABILITY

The business would also continue to pay its share of Social Security payroll taxes on its wage and salary distributions, and those taxes would be deposited in the Social Security trust funds just as they are now. The business would, however, receive a credit against the business tax for the amount it pays in employer payroll taxes. Our system replaces the wage and salary deduction with the payroll tax credit in order to make our exports more competitive by achieving border adjustability which may of our trading partners already enjoy. The Employer Payroll credit would neutralize the payroll tax' adverse impact on job creation. The integrity of the social security trust fund is protected.

BORDER ADJUSTABILITY ACHIEVED/IMPORT TAX ACHIEVES PARITY FOR ALL GOODS COMPETING IN U.S. MARKET

To complete the "border adjustment" for import/export parity and fairness, an import tax equal to the business tax would be imposed on the production of goods and services outside the U.S. that are sold in the U.S. Through the import tax, any company (regardless of whether it is U.S.- or foreign-owned) located on foreign soil that manufactures goods to be sold in the U.S. market would be taxed essentially the same as if the factory were located in the U.S.

DIFFERENT RULES FOR FINANCIAL INTERMEDIARIES

There are different rules for banks, for insurance companies, for financial pass-thru entities and other businesses engaged in financial intermediation, for international transportation services and international communications.

BUSINESS TAX RATE

The Business USA Tax rate is modeled to be a flat 11.5 percent. And remember, total business taxes collected would be the same as today, but collected in a greatly simplified and more efficient way.

GENERAL DESIGN ASSUMPTIONS

As we started to design the Unlimited Savings Allowance Tax Act (USA) we made certain general assumptions:

* Raise as much revenue as the current code; corporations and businesses would continue to shoulder the same share of the total revenue burden as under current law.

* Retain current code progressivity so that people as a group would pay no more, no less in taxes. The top 20 percent of taxpayers would still pay the same percentage of taxes as they currently pay. The bottom 20 percent would still pay the same percent of the individual USA taxes.

* Replace the anti-savings and investment incentives in the current income tax code with a system that defers savings from taxation.

* Create a system under which:

1. wages, if saved and interest earned from those savings would be deferred from taxation until spent.
2. dividends received and saved would be deferred from taxation until the proceeds are spent;
3. tax on capital gains could be indefinitely deferred as long as the proceeds are rolled over in to other qualified savings and investment assets.
4. there would be no bias in favor of either debt or equity financing.
5. the export competitiveness of the United States would be enhanced by providing border adjustability on terms meeting the requirements of the General Agreement on Tariffs and Trade.
6. expensing of capital costs would replace other cost recovery systems.
7. dividends would be taxed only at the corporate level if the recipient reinvests or otherwise saves the dividend proceeds.

With a new tax code, America's rate of corporate investment in new plant, equipment and technology can be improved and increased--reversing a dangerous trend in the opposite direction.

We hope we will achieve simplicity by eliminating at least three-quarters of the tax code.

Our current code is primarily a wealth redistribution system. Recent tax policy debates quickly degenerate into class warfare shouting matches. Our proposed system is a wealth creation system for all Americans.

A central focus of your hearings is what is the best tax base, or said another way: whether it is better to tax income that is earned or income that is spent. We believe the better system is the latter. Our tax is more neutral than the income tax

in its treatment of present versus future consumption. It is neutral regarding the choice of saving or spending. It would be easier to administer than the income tax. Our tax base can be measured more accurately and simply than an income tax base.

Our tax system would avoid the basic inequity that arises depending upon how savings are accumulated and managed. It would eliminate the need to determine when "realization" and taxation occur. There would be no need for the nonrecognition rules. Our system eliminates the lock-in effect, the potential bunching of gains, and the need for a distinction between capital gains and ordinary income. Under our system amounts invested in productive assets are immediately deductible, making capital recovery deductions unnecessary. As a result, there would be no need to guesstimate decreases in value due to wear, tear, and obsolescence of assets and there would be no need to continue current law recording keeping. Because inflation is often dealt with on an ad hoc basis in the current code and has been used as a justification for accelerated capital recovery deductions, preferential capital gains rates and other special provisions in the income tax system those provisions and their accompanying complications would not be necessary under our system. The mismeasurement of real net worth changes that takes place under the current code because of inflation would not be factor under our system .

There would be no:

Alternative minimum tax.
Foreign tax credit calculations requiring supercomputers.
Heavy-weight tax returns weighing pounds.

REASONS FOR ABOLISHING THE CURRENT CODE

We want to abolish the current income tax system and replace it with the USA tax system because the federal income tax code is unamerican in spirit and wrong in principle. It levies a double tax on dividends and taxes savings, it discourages risk-taking, entrepreneurship and the creation of jobs. It is hostile to savings and investment and tilted toward consumption. It favors debt over equity financing. It encourages corporate management to neglect long-term investment in favor of focusing on short term profits.

Our current code is far too complex. Companies complain about IRS agents being permanently housed in their corporate headquarters and that the IRS is years behind in their auditing. Others perversely brag about needing supercomputers to calculate certain foreign tax credit computations.

Our current code penalizes savings by taxing income first when it is earned and again if that income is saved and earns interest or dividends. When an activity is penalized in the tax code, it influences behavior. Taxpayers do less of those disfavored activities. And the current code is doing a good job of discouraging saving. Americans are only saving about 2.8 percent of GDP.

This lack of saving leads to a shortage of investment, which, in turn, leads to insufficient growth, stagnating incomes, and the loss of high-wage jobs.

S. 722 IS THE STARTING POINT

We took the approach that the tax base in our bill should be as broad as possible. Since we introduced the legislation, we have been contacted by various groups who where included in the base broadening initiative of our bill. It will not surprise you that each group is eager to retain the favorable treatment they receive under the current code. We urge the tax writing committees to carefully evaluate each of these base broadening provisions. You are the experts, and are in the best position to determine which provisions would make sense in this new tax universe should you choose to create it.

Thank you , Mr. Chairman.

Updated May 11, 1995

OVERVIEW OF THE DOMENICI/NUNN TAX PROPOSAL
THE UNLIMITED SAVINGS ALLOWANCE (USA) TAX
S. 722

This complete reform of the income tax system removes the bias of the current tax system against savings and investment. The USA tax maintains the current progressive nature of the individual tax code, makes U.S. products more competitive in world markets, and maintains the same split in total tax burdens between businesses and individuals.

The Individual Tax	The Business Tax
A progressive, 3-bracket individual tax that allows a full deduction for income that is saved rather than consumed.	**A flat-rate tax applying to both corporate and noncorporate business that allows an immediate deduction for capital investment and new inventory.**

Features of the Business Tax

The business adds up its receipts from sales of goods and services made during the year, excluding sales of American-made products to foreign markets.

The business deducts the costs of purchases from other businesses: the cost of plant and equipment (equivalent to expensing), parts, components, and contracted services such as accounting, engineering, legal and transportation services.

After subtracting purchases from U.S. sales, the remainder is "gross profit," or the tax base to which the business tax rate is applied. The business tax rate would be imposed at a flat rate of 11.5 percent.

To complete the "border adjustment" for fairness, an import tax equal to the business tax would be imposed on the production of goods and services outside the U.S. that are sold in the U.S.. Through the import tax, any company (regardless of whether it is U.S.- or foreign-owned) located on foreign soil that manufactures goods to be sold in the U.S. market would be taxed essentially the same as if the factory were located in the U.S..

Out of "gross profit" the business must pay the business tax, wages and salaries to workers, and dividends and interest to shareholders and debtholders. The business would also continue to pay its share of payroll taxes on wage and salary distributions. The Domenici/Nunn business tax proposal therefore allows the business to take a credit against the business tax for the amount it paid in employer payroll taxes.

Features of the Individual (USA) Tax
To figure his or her tax, the individual subtracts total new savings from total income, and pays tax on the remainder. A standard deduction, personal exemptions and an EITC are allowed as under current law, and together are known as the "family living allowance." For a family of four, the "family living allowance" would be close to $17,600.
Individuals' total income includes wages, salaries, interest, dividends, earnings withdrawn from unincorporated businesses, proceeds from asset sales, rents, royalties, annuities, withdrawals from savings accounts and other similar cash inflows. During a transition period, some consumption from savings acquired prior to enactment of Domenici/Nunn would be excluded.
Individuals total up their income, then deduct any amount of income that is saved. Amounts deducted as savings include net increases in bank accounts, purchases of financial assets, other investment purchases, including homes, and life and casualty insurance payments.
The USA Tax allows charitable contributions, mortgage interest, large out-of-pocket medical expenses and to be deducted from income.
Retains current law treatment of mortgage interest.
Low and middle income workers are allowed a credit against the individual USA Tax for employee payroll taxes paid during the year. This way, the family living allowance combined with a refundable payroll tax credit would free the lowest income families from both income and employee payroll taxes.
The marginal rate of taxation, as under current law, is progressive and increases with consumed income. The brackets are designed so that the richest 20% of families continue to pay their current share of federal taxes, and the poorest 20% continue to pay their share of federal taxes. After allowing for the "family living allowance," the approximate consumed income brackets are: 8 percent, 19 percent, 40 percent.

USA INDIVIDUAL TAX

1. GROSS INCOME	Wages, salaries, interest and dividends and income from sale of stocks and other assets. If it is included in gross income under current law it is included in gross income under USA Tax.
2. VALUE OF FRINGE BENEFITS	Counted as part of Gross Income.
MINUS	
3. PERSONAL EXEMPTIONS	$2,550 for taxpayer, spouse and each dependent.
4. FAMILY LIVING ALLOWANCE	$4,400 single $7,400 joint return $5,400 head of household
4a. AMOUNT OF GROSS INCOME EXEMPT FROM TAXATION FOR FAMILY OF 4	$17,600 Total comprised of: $7,400 family living allowance and 4 $2,550 exemptions

4b. AMOUNT OF INCOME EXEMPT FOR SINGLE INDIVIDUAL	$ 6,950 Total comprised of $4,400 family living allowance and one $2,550 exemption
4c. AMOUNT EXEMPT FOR HEAD OF HOUSEHOLD WITH 3 CHILDREN	$13,050 Total comprised of $ 5,400 family living allowance and 3 $2,550 exemptions
5. UNLIMITED SAVINGS ALLOWANCE	Taxpayers can deduct any amount of new savings or investment. One investment can be sold and another purchased without incurring USA Tax liability--unrestricted rollover. Tax is deferred on income saved or invested until income is spent.
6. MORTGAGE DEDUCTION	Same as current law.
7. PHILANTHROPIC DEDUCTION	Same as current law.

8. POSTSECONDARY EDUCATION DEDUCTION	$2,000 per person for the taxpayer, a spouse and up to two dependents capped at $8,000 per year.
9. ALIMONY PAID DEDUCTION	Same as current law.
10. PREVIOUSLY ACQUIRED ASSET ADJUSTMENT	A retiree living on previously taxed savings accumulated prior to the USA Tax can spend that savings without paying USA Tax. (This is fair because it has already been taxed under the old federal income tax system). This rule applies to anyone with assets acquired with after-tax dollars prior to enactment of USA Tax.
11. TREATMENT OF BORROWING	Borrowing is not included in gross income. Repayments are not counted as qualified savings. This makes the tax a consumed income tax (income minus savings) and not an expenditure tax.

12. CAPITAL GAINS	Determining factor is use of proceeds. If proceeds are reinvested the tax on the gain is zero.
13. TREATMENT OF RENTAL PROPERTIES	Treated as a business Purchase expensed instead of depreciated. Income taxed at 11 percent business rate.
14. TREATMENT OF TAX EXEMPT BOND INCOME	Same as current law.
15. TREATMENT OF SOCIAL SECURITY INCOME	Same as current law except that amounts saved are eligible for unlimited savings allowance deduction.
16. TREATMENT OF GIFTS	Not a taxable event for USA tax purposes. Beneficiary takes same basis in the gift as the person making the gift. If recipient spends the gift it would be included in his/her taxable income.

ADJUSTED GROSS INCOME	
Minus	
17. EMPLOYEE PAID PAYROLL AND HEALTH INSURANCE TAX CREDIT	Both Social Security and Medicare portion of the payroll tax are eligible for the tax credit.
18. EARNED INCOME TAX CREDIT	Credit is doubled but eliminated for wage earners without children.
Equals	
TAXABLE INCOME	
Multiplied by	
USA TAX RATES after transition (beginning in year 2000)	8 percent 19 percent 40 percent
COMBINED USA TAX AND PAYROLL TAX RATES (beginning in year 2000).	.35 percent 11.35 percent 32.35 percent

CHANGE IN COMBINED USA and PAYROLL TAX BURDEN BY VARIOUS INCOME GROUPS after transition (beginning in year 2000).	People with taxable income of : 0 to $10,000: Combined USA and payroll tax burden decreased by 75% $10,000-$20,000 decreased by 9% $20,000-$30,000 decreased by 14% $30,000-$50,000 decreased by 5% $50,000-$75,000 decreased by 0 $75,000-100,000 decreased by 0 $100,000-$200,000 increased by 3% Over $200,000 increased by 4%

Mr. CHRISTENSEN [presiding]. Thank you, Senator Domenici. I have a couple of questions, and then I will let my colleagues address you.

First of all, I want to thank you for your leadership on this issue. It has been fun being on this Committee and listening to the various proposals that have been outlined. One of the things that we are trying to do is look at a system that will provide efficiency and equity, simplicity, and administration that gets away from the 14,000-plus pages of our current Code.

You stated that you currently have no bias in favor of debt or equity in the Nunn-Domenici plan. So that would apply in the municipal bond market. How would that affect that area?

Senator NUNN. The municipal bond market? The reason why we don't have any basic distinction between equity and debt is because neither is deductible in the business tax we have. They are placed on the same level playingfield.

Today, of course, interest is deductible and dividends are not. They are both on the same playingfield. So it neutralizes it in that way.

As far as the municipal bond market, that is a very good question. We wrestled with that one long and hard, and we basically came to the conclusion that municipal bonds had to continue to be given a preference. The way they are given a preference on our proposal is, since you can save and put money into a savings account and get the same kind of exclusion or deferral as you do today when you buy a municipal bond, in terms of interest, that would be level. But when you bring in that municipal income from a municipal bond or a State bond, you basically can consume that without being taxed on it.

So the preference is there as it is today. It is less of a preference, in all fairness, than it is today, because you can put money in the savings account or you can put money in a stock and defer income on it because it is investment—or defer income tax on it. So the preference remains, but it is not quite as significant a preference over other forms of saving as we have today.

Mr. CHRISTENSEN. OK.

Congressman Herger.

Mr. HERGER. Thank you, Mr. Chairman. I thank both of our Senators for being here. Your contribution—if there is one thing we hear as we go around to our townhall meetings in our districts is that people are universally unhappy with the system that we have now. It seems like every time we talk about simplifying it, at least in the years past, has made—that has merely meant that we made it more complex.

Senator Domenici, if you can tell me, compared to our current tax system, how much easier would it be to comply with your new U.S.A. tax proposal?

Senator DOMENICI. I can only give you what we have collectively assessed.

On the business side, it is about as big a simplification as you are going to get. I mean, the business side is truly simple. We actually believe it will be a revolution in terms of how corporations and businesses keep their books, how many records they have to keep;

and at the same time, there will be a bias toward investing rather than a bias against investing by the businesses.

On the individual side, we estimate that it is about 75 percent simpler than what we have now. How do I estimate that? I merely look at how many pages we get rid of and we get rid of about 75 percent of the Code pages, or more.

If there is some tax bill that this Committee, in the best interests of America, could pass that is as simple as the notion of a flat tax then we will admit to you the U.S.A. tax is not that simple. But we aren't here to criticize other plans, merely to say that a flat tax can't be flat; there will have to be some other things added and some appendages put on, and everybody knows that.

We opted for progressivity, because as my cohort, Senator Nunn said, we want—we think there is a certain fairness to progressivity, and so we built it in. In fact, wherever we could make things more progressive, we did, even on the FICA tax as you have heard us explain. We tried to get rid of its lack of progressivity by building a tax credit into the total tax base here.

Mr. HERGER. Also, in the area of the small businesses, I guess businesses in general, how would your payroll tax credit work? For employees that you have, as you pay them, how would that work?

Senator NUNN. The basic tax we anticipate at the business level for small business, every level of business, would be about 11 percent. And remember also the goods coming in would be taxed at 11 percent. So we broadened the tax base rather significantly.

We bring in an import tax—not in a discriminatory way; we think it is GATT-compliant—and therefore we have a much lower business tax rate than today. If you paid 11 percent on your business tax and then whatever your payroll is, you would take the payroll and you would take the full $60,000 where the cutoff is on FICA and Medicare and Social Security, you would then apply the 7.65 percent to that and that would be a complete tax credit against the 11 percent. So it is not a deduction, it is a credit back.

If your tax were $100,000 and you are multiplying 7 point—whatever the percent is, 5 or 7, I forget the exact number—times your payroll up to $60,000, then you would—if it was $50,000, you would credit that $50,000 against the $100,000 in tax otherwise owed.

Senator DOMENICI. So, Representative Herger, what we are doing now is, we have the experts that put this together, modeling different scenarios, because we have heard from businesses that are highly professional and they all are highly paid professionals and they want to know whether this approach, as compared with deducting all of the salary, turns out to be reasonably fair to them or not. We can't tell you that in every case it is. But you understand, we don't deduct total payroll; we give a tax credit for the FICA tax against business income, as defined. That is our approach. And we think we have to do that for border adjustability reasons, to comply with GATT. And we think there are a lot of benefits from it, and this will be looked at carefully, I am sure, by various committees.

Senator NUNN. Some of our friends in Europe and Japan may raise the issue of whether it is GATT-compliant, and I think the answer to that is rather simple. Isn't that what you do in your

value-added tax? You basically do not charge value-added tax on your businesses' products going abroad. You do tax us coming in. We are trying to level the playingfield. It is not discriminatory; we are trying to level the playingfield.

But the reason we could not have a wage deduction in that and also accomplish that competitiveness purpose, which we think is a very big purpose, is because we do not believe if you deducted wages it would be GATT-compliant.

Mr. HERGER. Thank you.

Senator NUNN. I think everyone needs to recognize when we say "not deducting wages," that is—at first sight is frightening, but you have to compare the percent. We are down to about an 11 percent rate. So the percent is much, much lower and you have the FICA credit back. So it is a different picture when you start looking at it in that light.

Mr. CHRISTENSEN. Mr. Levin.

Mr. LEVIN. Thank you very much, Mr. Chairman, and welcome to our two, to put it mildly, very distinguished colleagues. You know, we have talked about at least three standards here—simplicity, efficiency, including the savings rate, and fairness—and I think your proposal is—embodies an effort to touch, if not cover, all three. And I am not sure that some of the others make as serious an effort. But let me ask you a few questions within that spirit, and I mean it that way, and then a general question.

For example, health insurance payments by employers. How does that figure? Reading your testimony in the Joint Tax Committee analysis I can't quite tell whether health insurance payments today, which are now deductible, would continue to be.

Senator NUNN. They would not be deductible. The main exemptions today that we retain would be home interest, the mortgage deduction which we preserve, current law, and charitable, and then some of your low-income safety net proposals. But on health insurance, it would not be deductible and it would be includable.

We think that at first glance some people will not like that, but we think it is essential in order to have the rates get down, and we also think it would be part of health care reform in a way. We are not trying to do that, but it would, because it would make people think about the kind of plan they were going to have.

And third, it would add an element of progressivity because normally the people with the highest health benefits are those in the highest income brackets.

Mr. LEVIN. I think, if I might say so, that is an example of an issue that needs to be seriously considered. I think many people, though not all, would admit that if we had had that kind of a system 30 years ago without that kind of deductibility, that probably a large number of middle-income families, truly middle-income families that today have health coverage would not.

Senator NUNN. If you had had the savings account deduction over the years along with that, it would make an enormous difference, because people are going to be able to save. They also are going to be able, in our proposal, to deduct $2,000 for the cost of education. So you have to look at the offset. You have to be—you have to look at the opportunity people have.

Any of these deductions, though, that are currently available that we would eliminate could be added back. It would simply require higher rates. That is the tradeoff. The same thing under the flat tax.

I am not sure how Dick Armey's proposal handled the health insurance. I would imagine, though, to get his rates down, he is going to have to abolish virtually every deduction. It is a real tradeoff here. Any can be added back as a matter of policy; you just have to adjust the rates accordingly.

Senator DOMENICI. Representative Levin, I think that one has to look at the tax brackets and how much we have lowered the brackets for low/middle income and low income; and obviously, if we start putting more things off the table, so to speak, those rates go up.

Mr. LEVIN. Sure.

Senator DOMENICI. And frankly, we are trying to make it simple, and we have three progressive rates—we started with two, but we thought three was more fair—and that is part of the overall scheme.

Mr. LEVIN. All right. But take the typical family. I was going to talk about real estate taxes, but let me forget that for a moment.

Take the typical family, two or three kids, middle income, and you have a several tiered system, but the emphasis is on savings. Now, they have kids; the $2,000 a year education credit, or whatever it would be, doesn't go very far toward meeting those needs.

So this family that isn't able to save much over the years—it isn't easy—it is possible their rates would go up under your proposal. I mean, somebody's rates have to go up if other rates go down, right, if you receive the same amount in the Treasury; and I think yours is revenue neutral.

Senator NUNN. That is right.

Mr. LEVIN. So what assurance for middle-income families is there for those with several children, two or three kids, that this isn't going to hit them hard? Remember, what, 50 percent of the families kind of live, if not week to week, month to month. To——

Senator NUNN. I would say, Congressman Levin, I think that that is a very important question.

First of all, I would say that we think that the FICA credit back will really be a tax break for literally millions of people.

The second point I would make, our low-income brackets and low/middle-income brackets actually—by all tax measurements we have been able to have, their taxes go down.

The third point, we would retain the home mortgage and charitable deduction.

The fourth point, it is almost impossible for the kind of family you talked about to save money today because they have to pay taxes before, and it is the aftertax income that they save. In our proposal, it is before-tax income that they save, an enormous difference in their ability to save.

And finally, I would say we designed our system so that in each bracket, you are right, when taxes go down for somebody, they have to go up for others to be revenue neutral, or the economic pie has to grow. The more the economic pie grows—we think ours will

have enormous growth in the economic pie, but we don't claim that in terms of our scoring.

We tried to design our system so that within the present brackets, generally speaking—I am not saying it is absolutely precise—that within each bracket there would be about the same amount of income as coming in today. Obviously, those who save more will pay less taxes; those who save less will pay more taxes. But I would say to those who save less, they usually are—like me, they are borrowing money. The interest rates are going to be lower in this country than they would otherwise be, because our savings pool is going to go up. So even for borrowers who save less money and pay, thereby, more tax under our proposal, they are going to pay less interest, and I would think that over a period of time the economic pie is going to grow and our jobs are going to be better and they are going to make more income. So I would say, even for people under our proposal who actually pay some slightly more tax, I believe they are going to be net beneficiaries because the economic pie is going to grow and they are going to pay less for their borrowing, whether it is on an automobile or a house or a washing machine or whatever they would otherwise do, because our savings pool is bound to go up under this proposal.

Mr. LEVIN. Thank you.

Thank you, Mr. Chairman.

Senator DOMENICI. Could I also comment?

We went to great lengths in the modeling of this tax proposal to use the quintiles which are commonly used on the distributional tables prepared by the Joint Tax Committee. Each 20 percent current structure will pay essentially about the same amount that they paid before. So that the adjustments within each quintile will be for those who save or don't save. But essentially, each 20 percent of the current tax total will still yield about the same amount. So the top end will still yield its, the bottom end will yield its—it is a small amount, but it will yield the same; and some might want to change that as you move through this process. We just used that—and that is a partial answer to your question.

Mr. LEVIN. My time is up, and I appreciate the indulgence of the Chair.

You have some material, because I think it is an interesting proposal, but we really need to—and I know you agree, to think of it in terms of the impact on the people who pay the taxes. And any material that you have that would show the impact on middle-income families on the third and fourth quintiles, for example, by the number of dependents or the ability to save, the likely expenses for education.

I don't think either of you want a proposal that helps—in order to help savings, squeezes families, especially with several children, for whom savings isn't so easy, though it would be helpful if they would save more. So any material you have on that I would love to see.

[The information was not received at the time of printing.]

Senator NUNN. We have a number of examples, and we really thought as we were developing this right along the same line you are thinking now. We do not claim perfection. We do not claim that

this proposal can't be improved. We welcome constructive improvements in it. But that is exactly the kind of questions we asked.

We spent about 2 years doing this, and a lot of the second year was addressing this question that you have just posed and addressing the very difficult question that Senator Domenici has already alluded to; and that is, when you go to more of a consumption tax, what do you do about old savings? That is a tough question.

We believe we have a transition here that takes care of that problem as well as it can be taken care of for 90 percent of the people. The other people will have a little bit more complexity, the other 10 percent, but for the people who have net savings of $50,000 or less in financial, we think we have handled that.

Now, what you will face if you go to a sales tax or a value-added tax, let's take a couple that have $100,000 that they have saved. That is their life savings. They are now 70 years old or 75 and they want to spend that. They have to spend that. When you take a 17 to 20 percent sales tax, you have just grabbed $17,000 to $20,000 of that $100,000 right out of their pocket. And you are basically taxing old savings twice.

Now, that comes into play bigtime with a value-added or a sales tax, as it would in ours, but we think we have handled that. We let people who have $50,000 or less write off that $50,000 by claiming new savings over a 3-year period. That takes care of 90 percent of the savings in the country.

Mr. CHRISTENSEN. The gentleman's time has expired.

Mr. Ramstad.

Mr. RAMSTAD. Thank you, Mr. Chairman. Distinguished Senators, I want to thank you for your leadership on fiscal issues generally, and certainly no two Members of either body have done more to point out the savings crisis—and I use that term advisedly, as I am sure you would concur—that we have in this country. I think it is alarming that when you think of the G–7 nations, we have such an abysmally low savings rate, rating a distant seventh with our trading partners.

Professor Feldstein did a study not long ago, I am sure you are familiar, saying if we converted all of—everything in terms of plant and equipment into savings, we couldn't—or savings, rather, into plant and equipment, into capital formation—we couldn't sustain any long-term economic growth. So I applaud your leadership certainly in that area.

Let me ask you a question specifically on your testimony, your proposal here today. I think we all know that the current tax system penalizes savings, as you have pointed out, through double and triple taxation and certainly discourages work and entrepreneurship. Any time you have marginal rates in excess of 50 percent, you can get no other result.

Tomorrow we are going to hear from proponents of the flat tax proposal. Doesn't the flat tax proposal in a more simple and direct way really also eliminate the double taxation of income derived from savings that you are trying to accomplish, thereby providing the same incentives to increase savings?

Senator NUNN. I would say that the flat tax has many similarities with our proposal. I think that—a lot of things in common, I believe that those who are proposing the flat tax are striv-

ing for more savings and for more investment and more simplicity. I believe that is the advantage that our proposal has over the flat tax, although I am saying I identify with almost every proposal as an alternative to what we have now, so I don't want to say that I am negative on other proposals vis-a-vis the current Tax Code. But comparing it to ours, we are revenue neutral, first of all, and I think any tax in this fiscal environment is going to have to be revenue neutral. I think the flat tax hasn't yet met that challenge.

The second thing is, I believe our proposal does much more on the competitiveness feature, putting businesses on the same level, because of what I have already explained in terms of goods sold in this country, and goods sold from other countries in this country would have the same tax.

The third thing, I think we have—the FICA credit is a big change in the current position. I think it is a much bigger improvement. Perhaps a flat tax could incorporate that change. It doesn't necessarily preclude that.

And finally, I think ours is much fairer than a flat tax. Just as Congressman Levin mentioned a few minutes ago, if somebody's rate goes down from 50 to 25 percent and you are going to be revenue neutral, somewhere, somebody else's rate has got to go up. Now, where is that going to be? As I understand the flat tax, it basically takes care of people at low-income levels by having a much bigger exclusion, but still, somebody has got to make up that revenue.

Now, where that will come from I think is probably—I haven't analyzed it and others would have to—it is probably going to have to come from people in middle income who now have a deduction on mortgage interest and also a charitable deduction. I think they are going to have to end up paying more, but that would be subject to someone else's scrutiny.

So those would be the big differences in terms of where I see our proposal having an advantage, but the flat tax would have—under the current reference, it would have some advantage on simplicity. It is more simple than ours because it has not dealt with some of these challenges that I think eventually it will have to deal with.

Mr. RAMSTAD. I am glad to hear you say, Senator Nunn, that either is preferable to the current structure and the current system. And certainly conceptually I like what you are saying and I support what you are saying. I also like the flat tax. But both look certainly superior to the situation we currently have.

My last question in the remaining seconds I have, when you look at value-added tax on businesses, aren't we really talking about a sales tax, because won't this in effect be passed on to consumers?

Senator NUNN. On the business tax?

Mr. RAMSTAD. Right.

Senator NUNN. That is a very good question, and our tax panel coming up next can talk about that incidence of taxation. I don't pretend to know how you basically allocate business tax. Some people say it falls on wage earners, some people say it falls on consumers, some people say it falls on profit, and it depends on the model that the Joint Economic Committee uses. That is a raging and technical debate.

But certainly any tax at a business level has to—businesses are not people, generally, but somebody has to pay it. It is either the stockholders pay it through less dividends or the consumer pays it through higher prices, or the wage earner pays it through lower wages. Somebody has to pay a business tax.

Senator DOMENICI. I would say obviously you could solve the problem and answer your question unequivocally if you had no business tax. There is plenty of thinking based on sound economics and tax policy that you don't necessarily—shouldn't necessarily have to have a business tax. We understood that and we went all the way through that in our thinking, but we thought in passing a new Tax Code you would probably have to have a business tax.

We went with a flat one, made it much broader because we taxed what people—what companies outside America bring in. That is, they are as if they were located in Savannah, Ga., or Albuquerque, N. Mex., as to what they import. And in addition, it seems that we could not find an easy way, such as not paying any tax on dividends, which some would have; and maybe the flat tax has that.

We don't think ultimately the people are going to support a system that taxes people on what they earn for working, but doesn't tax dividends they get. So we have something in between that we think works pretty well.

Senator NUNN. I think one of the big features in ours that is very important and Senator Domenici just referred to is, really, we get very close to treating all of the income alike, municipal bonds being one exception.

But we have had this raging debate ever since I have been here. We walk up the hill on capital gains and we walk back down. It goes back and forth and back and forth, and it is always a rich versus average income argument. But I would like for the first time to say to someone who had a $100 capital gain, fine, if you reinvest it; it keeps the money working for all of our citizens. Then it is tax deferred. But if you go out and get yourselves—if you have a party or you basically buy consumer items, you will pay the same tax that the wage earner pays.

We say the same thing to the wage earner. If you are making $45,000 a year and you save $5,000, you deduct the $5,000. So it puts both capital income and wage income on the same level. I think that would be an enormously important breakthrough in terms of both fairness and understanding and encouraging reinvestment.

The one other thing I would say is that there will be a complaint from some that wealthy income people can save more than others. There is no doubt about that. But as long as wealthy income people in America keep their capital working for the good of all of us, then fine. It is when they put it in the consumption stream and use it for themselves—nothing wrong with that, but at that stage, they ought to pay taxes on it. So that is the theory.

We are not trying to tax people that make a big income as long as their money is working for the whole good of the country. And when they are putting it in plants and equipment and savings accounts that we can all borrow, it is. So that is the philosophy behind it.

Mr. RAMSTAD. Thank you both for your bipartisan, pragmatic work in this area.

Thank you, Mr. Chairman.

Mr. CHRISTENSEN. Ms. Dunn.

Ms. DUNN. Thank you, Mr. Chairman. And I too have enjoyed your discussion of this tax program that you have proposed. We have been hearing a lot about it at home and here and there for the last—actually since about 2 years ago. So I have been eager to hear your explanation of it and will look forward to reading it in detail.

During the conversations we have had with folks in the last day and a half, we have heard about different types of replacement taxes, including the consumption-based tax and where your proposal has touched in a favorable way on all of the items that are of concern to me that I have heard back from the folks in my district, what I don't see mentioned here—and it may be, Senator Nunn, because I missed your explanation since we had a vote—I am wondering what your thoughts are on the underground economy.

Is this a problem that simply cannot be solved, or do you find that your proposal is more effective in getting your arms around this problem?

Senator NUNN. That is a very good question. I was hoping I wouldn't have to make any concessions to alternatives today, but on this one I have to make a concession, and that is, we do not get to the underground economy in our proposal. I kept thinking, how can we do it, and I can't think of where you can do it at the income tax level. I think that is the advantage that value-added tax or sales tax would have over our proposal.

There are a whole lot of disadvantages that they would have, including greatly increasing the cost of living, including the fairness challenge; the more you try to make it fair, the higher the rates are going to go. All of those things come into play.

But on the underground economy, I think you have to go to something like a sales tax or a consumption tax to really get at that.

Senator DOMENICI. Representative Dunn, I concur wholeheartedly, but I would have a caveat obviously. In going after the underground economy, I think we all have to be careful as to what kind of tax law we write for everybody else.

Senator NUNN. The other thing I would add is, I don't—although we don't get at the underground economy, that is, the taxes that are avoided altogether, I do think we dramatically reduce the search for loopholes, because there is a loophole that is available to everybody. Just put your money in a savings account. It is up front, you don't have to go paying a lawyer or an accountant or anyone else to tell you how you basically defer taxes. You don't avoid them, but you defer them. You put it in a savings account or a stock or a bond.

Ms. DUNN. I think that when we talk about incentives, there is an incentive in the current Tax Code to create an underground economy, so I think that is really going to have to be the effect we look for.

You have been sensitive in how you address senior citizens, and I appreciate that, because this is a big problem for them when they have gone through their income-earning years and have paid the penalty and now have—many of them have been self-reliant and responsible and set aside funding, but they are on fixed incomes and would be hit terribly hard by any kind of a national sales tax.

I also appreciate your keeping in the tax policy the incentive for home ownership, because I believe that is terribly important, and I think we really—we really have to pay attention to what our Tax Code is doing in terms of encouraging certain types of behavior here.

So—and the border adjustment, I like that very much too. I think that is just great, and I think you have been very good on that.

So I look forward to this, and thanks very much——

Senator NUNN. It sounds like to me you have already done your homework on this proposal. I am amazed.

Ms. DUNN. Thank you.

Senator DOMENICI. The last time I worked with you, Representative Dunn, was on the reform package, and I just want to say, if you spend as much of your good effort on this, you will come up with some good things, because I was very pleased to have an opportunity to work with you on that.

Ms. DUNN. Thank you.

Mr. CHRISTENSEN. Mr. Payne.

Mr. PAYNE. Thank you very much, Mr. Chairman. And welcome and thanks very much, Senator Nunn and Senator Domenici. I too want to commend you for the leadership role that you are playing in terms of fiscal responsibility, in terms of economic development and competitiveness, and I too appreciate your testimony and appreciate what you have done.

Earlier today Les Samuels was here from the Treasury Department and he was commenting on various proposals. He had a lot of good things to say about your proposal, but he went on to say he had some concerns about complexity and specifically mentioned that your proposal would require some new calculations. In effect, you would have to calculate a personal balance sheet. Because of the fact that as long as your money was in either a savings pool or an investment pool it wouldn't be taxed, but if it should come out, then it would be; there would have to be some way to know when it was coming in and out.

Also, you spoke about the fact that there would be an attempt over 3 years to look at old savings, and so there would have to be some way to identify what old savings were and how then each year you would show what might have been used out of old savings versus other sources. How would you respond to that? I don't know what these calculations are, but do you think they are onerous? Do you think this is something that would make it more difficult for the taxpayer?

Senator DOMENICI. Well, I will take the old savings and Senator Nunn will take the other part. Actually I believe almost any proposal that you are going to be considering has a real problem for senior citizens with a pool of old savings, savings acquired with aftertax dollars under an old system. Because we all know, they

have already paid tax on that and now we are trying to figure out a way to tax income completely different, and so you have their savings that they are going to start spending, and you have got to work on trying to alleviate that double taxation.

We think if you admit that to be a problem and acknowledge it, we think our experts have come up with as good a way as you can come up with. There will be some recordkeeping, but obviously if you are trying to make that transition in a 5-year period, I would assume what we propose would be welcome compared to what might happen under some proposal where they would have to pay 20 percent of every dollar they take out of there and spend or 23 or 18 percent.

Sam, do you want to take the other part?

Senator NUNN. Yes, I think by the time people get through examining a sales tax or consumption tax that is more probably from one point of view more simple, they will be screaming for some complexity, that is, what do we do with old savings. They will be demanding one complex alleviation of that burden on old savings.

On the question of balance sheet, we don't think it would take a balance sheet approach for 90 percent of the American taxpayers. You basically—let's assume, for instance, and this is pretty close in concept of what we do—let's assume you had an IRA account, and you basically said you could take any amount of money and put it in an IRA every year and you would basically keep up with how much you deposited and you would keep up with how much you were withdrawing.

For 90 percent of the American people, it is going to be that simple, and whoever is handling your IRA would give you a sheet at the end of the year, you would have net deposits, net withdrawals, and the calculation would be what you actually net in terms of increased savings or what your decreased savings, which would be consumption, so it would be that simple for most people.

Obviously, people having more financial transactions would have a more complex account of calculations because they have to keep up with it but they already have to keep up with it. They have to keep up with it now for capital gains purposes, they have to keep up with it for any kind of basis on any kind of investment, so we don't think it adds complexity, we think that basically it is rather simple to do for most people.

But we do, and this is important, we do have a different approach than what we had on the IRAs. We are talking about net savings. We are not talking about simply shifting from one bank account to another, we are talking about net savings. So, basically, if you have a net withdrawal from savings, that is deemed consumption.

Mr. PAYNE. Let me shift gears just a minute. Another thing Les Samuels said was that Treasury didn't think, given the research that had been done by various economists, that there were any of these tax proposals that could be guaranteed to increase savings, no matter what they were, and he mentioned the OECD economist and what had happened in other countries and so forth.

How do you feel about that?

Senator NUNN. I think that, analytically, in terms of us being able to show you analytically that this is going to increase savings,

that he is right. We don't have an analytical study doing that. You would have to have a system in order to be able to do that, but in terms of common sense, if you get to deduct your savings, I think just good old common horse sense tells you we are going to increase savings in this country.

Senator DOMENICI. I agree. There is no empirical way we can present to this Committee that the U.S.A. tax system will increase savings 10 percent. However, if you think of it, think about families, you know, who are making family budget decisions, wouldn't they—aren't they apt to say, well, this year I think we should save $5,000 instead of spending it, especially since we deduct it from our income. If we spend it we pay taxes, if we save it we don't. And by saving we will have a better future.

I think it is going to change American attitudes in due course and that will result in higher savings rates and more investment in stock. It doesn't have to be a savings account. I think all of that turns out on the plus side for America's future.

Mr. PAYNE. I agree, and I commend you both very much for coming up with such an innovative plan.

Senator NUNN. Thank you, Mr. Payne. We appreciate it.

Mr. PAYNE. Thank you.

Mr. CHRISTENSEN. Mr. Collins.

Mr. COLLINS. Thank you, Mr. Chairman.

I noticed in your schedule of the different taxes in the back, Mr. Domenici, I do not see anything on estate tax, so I am assuming that estate tax will be eliminated or abolished?

Senator DOMENICI. We left current estate tax laws on the books. We didn't raise it, change it, we just left it as it is.

Senator NUNN. We didn't address that. We figured that is somebody else's, we are going to leave that up to the wisdom of the Ways and Means and Finance Committees.

Mr. COLLINS. But the estate tax, though, those are assets that have already been tax paid; is that not true?

Senator NUNN. It taxes previously taxed items, that is right. Now, it is important in our proposal to understand that, let's say, an individual bought a stock and that stock had gone from a value of $100 to $1,000, and it was passed on in the estate, we don't change the estate tax, depending on the bracket, they would still pay the estate tax. If the heirs kept the investment in that stock, though, there would still be no tax on income tax.

Mr. COLLINS. How about a farm that exceeds the $600,000 or the $750,000 limit that we set in place, how would you treat that? Say the estate was worth $1.5 million based on the value of the farm but no cash in the estate.

Senator NUNN. If we keep the same system we have today, I favor increasing that exemption on estate tax. I think the House bill that has passed does that, and if Senator Domenici can assure us he has found the revenue to pay for that, or the spending cuts to pay for it, then I think there will be a lot of support for adding it to the $1.2 trillion that he is already hunting for or found.

Mr. COLLINS. We figure he will be able to find some somewhere, he is good at that. How about the earned income tax credit? That is a refundable credit today that has created a lot of problems for the IRS, especially in the area of fraud and abuse. I notice you are

doubling the credit. What do you anticipate being the results based on the current situation with the IRS and the fraud?

Senator DOMENICI. Well, frankly, this was another part of our struggle to see if we could create fairness in lower income groups of working people, people that were earning some money. We are fully aware that the current EITC is subject to fraud. In theory and in numbers, we think something like this would work very well for lower income groups to assure more fairness.

We started this out this way, Representative Collins. We knew that by proposing a tax system that taxes income spent rather than income earned, people would say: "how about those who don't have enough money left over at the end of the month, who cannot save, and therefore this plan doesn't help them." We wanted to prove to the American people and the taxwriters that we have a program that is not going to make it more difficult for those who don't have enough to save, and the EITC expansion was one effort to build into our new tax base an assurance that that would occur. That is the best way I can explain it to you.

Senator NUNN. I think whether this proposal goes into law or not, that fraud in the earned income tax credit has got to be addressed. We did not pretend to solve that problem, but we do believe that the fairness element here is absolutely essential for low-income working people.

Mr. COLLINS. The FICA refundable credit, it is refundable according to the statement. Will this again add another situation similar to the EITC or possibly add another area of fraud?

Senator DOMENICI. I wouldn't think so. As you probably know, the earned income tax credit is not based on any records as authentic as payroll tax and the FICA tax. Those will come right off, everybody prepares them, everybody has them, they are turned in regularly, and it will come right off those. Now, ingenious tax cheaters can use any system and they may be using FICA today to cheat, but essentially we think that is pretty authentic and authenticatable.

Mr. COLLINS. I was thinking more in the area of the independent contractor whose bottom line may be very small, and the 11 percent, very small, sure enough, and you have a large credit based on FICA, that could exceed what his bottom line was before taxation, you are opening yourself up again for possible fraud.

Senator DOMENICI. It is possible.

Senator NUNN. Remember one thing on this one, it would be money already paid in under our present deduction system, so it would be money paid in and they would be asking for money back.

Mr. COLLINS. But they could get back beyond what they paid in?

Senator NUNN. I think it is possible under any system to cheat, and that would certainly not be exempt in ours. That possibility is there.

Mr. COLLINS. Well, I too commend both of you for your work. I think you put together a package that has a lot of merit to it, makes a lot of sense. We thank each of you.

Senator NUNN. Thank you very much.

Senator DOMENICI. Thank you.

Mr. CHRISTENSEN. Mr. Ensign.

Mr. ENSIGN. Thank you, Mr. Chairman.

I talked earlier to the administration, and got to the issue of fairness because I think that that is an issue within our Tax Code that we need to address as a fundamental issue. Where does our definition for fairness come because that word is bantered about quite a bit, progressive taxes seem to be more fair than flat taxes and you have attempted to make this a fair tax system.

So, first of all, what is your definition of fairness and where do you come up with it?

Senator NUNN. I guess the ultimate definition is the perception of the American people. And I think this proposal will depend on whether the American people believe that it is fair to everyone for savings to be deferred, for savings not to be taxed, and that depends on whether we can convince people that when even wealthy people save and defer tax, that it helps everybody, it helps us all, the economic pie grows, the less interest paid by people who have to borrow, I think it will depend in terms of this proposal on whether people who are borrowers and don't believe they are going to be able to save even when they get savings deductions before they pay taxes believe that it is in their benefit for the economic pie to grow, the savings pool increase, all of us pay less interest rates. So, on these features, I think those are the big elements of fairness that I think this proposal has to be weighed against.

What we didn't want to do was do something in this proposal that made the system on its face an unfair system, and we did everything we could to avoid that by the earned income tax credit, by the FICA credit, by the progressive rates and so forth. So it is a matter of perception in the eyes of the taxpayers, but if you are going to have a fundamental reform, I think people have to be convinced that the system is not tilted in favor of the rich and against the working and middle-income people.

Mr. ENSIGN. Well, you know, I think that when we are addressing the question of fairness, the reason that I think it is such an important issue is because if 90 percent of the people benefit by something and 10 percent are hurt by it, those 90 percent can perceive that as fair. When we start getting to definitions based on perception, the administration's definition today was based on ability to pay.

And, you know, in that case, somebody who makes seven figures a year could afford to pay a 90 percent tax rate much better than somebody could pay a 10 percent tax rate making $20,000 a year, so I think we have to be very careful.

While I like your proposal, I like a lot of the aspects of your proposal, I just have a lot of problems with progressive taxes, progressive tax rates in that we still get to the fact that we penalize people that work harder than other people, not all the time, sometimes people get lucky or whatever. But the bottom line is that most people that make more money than other people work a lot harder than everybody else, that has been my experience in the workplace.

And it gets back to the old analogy, if you have two farmers and one works twice as hard and produces more crop than the other one, should the farmer that works twice as hard be taxed at a higher rate or should they both be taxed at the same percentage? That is where I think we get into penalizing instead of rewarding effort.

Senator DOMENICI. Well, let me say, while I tend to agree with my partner, Senator Nunn, on perception, I would not agree that the basic premise of fairness is based on perception because I would have thought of the same concern that you raised, but you must be assured that these two Senators are staunch believers in a capitalistic system of government.

We didn't go to this trouble because we were for taxing people more than they ought to pay or for taxing people at a marginal rate which would knock out drive and enthusiasm and effort, quite to the contrary. But we also understand that the American people would be very leery of a Tax Code that permitted people who were making a lot of money each year, part earned and part unearned, to get by without paying any taxes or paying the same percentage as somebody making $22,000.

Mr. ENSIGN. That is because we have allowed that. That is because we have allowed that in the public debates. When the 16th amendment was adopted, nobody thought that. This is something that we have allowed to develop, and we are perpetuating it.

Senator DOMENICI. I would agree that we have allowed it, but I think so long as you don't go with your marginal rates to the point where you are truly having an adverse effect on the things that you obviously are concerned about, the farmer that works harder than somebody else, so long as you are not having an adverse effect on that, and I think that might be measurable, marginal rates, when they get to a certain level, are probably negative in a quantitative and quantifiable way, and we don't think we are at that level. We are not up in that 70 and 80 percent which we had at one point which just pushed Americans into loopholes seeking tax shelters in order to convince people we were being fair.

We think this is, in concept, fair, and unless one believes that every dollar earned and unearned that goes to a citizen should be taxed at the same percent regardless of how much they earn each year, which maybe you believe, and you are entitled to it, it might be as fair as ours, we are not quite there, but, otherwise, we think we are pretty much for a system where capitalism will flourish, people will save to make the system work better, and have a little more control over how much tax they pay.

Mr. ENSIGN. Thank you very much for my time, Mr. Chairman.

Just one last quick comment, and that is, politically, you guys are probably more realistic. Just ideologically, I would just oppose the progressivity of what you have done but, politically, it is a lot better and, even from an ideological standpoint, it is a lot better than the current system. Thanks.

Senator NUNN. I would say there is a pretty good test of fairness, whether it is perception or some other definition, in whether you can get a proposal that is sweeping tax reform through the U.S. Congress, that is a test, it is a democratic test of both perceptions or whatever one might say it takes a lot of convincing.

But I would ask you to remember one thing, Mr. Ensign, that marginal rates in our proposal are fundamentally different than marginal rates today, not just amount of money, whether it is 40 percent or 30 or 35 or 25, you have marginal rates that are applied after you have deducted your savings and investment. That is a major difference in the current Tax Code.

Mr. CHRISTENSEN. Mr. Neal.

Mr. NEAL. Thank you. Thank you, Mr. Chairman, and thank our two panelists for a thoughtful analysis.

I guess one of the jobs that we have in the governmental system is to draw the distinction between what is fair and what is favorable, and that indeed is not an easy responsibility because those who find themselves outside of the argument will typically say we have been treated unfairly when oftentimes they mean we have been treated unfavorably.

I also might say that I want to thank you for your comments about the earned income tax credit today because I think that there has been an effort in some quarters to kind of demagog that issue when there seems to be considerable empirical data that supports what the earned income tax credit set out to do. This morning, Congressman Cox offered kind of a thoughtful analysis, again, of tax policy in the country. Also, Chairman Archer spoke of a fairly compelling statistic, and I thought you two fellows might want to comment on it.

Mr. Cox talked about, increasingly, the IRS is seen as the opponent of the American people, and then Chairman Archer suggested that there are up to 40 million people in any given year who will have a problem with the IRS. That is a fairly chilling statistic if you consider there are about 260 million people in the country. He did not suggest that all those problems were adversarial, but there appears to me to be the growing perception, if we want to use that word, that the IRS indeed is overreaching, and I think, in some measure, that is what is driving this tax debate.

Perhaps you two gentlemen would want to comment on that.

Senator DOMENICI. Well, I was kind of surprised. I conducted in my State a series of meetings with small business people. I used it to form an advocacy group and I went to 7 cities and talked to about 800, maybe 1,000 small business people in a conference mode where they actually sat down and talked about their problems. And before we were finished, they told us which agencies of the Federal Government were most adversarial and most considered to be their enemy instead of one to work with them, and I would not have thought that the number one was the IRS, but it was. Number two was OSHA, number three was EPA, the latter two in some order, second or third. There is no question.

Oh, let me give you another one. I talked to a major American corporation that said that the IRS year after year was in their office for 9 months out of the 12, and they went to Japan and talked to their counterparts, somebody about equally as big with a similar amount of workers and the factories and that in Japan they audited them in 3 weeks with a similar sized team. So obviously something is very wrong.

On the business side the current Code is utter complexity of the amount of records you have got to keep and subjective determinations. Taxpayers are constantly being put to the test by the auditors. That has to be fixed, and I think our bill meets that test. When you look at the corporate side, I think we have done that.

On the individual side, you have got to have less and less interpretations. We are very hopeful that we got rid of a lot of the Tax Code that is subject to interpretation. We can't claim that it is the

most simple ever and will eliminate IRS. You can't just say we don't need them anymore, but we think a lot of CPAs and lawyers will be out of work if this Code is adopted.

Senator NUNN. We hope.

Mr. NEAL. Thank you.

Mr. CHRISTENSEN. Thank you.

Mr. Johnson.

Mr. JOHNSON. Thank you, Mr. Chairman.

I would like to welcome you all and thank you for bringing this issue up because I have heard a lot of good comments about how thoughtful the process has been, and I agree with you on the IRS.

As a matter of fact, they not only send whole teams in, but they make companies provide office space for long periods of time, which is an expense that shouldn't be, and it is too much government, and I think you both agree with that.

Senator NUNN. I certainly do, though I wouldn't defend them for 1 minute, but I would say we need to keep in mind two things: We have given the IRS the Code they are enforcing, as the Congress has done that.

Mr. JOHNSON. That is true. The fault lies everywhere.

Senator NUNN. That is right. And we have given them the $200 billion deficit, and somebody over there in Treasury keeps telling them they need more money, and that basic premise is probably correct.

Mr. JOHNSON. The U.S.A. tax, as I understand it, would disallow current deductions for wages and benefits and, therefore, increase the cost of doing business for companies that have a relatively large number of employees and a relatively small investment in plant and equipment. And, you know, the problem is masked by the fact that these proposals lower the corporate tax rate and provide some relief from current payroll taxes.

The lower rate, the payroll tax relief that we see doesn't necessarily offset the effect of the loss of deductibility of wages and benefits, and that is due, I think, in part to an effort to increase the value of deductions from investments in plant and equipment, while keeping your proposals revenue neutral.

In a revenue neutral proposal, which is confined to tax issues, the only way to reduce taxes for one sector of the economy is to increase taxes on another sector. In this case, the proposals result in double taxation of wages, sort of. I am wondering what the effect of this proposal would be on deductions for wages and benefits and would there be any net increase in the cost of labor.

Senator DOMENICI. Let me try my hand on it. Certainly it is a fundamental question that we must answer every time we appear. First of all, I don't think you were here, Representative Johnson, when we discussed the fact that we have a proposal which is border adjustable. Therefore, it meets GATT. We believe that if we have a business tax system where wages would be deductible we would not have a GATT-legal cleared Code to help exports by allowing the tax on exports to be reported.

So we went with two or three concepts that we think make up for the problem, but it is being modeled now, most of the companies we modeled, it came out all right, even if they were service industries. What we are now hearing from a few who are highly profes-

sional with very few investments and high paid and we are running those through, but when you get a tax credit for FICA, that is a credit that is against a very low corporate tax. The tax is somewhere around 11 percent and you get to deduct all of the—not deduct it, you get a full credit for it.

When you add all of those things together, we thought the benefits, overall, were on the side of the country and were not going to discriminate against businesses.

Now, when you put something like this together, even though there are a lot of resources and wonderful people putting it together, we cannot sit here and tell you as you proceed with hearings you won't find some companies that are going to be able to show you their balance sheets and say it won't quite work, but we start with the proposition that for most American businesses and for many, many small businesses it is going to work very, very well.

Mr. JOHNSON. Thank you, sir.

Senator NUNN. If I could just add to that, Mr. Johnson, I think that as you think about this proposal, you are probably going to hear from companies that have a very large number of people that make over $60,000, the excess over $60,000 would not get the credit back because that is where it would cut off on FICA.

Those companies would tend to be service companies that don't have much in the way of investment in terms of depreciation because they wouldn't be investing much. I think that they will probably be able to show that their business tax will go up, but on the same hand, this has got to be viewed as a whole proposal. And those people are high-income people by definition, those people who work there. So if you look at their individual opportunity for savings and investment, it is going to be substantially more than people who make $60,000 or less.

Mr. JOHNSON. It will be an individual benefit.

Senator NUNN. So the individuals in those companies are going to tend to benefit. When companies come in and focus on nothing but the business tax and don't think about the opportunities, their people will have——

Mr. JOHNSON. I agree with you. Thank you for your answer. I appreciate it. I appreciate you all being here.

Mr. CHRISTENSEN. Mr. McCrery.

Mr. MCCRERY. Thank you, Mr. Chairman.

I want to congratulate both of you on your proposal. Senator Breaux and I introduced a very similar bill 2 or 3 years ago, at least on the individual tax side. Although we did not have it scored by Joint Tax, the initial reaction of the staff from Joint Tax was that by offering this unlimited savings exemption you would have a big hole, a big revenue hole in the short term at least.

Can you explain to me what you have been told by Joint Tax or anybody else as to what the effect of this is going to be in the short term and how you are getting it scored?

Senator NUNN. This is a very interesting question. And there is a real paradox there because, if you claim increased savings coming out of this, you will be probably accused by Joint Tax of dynamic scoring, because if savings really go up and we lose revenue in the short run, the first 3 or 4 years, the economic pie is going to grow

by most economic definitions and we are going to gain huge amounts of revenue over a 10-year period.

That would be the tempting way to show this proposal, would basically be a revenue gainer over 10 years, loser in the first 4 or 5 years because more savings, economic pie grows because more investment, therefore, it grows, then you can lower your rates, so as tempting as it is to do that, because I think that probably is what may happen, it would be said to be dynamic scoring which we know has its own criticisms, so we did not do that.

We used basically the model as best we could, we had experts model our proposal in terms of revenue loss, guessing what they think the Joint Tax Committee may do, and the next panel, I think Rudy Penner can address that in some detail, but we don't know yet how the Joint Tax Committee is going to score this, but if they show revenue losses in the first 3 or 4 years under this, by almost a consensus economic definition, that means revenue gains over a longer period of time.

Senator DOMENICI. Joint Tax Committee is not going to do that. That is way too much dynamics for them. They won't do that, and essentially we think it is going to work much better than IRAs in the past.

We also want to share this with you because, if you recall, there are still two schools of thought about IRAs and did it really increase the net savings pool or not. But part of that argument centers around the fact that you didn't have to have a net increase in savings. Remember when we started, that you could have a bank account and you could just determine that part of that was your IRA and the net effect on the savings pool of the country was zero, net increase. That is not the case here.

At a point in time when this becomes law, you will be talking about net, net savings, and we think that will have a big positive effect. But Senator Nunn is right, if it is as positive as we think, then it is positive on the other side, too.

Mr. MCCRERY. Well, thank you. I can't speak for Senator Breaux, but I can certainly say I appreciate what you have done with our proposal, and we look forward to working with you on it.

Senator NUNN. Thank you for your leadership. You and Senator Breaux helped pave the way on this. We appreciate it.

Mr. CHRISTENSEN. Mr. Hancock.

Mr. HANCOCK. Just a quick question.

Frankly, I haven't heard any of the panels address the question of abolishing the current income tax system, in fact, changing the income tax system or just getting rid of an income tax system completely. As you are well aware, there are an awful lot of States that basically have piggybacked their income tax onto the Federal tax.

What would be, or, in your judgment, have you had an opportunity to look at what the impact would be to those States that are in that position?

Senator NUNN. I would have to say that I don't know about Senator Domenici; I have not. That is a challenge for us that lies in front of us. We have not done that, and it is an important question.

Senator DOMENICI. I think we can ask our technical people, but my own conclusion would be that since we have not changed the percentile, the bottom 20 contributes about the same as they do

now. And right up the percentile, probably there is not going to be a very significant change if the States continue to piggyback on it, but our experts have looked at it because I recall them saying it sometime, but I don't remember it precisely.

Mr. HANCOCK. One of the things I would like to possibly suggest, and that is, I am very much in favor of, quite frankly, the repeal of the 16th amendment, the total abolishment of the income tax. If in fact we would advise people that probably would result in the abolishment of their State income tax, it might generate some support to get it done up here.

Thank you very much.

Senator NUNN. Thank you.

Mr. CHRISTENSEN. I thank the panel, and I would like to call up the fourth panel.

Senator NUNN. Thank you, Mr. Chairman. Also, if you would thank Chairman Archer and Mr. Gibbons for both of us for holding these hearings.

Mr. CHRISTENSEN. Thank you for your leadership. Around here we call it the Archer rule of common sense on the fact that this would allow more savings in this country, and appreciate your leadership on this issue.

Senator DOMENICI. Thank you very much.

Mr. CHRISTENSEN. Ernest Christian, Hon. Murray Weidenbaum, Rudolph Penner, and Barry Rogstad, our fourth and final panel of the day.

The oral testimony will be limited to 5 minutes. A red light will come on when the 5-minute timer is up. Your full written statement will be entered into the record.

Dr. Penner, would you please start.

Mr. CHRISTIAN. I think we have agreed among ourselves that I would start first.

Mr. CHRISTENSEN. Whoever would like to start first.

STATEMENT OF ERNEST S. CHRISTIAN, APPEARING ON HIS OWN BEHALF, FORMER TAX LEGISLATIVE COUNSEL AND DEPUTY ASSISTANT SECRETARY FOR TAX POLICY, U.S. DEPARTMENT OF THE TREASURY

Mr. CHRISTIAN. Mr. Chairman, Members of the Committee, I have appeared before this Committee, as some of you may know, on many occasions for the last 25 years, but never with as much enthusiasm and conviction as I have today.

The U.S.A. tax proposal by Senator Domenici and Senator Nunn is a true landmark in the development of tax policy in the United States. It shows that you can accomplish revolutionary change in the American tax system. It also points the way to do it. A full deduction for personal savings, allow wage earners a full credit for the payroll tax, full expensing of business capital equipment, exclude exports from tax while taxing imports, simplify the tax law, make it less wasteful, less intrusive, easier to understand, and easier to apply. That is all achieved.

You can do this without either raising taxes or increasing the deficit. You have choices. You are not forced to diminish progressivity. You can retain deductions for charitable contributions and home mortgage interest. You can add for investment in human cap-

ital. You have the choice to accomplish all of this within the framework of a tax on people's income, in this case, consumed income.

The U.S.A. tax does not stop at a theoretical stage. S. 722 contains a fully articulated new American tax system that would actually work. It is a successful exercise in the art of using the fewest and simplest elements to achieve the greatest effect. Its hallmark is neutrality, not regulation. It concentrates on fairness by removing barriers to individual choice, barriers to economic growth, barriers to greater personal independence and responsibility.

We will all still file tax returns. Tax returns remind us each year of how much tax we pay for what government spends. U.S.A. tax returns will also remind us that we, too, have a choice to spend or to save. Simply put, the U.S.A. tax levels the playingfield. Families will have a choice to save without tax penalty. Families will have a choice to invest in their children's future. All income is taxed alike and taxed at the same progressive rate.

All businesses are taxed alike at the same flat rate. All businesses can invest in new plant and equipment without a tax penalty. All American workers, all American companies can compete in global markets. Given a fair chance, they will win.

Foreign companies that compete in our markets will pay their fair share of the tax burden in this country the same as we do.

The U.S.A. tax is built from the ground up around a set of principles that are derived solely from the way that income is actually created, received, and used. Every dollar of income is created at the business level by people who do the work and people who provide the capital out of their savings. When a dollar of income is created by the production of goods and services, the first part of the total U.S.A. tax is collected from the business, unless the business reinvests the income to produce additional goods and services, additional dollars of income for us all.

When the reinvestment ends and additional dollars of income net of the tax paid at the business level flow out to individuals as compensation for work or for the use of their capital, the second part of the U.S.A. tax is collected from them unless they, too, choose to put the income back into the national savings pool where it will again be reinvested to produce additional goods and services, dollars of income for us all.

The U.S.A. tax taxes income when withdrawn from the national savings pool and spent but only if that income has not been taxed when earned. For example, a retiree who withdraws and spends aftertax savings accumulated under present law would not be taxed. Further, the U.S.A. tax only taxes income. For example, a student who borrowed money and spent it to live on would not be taxed. Borrowings are not income.

In conclusion, Mr. Chairman, the U.S.A. tax is not the only route to revolutionary change and improvement. There are other worthy alternatives. None of them are perfect. The U.S.A. tax is not perfect, either. You can improve it, as Senator Nunn said, as Senator Domenici said. The U.S.A. tax is, however, a great place to start.

That concludes my statement, Mr. Chairman, and thank you.

[The prepared statement follows:]

STATEMENT OF ERNEST S. CHRISTIAN

Appearing on Own Behalf and as Former Tax Legislative Counsel and Deputy Assistant Secretary (Tax Policy) of the Treasury Department

BEFORE THE COMMITTEE ON WAYS AND MEANS
U. S. HOUSE OF REPRESENTATIVES

JUNE 7, 1995

RE: S. 722, THE USA TAX ACT OF 1995

Introduction to USA Tax

Over the last 25 years I have on many occasions appeared before this Committee but never with as much enthusiasm and conviction as today. The USA Tax proposal by Senators Domenici and Nunn is a landmark achievement in the on-going development of tax policy and design. It shows how you can accomplish revolutionary change in the American tax system. You can allow a full deduction for personal savings. You can allow wage earners a full tax credit for the FICA payroll tax on their wages. You can allow full expensing of business capital investment. You can exclude exports from tax while taxing imports. You can simplify the tax law, thereby making it less wasteful and less intrusive. You can do all this and more within the framework of a tax on income -- in this case, *consumed* income. You can do it without either raising taxes or increasing the deficit and without diminishing progressivity unless you choose to do so.

The USA Tax does not stop at the theoretical stage. S. 722 confronts the hard questions of reality and contains a fully articulated, fully functional new American tax system that would actually work in our complex economy and society. Yet, it is a true and successful exercise in minimalism.

> *The art of using the fewest and simplest elements to achieve the greatest effect.*

Its hallmark is neutrality, not regulation. The USA Tax is expressly designed not to interfere in the economic lives of Americans to any material extent beyond the amount of tax they pay. It concentrates on removing barriers to individual choice and barriers to economic growth. These are the keys to greater personal independence and responsibility. These are the keys to a higher standard of living which is the true measure of fairness.

The USA Tax is a completely new replacement tax. It is built from the ground up around a set of principles derived solely from the way income is actually created, received and used. Every dollar of income is created *at* the business level *by* the people who do the work and the people who provide the capital out of their savings.

When a dollar of income is created through the production of goods and services, the first part of the total USA Tax is collected from the business -- unless that income is reinvested to produce additional goods, services and income for us all. In that case, the business tax is deferred and is collected later when reinvestment ends. At that point, assuming a successful reinvestment, additional dollars of income will have been created and a greater amount of tax will be collected.

When the same dollars of income, net of the tax paid at the business level, flow out to and are received by individuals as compensation for work or as compensation for the use of capital, the second part of the USA Tax is collected from them -- unless they choose to put the income back into the national savings pool where it will again be reinvested to produce additional goods, services and income for us all. In that case, the individual tax is deferred and is collected later when income is withdrawn from savings and spent. Only at that point have people actually

"received" income for their own use and enjoyment and only at that point is the individual part of the USA Tax collected.

Although the USA Tax collects tax at points, it also splits the tax rate into two parts. The total tax is the same as if (i) individuals were allowed a tax credit for the business tax or (ii) there were no business tax and all tax was paid by individuals. This is illustrated below where in all three cases the desire is to collect $28 of tax on $100 of income created.

> USA Tax Split Rate: $100 of income × 11% business tax rate = $11 tax; $89 income received by individual × 19% individual tax rate = $17 tax. Total tax of $28 collected.
>
> Credit For Business Tax: $100 income × 11% business tax rate = $11 tax; $100 "grossed up" income received by individual × 28% individual tax rate = $28 gross tax less $11 credit = $17 tax. Total tax of $28 collected.
>
> Individual-Only Tax: $100 income received by individual × 28% individual tax rate = $28 total tax collected.

The USA Tax Removes the Tax Bias against Saving and Allows All Americans a Fair Choice. For individuals, the USA Tax is a simple tax on income minus the amount saved -- like a fully deductible IRA but without special governmental restrictions or accounts. For example, the Jones Family earns a combined salary of $48,000 and saves $5,000 which they use to start their own small business. They deduct $5,000 and pay tax only on the amount by which $43,000 exceeds their other deductions and exemptions. Having deferred tax on $5,000 of salary, if the Joneses later withdraw $5,000 from the business (and from the national savings pool), they will pay tax on the $5,000 of deferred salary at that time -- unless they roll it over into a stock, bond, a CD or any one of the many other choices people can make both when they initially save and when they move savings from one investment to another. So long as earnings are deferred and remain in the national savings pool, the tax continues to be deferred. Not only is the USA Tax neutral in an economic sense -- in the choice to save -- it also gives people full control over their savings. The USA Tax also does not tell people how much or how little they can save or for what purpose. Saving is not limited in amount or restricted to retirement uses.

The USA Tax is also even-handed in its definition of income. Interest, dividends and gains are treated the same as wages and salaries. All are included in income -- less the amount saved -- and are taxed under the same rate schedule.

The USA Tax Simplifies the Tax Law, Thereby Reducing the Presently High Cost of Compliance and Administration. The proposed new income tax code in S. 722 is much smaller in size than the present monstrosity and will be much easier to apply. It consists primarily of straightforward, understandable rules of universal application with few exceptions. For a tax statute, and given the complexities of the economy in which it must operate, the USA Tax is written in plain English.

The USA Tax retains deductions for charitable contributions and home mortgage interest, and allows a new deduction for education costs but these are not the source of any significant amount of complexity. For example, the home mortgage interest deduction involves no more than transferring onto a tax return a single number furnished annually to the homeowner by the mortgage lender. The USA Tax uses progressive tax rates in a three-bracket system, but the use of one, two or three rates has no material effect on complexity one way or the other.

Under the USA Tax, people will still have to file tax returns. In that respect, paying taxes will still involve some paperwork and computation, although much less than today. We might all wish to be totally relieved of that burden, just as we all might wish to be excused from paying taxes altogether. On balance, however, the annual process of Americans filing simple tax returns is a net positive. It reinforces in our minds an acute awareness of how much tax we pay for what government spends.

The USA Tax Allows Wage Earners a Full Tax Credit for the Employee-Paid 7.65% FICA Payroll Tax, Thereby Assuring That the Real Marginal Rate on Wage Income Is No Longer Higher Than on Dividends, Interest and Other Financial Income. Because of this credit, the nominal rates under the USA Tax are *inclusive* of the payroll tax and are, therefore, the real marginal rates on both wage income and financial income. In contrast, the rates under present law are in *addition* to the payroll tax. For example, a middle bracket rate of 31% under present law is 31% on dividends, but the real marginal rate in the same bracket is 38.65% on wage income up to the OASDI wage base.

Another Way of Looking at the Payroll Tax Credit Is to Say That the Stated Rates under the USA Tax Are Lower Than They Appear To Be. In the first year, on a joint return, the USA Tax rates in S. 722 are 19%, 27% and 40%, and after a transition period are 8%, 19% and 40%. From the perspective of most wage income, another way of looking at the rates under the USA Tax is to reduce each bracket rate by 7.65 percentage points. Viewed that way, the rates under the USA Tax on wage income up to the OASDI wage base are as follows.

First Year (Joint Return)	Fifth Year (Joint Return)
11.35%	1%
19.35%	11.35%
32.35%	32.35%

The USA Tax Removes the Bias against Business Capital Investment and Levels the International Playing Field. In the business area, the USA Tax also concentrates on eliminating arbitrary distinctions and removing barriers to productivity and growth. All businesses are taxed alike without regard to size, corporate or noncorporate form of organization, or whether financed by debt or equity capital. The business tax rate is a uniform 11%. Because the USA Tax allows all businesses a full credit for the employer-paid 7.65% FICA payroll tax, the uniform 11% rate is *inclusive* of the payroll tax. This 11% inclusive rate compares to a 35% present law corporate tax rate in addition to a 7.65% employer-paid payroll tax rate.

All businesses are allowed to expense the cost of plant and equipment, inventory and supplies. Having recovered these costs out of sales, the remaining "gross profit" is taxed at 11% before paying employees their share and before paying shareholders and debtholders their share. The result is a uniform 11% tax at the business level on returns to labor and returns to capital. Both are treated the same, just as they are under the individual tax.

The USA Tax achieves parity in the international arena, thereby giving American workers and companies a fair chance to compete and win in global markets. The USA Tax excludes export sales from the 11% business gross profit tax. It taxes imports at 11%. Thus, the more a U.S. company increases its exports to foreign markets, the less tax it will pay in proportion to total revenues and total gross profit. Conversely, the more foreign-based companies manufacture abroad and compete in the U.S. market, the more import tax they will pay. All businesses that compete in our markets will pay their proportionate share of the cost of government in this country.

The USA Tax Neither Increases Nor Decreases Total Revenues and Does Not Materially Alter the Distribution of the Total Tax Burden Either Between Businesses and Individuals or Among High, Middle and Low Income Groups. The USA Tax concentrates on restructuring the fundamental components of the tax system. Separating the *way* we tax ourselves from the *amount* we tax ourselves serves several purposes. First, it permits full and objective concentration on arriving at the best fundamental tax structure for the long-term best interests of America, unimpeded by other considerations that will vary over time as revenue needs change and as attitudes about progressive versus proportional taxation change. Second, it serves to demonstrate that such a tax structure can be created and that the fundamental goals of tax restructuring can be achieved even within the constraints of revenue and distributional neutrality.

For example, within these constraints, the USA Tax still allows a full deduction for personal savings, expenses business capital investment, excludes exports from tax, and greatly simplifies the tax law.

If the constraints of revenue and distributional neutrality were to be relaxed, the rates of tax could be lowered and compressed -- even into a single rate, if the Congress desired. Similarly, the Congress could decide not to allow personal deductions for charitable contributions or home mortgage interest. The structure of the USA Tax would, however, remain the same and all the goals related to savings, business investment, exports and simplification would still be achieved. Rates of tax, the total revenues raised, etc. are important policy decisions, but they are extraneous to the highly salutary basic structure of the USA Tax which is designed to produce fundamentally correct and consistent results in all events.

It should be kept in mind that by historical standards, the USA Tax rates are already fairly "flat." There are only three bracket rates, the brackets are not very wide, and the top rate is only twice the bottom rate. The credit for employee-paid FICA tax, allowed by the USA Tax but not allowed by present law, plays a major role in maintaining distributional neutrality relative to present law.

USA Tax for Individuals -- Rates, Exemptions, Deductions and Basic Computations

The USA Tax has three brackets and three rates that increase as income increases. For illustration, the rate schedule for married persons filing jointly is set forth below.

Taxable Income Above	1996	1997	1998	1999	2000
$ 0	19.00%	15.00%	13.00%	10.00%	8.00%
5,400	27.00%	26.00%	25.00%	20.00%	19.00%
24,000	40.00%	40.00%	40.00%	40.00%	40.00%

Taxable Income equals Gross Income minus Exemptions and Deductions.

Gross Income = Wages and salaries plus financial income such as interest, dividends and amounts received from the sale of assets.

Exemptions = A Family Allowance:

..... $4,400 Single

..... $7,400 Married/Joint

..... $3,700 Married/Separate

..... $5,400 Head-of-Household

Personal and Dependents: $2,550 each for taxpayer, spouse and all dependents.

Deductions = The Unlimited Savings Allowance -- Everyone is allowed a full deduction for the amount of income they save. E.g., deposits in a savings account, purchase of a stock or bond, start-up capital contributed to one's own small business.

Higher Education Deduction -- The USA Tax allows a deduction for tuition paid for higher education. The deduction is limited to $2,000 per person for the taxpayer, a spouse and up to two dependents. The total deduction in a year is limited to $8,000. Higher education generally includes college and similar vocational education. The deduction is also allowed for remedial education of students under 18 years of age.

Home Mortgage Interest Deduction -- generally same as under present law.

Charitable Contribution Deduction -- generally same as under present law.

Alimony Paid Deduction -- same as under present law.

Tax Due equals (Taxable Income × Tax Rate) minus Credits.

Credits = A refundable credit for the employee-paid portion of the FICA payroll tax.

A refundable credit for the amount of withholding tax paid in advance.

A refundable credit for the amount of estimated tax paid in advance.

S. 722 also allows a refundable Earned Income Tax Credit, although the status of the EITC in general may be uncertain under House and Senate budget resolutions.

Because the deduction for income that is saved defers tax only for so long as that income is left in the national savings pool, taxable income for a year may include withdrawals from savings of income that had been deducted and deferred in a prior year. Further, in the year that prior-year savings is withdrawn, the same person may also have deposited some current-year income in savings. Thus, depending on whether the amount withdrawn exceeds the amount deposited or vice versa, the person may have "net withdrawal income" or a net savings deduction. For example, in 1996 (prior year), the Smith Family deferred tax on $1,000 of salary income by putting it in Savings Account A. In 1998 (current-year), the Smith Family deposits $500 of 1998 salary in Savings Account B, but withdraws $1,000 from Savings Account A. In 1998, the Smith Family has net withdrawal income of $500 ($1,000 withdrawn from Savings Account A less $500 deposited in Savings Account B). On the other hand, had the Smiths in 1998 deposited $1,000 in Savings Account B and withdrawn only $500 from Savings Account A, they would in

1998 have a net savings deduction of $500 ($1,000 deposited in Savings Account B minus $500 withdrawn from Savings Account A).

Because the USA Tax only taxes income (current-year plus prior-year income on which tax has been deferred), retirees and others will not have additional taxable income when they withdraw "old savings" that has already been taxed under present law. For example, before they retired in 1996 (first year of USA Tax), Mr. and Mrs. Brown had saved $100,000 out of after-tax income. Because they had been allowed no deduction (and had prepaid tax instead of being allowed to defer tax), they can during retirement withdraw the $100,000 without having to again pay tax on it. The USA Tax only taxes income *once,* not twice.

Also, because the USA Tax taxes income (not expenditures), borrowing does not result in tax even though the amount borrowed is "consumed." For example, James Jones borrows $7,000 to live on while in his last year of college. James will not pay tax because he has no 'income." However, when he graduates, gets a job and earns a salary, he will repay the loan out of income and get no deduction for the repayment. Thus, when James does have income, he will pay tax on the income that he had "consumed in advance" while in school.

It is under the USA Tax conceptually and in every other way correct not to include in income either borrowing or withdrawals of "old saving" that has already been taxed. It is, however, necessary to take these events into account in another way in a some circumstances. For example, in 1998 Mr. Executive earns $200,000, consumes $200,000, borrows $200,000, and buys Stock A for $200,000. The USA Tax would not allow him to claim a $200,000 savings deduction and pay zero tax on his $200,000 of earnings. *Reason*: Net of borrowing, Mr. Executive did not save anything. He did not add to the national savings pool. He only borrowed someone else's existing savings and shifted it into Stock A. Similarly, Mr. Executive could not withdraw $200,000 of his own "old savings" *and* at the same time, claim a deduction for $200,000 Stock A purportedly bought with his $200,000 current-year earnings. Again, he did not add anything to the national savings pool. He only shifted his savings to another investment.

This special netting rule for borrowing and old savings involves some amount of computation and complexity. Borrowing must be accounted for and old saving must be distinguished from new saving that has been deducted. In order to relieve nearly all taxpayers from the special netting rule, the USA Tax contains two simplifying rules. First, all home mortgage debt plus ordinary consumer debt up to $35,000 is excluded. Second, people with less than $50,000 of previously-taxed "old savings" can elect to deduct it over three years. Thus, nearly all taxpayers will be excluded from the special netting rule and will never be involved with it.

The three-year amortization deduction for $50,000 of old savings also provides an additional and substantial monetary benefit to retirees and others. The amortization deduction, in effect, gives back to them the present law tax that they prepaid on savings up to $50,000.

The USA Business Tax -- Rates, Deductions and Basic Calculation

Every business that is producing and selling goods and services, and, therefore, creating income, must file an annual business tax return and pay the 11% tax on its annual "gross profit" which is a defined term under the USA business tax. In calculating its gross profit tax base to which the 11% tax is applied, the business adds the amount it received from sales of goods and services and subtracts the amount it paid to other businesses for the goods and services it had to buy from them (plant, equipment, inventory, supplies, rent, utilities, telephones, fuel, legal and accounting fees, etc.). Excluded from the gross profit calculation are financial receipts and payments. For example, the business neither includes interest and dividends received nor deducts interest and dividends paid. Compensation payments to employees are not deductible. Amounts received from export sales of goods or services to a purchaser outside the United States are excluded from the calculation of gross profit. Correspondingly, an 11% import tax is imposed on the sale of goods and services into the United States from abroad. E.g., a foreign business that manufactures outside the United States but sells its products in the U.S. market will pay the import tax. A tax credit is allowed for the 7.65% employer FICA payroll tax that

businesses must pay on wages paid to employees. The USA business tax is territorial. Businesses will not include in gross profit the proceeds from sales made or services provided outside the United States and they will not subtract amounts paid for the purchase of goods or the provision of services outside the United States. Businesses will not be taxed on dividends paid by foreign subsidiaries. Foreign businesses will include in gross profit amounts received for goods sold or services provided in the United States and will subtract amounts paid for goods acquired and services provided in the United States.

Resisting Analogies -- The USA Tax Is *Sui Generis*

The USA Tax combines some elements that may also be found, variously, to some extent, and in different forms, in taxes said to be based on net cash flow, net income, consumed income or true business valued added, but because the USA Tax is a hybrid, none of those analogies is altogether accurate or especially illuminating.

Interesting and fairly accurate analogies could also be made to an amended, much improved and simplified version of present law. For example, the USA Tax on businesses has been analogized to a combination of the existing employer payroll tax and a low-rate version of the existing corporate income tax amended to provide for expensing of capital investment and amended to treat debt and equity the same. The USA Tax on individuals has also been analogized to a simple version of the existing individual income tax amended to allow an unlimited, unrestricted IRA deduction for income that is saved and that is taxed only when withdrawn from the IRA. But, here again, the attempt to translate the USA Tax into something else tends to obscure its own merits.

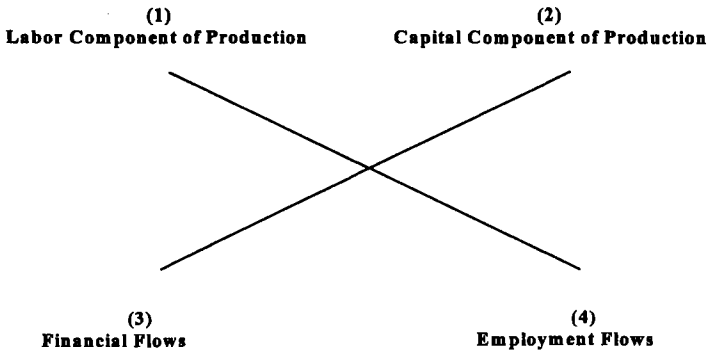
The USA Tax is best understood in terms of its own actual substance and its own consistently applied concepts -- not in terms of the tax system of the past that is being repealed and not in terms of some tax system that exists somewhere else or that is only generally described in academic literature.

Fundamental Concepts -- Understanding the USA Tax as an Integrated Whole

The USA Tax is an integrated, internally consistent whole that collects a single amount of tax in two parts and at two points in the economy. The first part is collected at the business level where income first arises from the production of goods and services and the second part is collected when the income (net of the tax collected at the business level) is received by individuals either as wages and salaries or as interest, dividends, gains, etc.

Because the rate of tax is also split into two parts, with one part applying to income when created and another part applying to income when received, the total amount of tax and the total rate of tax on a dollar of income is the same as if the total amount of tax had been collected solely at the business level or, in the alternative, solely at the individual level.

The USA Tax derives from the way the economy actually works -- from the way real goods and services are actually produced, from the fact that this productive process is the source of all income, and from the way that individuals actually receive that income either as employment flows (wages and salaries as compensation for work) or as financial flows (interest and dividends, etc. as compensation for the use of their capital and, ultimately, a return of that capital). When a tax is injected into the economic process by which income is created, it must be collected either at the point of production (businesses) or the point of receipt (individuals). If the tax is collected at the point of production, it must be based either on the labor component of production or the capital component of production, or both. If the tax is collected at the point of receipt, it must be based either on the employment flows to individuals, or the financial flows to individuals, or both. Therefore, this basic structure and operation of the economy dictates the structure of almost any tax -- whether it is called the USA Tax or, generically, "X."



A potential component of a tax base appears at each of the four endpoints marking the extremities of the two intersecting lines in the form of an "X," but there is, in a sense, some duplication. The Employments Flows (4) are a reappearance at the individual level of the Labor Component (1) at the business level, and (4) is equal in amount to (1) less any tax already collected out of (1) at the business level. Similarly, the Financial Flows (3) are a reappearance at the individual level of the Capital Component (2) at the business level, and (3) is equal in amount to (2) less any tax already collected out of (2) at the business level.

Within this rigid construct, there is flexibility in the design of a tax in choosing to impose tax at all or only on some of the four possible points, in choosing to impose tax at uniform or varied rates on one, more or all of the potential components of the tax base, and in choosing to specially define one, more or all of the potential components of the tax base. Even these choices are, however, not open-ended. Great care must be exercised in order to avoid inconsistent treatments of "likes" and similar anomalies that cause undesirable economic or political consequences. The administrative consequences of choices and combinations of choices must also be taken into account.

Setting aside matters such as the tax rates, and concentrating on fundamentals, there are four basic constructs that are highly pertinent to the origins and development of both the USA Tax as well as various alternatives.

Basic Construct X-1. Collect all tax at the business level based on the Labor Component (1) of production and the Capital Component (2) of production.

Basic Construct X-2. Collect all tax, in the same total amount, at the individual level based on the Financial Flows (3) and the Employment Flows (4).

Basic Construct X-3. Collect the same total amount of tax, but collect it in part at the business level and in part at the individual level as follows. Tax the Capital Component (2) at the business level and tax the Employment Flows (4) at the individual level.

Basic Construct X-4. The same as X-3 except that a partial tax at the business level is collected from both the Labor Component (1) and the Capital Component (2), and, at the individual level, the remainder of the tax is collected from both the Employment Flows (4) and the Financial Flows (3).

Basic Construct X-4 represents the USA Tax. The essential ingredients of a modified business cash flow tax or true tax on business value added (as distinguished from the VAT form of retail sales tax) can be found in Basic Construct X-1. Basic Construct X-2 contains the basic building blocks of a household-only cash flow tax. Basic Construct X-3 represents the Flat Tax.

Although less clearly and completely, a sales tax can also to some extent be fitted into and understood within this framework. Like X-2, a sales tax is also a household-only tax. Unlike X-2, however, the sales tax is not based on any direct measurement of total Employment Flows (4) and Financial Flows (3), but is instead based solely on item-by-item purchases. Therefore, it involves no tax return by a household and because it does not, the sales tax cannot vary the rate of tax by household income and cannot distinguish between purchases made with income, purchases made with previously taxed savings, or purchases made with borrowed funds.

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Mr. CHRISTENSEN. Thank you, Mr. Christian.

Mr. Weidenbaum, Dr. Weidenbaum.

STATEMENT OF HON. MURRAY WEIDENBAUM, PH.D., CHAIRMAN, CENTER FOR THE STUDY OF AMERICAN BUSINESS, WASHINGTON UNIVERSITY, ST. LOUIS, MO., FORMER ASSISTANT SECRETARY, U.S. DEPARTMENT OF THE TREASURY; AND FORMER CHAIRMAN, PRESIDENT'S COUNCIL OF ECONOMIC ADVISERS

Mr. WEIDENBAUM. Thank you, Mr. Chairman, Members of the Committee. To summarize my statement briefly, the U.S.A. tax is the only one of the proposals that has been discussed before this Committee that simultaneously promotes growth and simplification without losing fairness. It also leaves for the citizen a lot of decisions that are now made by the government—how much to save, how much to invest, and in what form. The taxpayer would make that decision.

Basically the U.S.A. tax puts the fiscal burden on what people take from society, the goods and services they consume. That is part of the fundamentals of this plan because, as someone who has worked with and observed this Committee for several decades, it is clear you have the taxwriting responsibility ahead of you.

Hopefully, some of the best of these various plans can help you in that important job, and the idea of exempting savings and writing off investment both simplifies the Internal Revenue Code and provides the economic growth that, over a period of time, is the most painless way of reducing the budget deficit. It is that growth that brings in more revenues and reduces the spending on entitlements.

We have worked, as you know, for several years on the details of this proposal. We are submitting it for the record and I emphasize that even though, very frankly, we are here to push our particular program, all of the four alternatives—the flat tax, the sales tax, the VAT, as well as the U.S.A. tax—are variations on the same theme. They all promote investment, they promote economic growth. They are all so much simpler than the status quo.

Some of them do have some differences. This is the plan that does more to promote, keep fairness than any of the others. There is a tradeoff. Some of them look like they are a lot simpler. However, I urge you to read the fine print. For example, I have heard claims that some of these will eliminate the IRS, but then they say, well, of course, we will have to provide refunds to low-income people.

Well, how do you provide the refunds? People will have to fill out a form and submit it to some bureau in the Treasury Department. You can call it something else, but it will still be the Internal Revenue Service reviewing and auditing the returns of millions of Americans. So as an old Treasury hand, maybe I am pleased to say the IRS won't be out of business under any of these plans, but under all of them. And that is the heartening thing, we move to a lot of simplification but, again, I don't overemphasize this.

Take the VAT. France originated the VAT. They had a real debate, was Head and Shoulders antidandruff shampoo a tax-exempt medicine or was this a cosmetic subject to the VAT? That is the

kind of debate that the VAT generates. There are all sorts of loopholes, by the way. The idea that you exempt medicines, you exempt food, things like that, that sounds good. But, very frankly, above average income people like my wife and I, we will do a lot better than low-income people if you exempt—we will get a much bigger tax saving if you exempt our food than the people with very modest incomes, so that there is a tradeoff as you write any of these tax bills.

But let me emphasize that, warts and all, the U.S.A. tax is the most attractive approach to fundamental tax reform. It provides the most favorable combination of simplification, economic incentive, and fairness, and, as pointed out earlier in this hearing, it simultaneously reduces the role of government in citizen decision-making and enhances our international competitiveness.

Thank you very much.

[The prepared statement follows:]

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ANALYZING THE NUNN-DOMENICI USA TAX

by Murray Weidenbaum

Testimony Before the
House Ways and Means Committee
Washington, DC, June 7, 1995

The Nunn-Domenici USA Tax is unique among the many attractive proposals for reforming the federal tax structure. It alone promotes economic growth and simplification without sacrificing fairness. Let us analyze the major alternatives in the light of these three goals: growth, simplification, and fairness.

Encouraging Saving, Investment, and Economic Growth

The Nunn-Domenici USA Tax reduces the tax burden on saving and investment. The intent is to encourage a higher rate of capital formation and a more rapidly growing economy.

Under the Nunn-Domenici approach, the basic way for taxpayers to reduce their tax liability — legally — is for individuals and families to save more and for companies to invest more. This tax treatment provides a powerful and direct incentive to engage in activities that will promote economic growth. Yet the decision on how much to save or invest — and in what form — is not made by the government, but by the taxpayer.

A consumption-based tax like the USA Tax Plan puts the fiscal burden on what people take from society — the goods and services they consume. Traditional income taxes penalize taxpayers for what they contribute to society by working and saving. Under this proposal and over a period of time, Americans are likely to achieve higher levels of *both* saving and consumption. This is so because the added investment, by generating a faster growing economy, will lead to higher levels of income — enabling taxpayers both to save more and to consume more, if that is what they want to do.

Fundamental tax reform is necessary because the United States devotes a smaller fraction of its national output to saving and investment than the other major industrial nations. This hurts economic growth because there is a very close relationship between the investment share of GDP and the growth rate of the economy. This close relationship between investment and growth has held true for the major industrialized nations over the past three decades.

A faster rate of economic growth also automatically generates two favorable budgetary consequences: more revenue into the Treasury and fewer payments for unemployment benefits, welfare, and other entitlements. That is the most painless way of bringing down the deficit.

In addition, by adopting a territorial approach, the USA Tax Plan eliminates the business tax on exports from the United States and imposes it on imports into the United States. Any effect on our foreign trade position will be to reduce our trade deficit.

Promoting Simplification

The Nunn-Domenici plan also simplifies the tax system. It eliminates about 75 percent of the income tax provisions in the Internal Revenue Code. The code is reduced from several thousand pages to about three hundred.

By making all saving deductible from gross income, there is no need for the paperwork and overhead expenses now required for IRAs, Keoghs, SEPs, and other "tax favored" accounts. Uncle Sam will no longer tell the taxpayer how much to save or in what form.

Similarly, by expensing investment, the business taxpayer no longer has to estimate the useful life of assets nor choose from an array of complicated depreciation systems. Also, there is little incentive to fuss with the conversion of ordinary income into capital gains because only the income actually consumed winds up in the tax base. Tax is deferred on capital gains, dividends, interest, and other forms of income that remain in the pool of savings.

Murray Weidenbaum is Chairman of the Center for the Study of American Business and Mallinckrodt Distinguished University Professor at Washington University in St. Louis. He has served as an Assistant Secretary of the Treasury and Chairman of the President's Council of Economic Advisers. The views expressed are strictly personal.

Because all businesses — whether incorporated or not — are subject to one and the same tax system, there is no incentive to go through the expense and bother of changing the legal form of the enterprise merely to take advantage of shifting differentials between individual and corporate tax rates.

Likewise, because interest and dividends are subject to the same tax treatment, there is no longer any tax incentive to leverage a company's financial structure or to convert dividend payments into interest payments. This will not end the merger boom, but businesses will take such actions on the basis of economic advantages — not tax considerations.

Maintaining Fairness

Economists view the fairness of a tax system in terms of horizontal equity and vertical equity. Horizontal equity is simply "equal treatment of equals." The idea is that taxpayers with similar incomes should generally pay the same amount in taxes.

The Nunn-Domenici USA Tax Plan increases horizontal equity in many ways. For individual taxpayers, virtually all types of income are treated the same, as is all forms of saving. In the case of businesses, all enterprises — corporations, partnerships, and individual proprietorships — are subject to a single tax system. Likewise, all capital investment is treated equally, as is the return on financial investment (e.g., interest versus dividends).

As for vertical equity, a progressive rate structure is usually chosen as the appropriate way of achieving this aspect of fairness. The Nunn-Domenici rate structure is clearly progressive. It contains three rates.

Nunn-Domenici and the Flat Tax

How does the USA Tax Plan compare with the other tax proposals? The most popular alternative is Representative Dick Armey's flat tax. Other current proposals include a national sales tax and a VAT.

It is fashionable to focus on the differences between Nunn-Domenici and the Flat Tax — and they exist. I, however, am struck by their similarities.

Both tax reforms promote economic growth by putting more of the tax burden on consumption, and lightening it on saving. Both expense investment. Both simplify the tax system and reduce the role of government in private decision making. Neither requires an additional record-keeping apparatus or enforcement system because neither creates a new tax. Both are "direct" taxes, paid by the taxpayer to the Treasury. By avoiding the form of a sales tax or VAT, neither is regressive or inflationary. Thus, either would be a substantial improvement over the status quo.

We can compare the progressivity of different tax structures by computing the ratio of the top rate to the bottom rate. By this standard, most of the move from a highly progressive rate structure to a flat tax already has occurred. In 1980, the top rate of 70 percent was five times as high as the bottom rate of 14 percent. By 1987, the ratio of the top rate to the bottom rate was down from 5.0 to 3.5. By 1994, it fell to 2.6. Under Nunn-Domenici, this measure of progressivity drops further to 2.1 (the ratio for the Flat Tax is 1.0).

Sales Taxes and the VAT

Sales taxes and value-added taxes represent a very different approach to raising revenue. They are levied on individual purchases. Hence, both are "indirect" taxes, whose amount is hidden from the taxpayer. As a result, both require a new record-keeping apparatus for business and a new collection system for government. The version that provides refunds for low-income people also requires continuing some variation of the present record-keeping arrangements as well as auditing by the IRS.

Because both the retail sales tax and the VAT are levied on individual transactions, they are included in the price of goods and services. Their introduction triggers an upward movement in the CPI and other measures of inflation. So does any future increase in the rates of either tax.

Because people with higher incomes tend to consume a smaller portion of their income than people with lower incomes, both proportional rate sales taxes and VATs are regressive. Efforts to reduce this regressivity require complicated adjustments and provide unintended loopholes.

Collecting the VAT is not simple. Exemptions are no minor matter. In France, an extensive debate occurred over whether Head and Shoulders anti-dandruff shampoo was a tax-exempt medicine or a cosmetic subject to the full VAT.

Conclusion

In their fundamentals, Nunn-Domenici and the Flat Tax are closely related. Both promote capital formation and economic growth, and move toward greater simplification of the tax system. Both reduce the current progressive nature of the federal income tax. The

Flat Tax provides somewhat more simplification at the expense of a loss of fairness (as measured by progressivity or vertical equity). In contrast, value-added or sales taxes generate a new array of problems, ranging from increasing inflation to new paperwork requirements to a regressive tax structure.

Therefore, I conclude that — among the different approaches to fundamental tax reform currently under consideration — the Nunn-Domenici USA Tax is the most attractive. Its structure provides the most favorable combination of simplification, economic incentive, and fairness. Moreover, the USA Tax simultaneously reduces the role of the federal government in personal and business decisionmaking and enhances the international competitiveness of the American economy.

Mr. CHRISTENSEN. Thank you, Dr. Weidenbaum.
Dr. Penner.

STATEMENT OF RUDOLPH G. PENNER, PH.D., MANAGING DIRECTOR, BARENTS GROUP, LLC, KPMG PEAT MARWICK

Mr. PENNER. Thank you, Mr. Chairman. I appreciate the opportunity to testify on some of the economic impacts of the U.S.A. tax. I will confine my remarks to our effort to design the tax to impose the same personal payroll and business tax burdens on different income classes as are imposed by the current tax system and to assess the effects of the tax on private saving and the macroeconomy.

It should first be noted that there is nothing sacred about the distribution of the tax burden applied by current law. Whether it is judged to be too progressive, too regressive, or just right is largely a matter of political values. To avoid arguing about progressivity, initially, the U.S.A. tax attempts to start where we are now and to design a system that approximates the current distribution of the tax burden.

Now, any effort to design a new tax to emulate the distributional impact of the current tax system is fraught with a number of conceptual and empirical difficulties. The Committee should clearly understand that the distributional tables that play such an important role in the political debates over any tax reform are largely based on black magic.

Saying that our proposed system has the same distributional effects as the current system presumes that we understand the distributional impact of the current system, and that is a statement more of faith than reality. The most difficult challenge is understanding the impact of the current corporate tax.

We know that there is not an abstract being called business that can bear a tax burden. Tax burdens must be borne by living, breathing people. But which people bear the current corporate tax? Is it shareholders, owners of all capital, employees, all wage earners, or buyers of corporate products?

One of the many issues related to this question is how mobile capital is internationally. If capital were perfectly mobile, it would flee any increase in a U.S. tax, thus reducing U.S. worker productivity. The end result would be that the corporate tax would turn into a tax on wages.

In our analysis, we assume that capital is highly mobile internationally but that international capital markets are not quite perfect. Because of this belief, we distribute the corporate tax burden on wages and capital incomes in proportion to their importance in the economy. We think that this is a reasonable judgment but wouldn't be surprised to find that others make other judgments. We do not, however, think it reasonable to assume that the current corporate tax rests entirely on capital income.

In designing the rate structure of the new tax, we are also hampered by our ignorance regarding the saving behavior of different income groups. This is obviously crucially important in deciding the distributional implications of a tax reform that allows the full deduction of saving from the tax base. The distribution of savings by income groups shown in survey data collected by the Bureau of Labor Statistics is quite different than that shown in surveys done

by the Federal Reserve System. In our analysis, we chose to rely more heavily on the Federal Reserve System's data simply because it looked more reasonable.

Now, because distributional analyses and the tables that they produce are so unreliable, it may be better to ignore them and start afresh when designing a new tax system. Admitting the distributional uncertainty, one might simply ask whether the new tax structure seems, on the surface, to have found the proper tradeoff between equity, efficiency, and administrative feasibility. In other words, does our top rate of 40 percent pass this test, and do our exemptions and family allowances seem reasonable? We think that they do, even though the distributional consequences cannot be estimated with precision.

Tax reforms that ease the burden on saving are often criticized for two opposite reasons. Many economists are skeptical that there will be a significant improvement in saving, and they, therefore, conclude that tax reform is not worth it. On the other hand, noneconomists often argue that the increase in saving and the implied reduction in consumption will be so large that the economy will be shocked into recession.

The skepticism of economists rests in part on the disappointing results of various marginal rate cuts and savings incentives tried in the eighties. However, there is little similarity between these policies and the reform implied by the U.S.A. tax.

There are good, theoretical reasons for the apparent failure of the initiatives of the early eighties on which I elaborate in my complete testimony. A major difference between the early eighties marginal rate cuts and the U.S.A. tax is that you did not have to save more in the eighties to get a tax cut. For the typical taxpayer under a U.S.A. tax, they will only get a tax cut if they save more.

Another important point is that since the same tax is extracted from each income group, there will be some redistribution of aftertax income within income groups. Those with a higher than average propensity to save within an income group will gain relatively, and they can be expected to save a disproportionate share of this gain. In contrast, those with a higher than average propensity to spend will face a relatively higher tax burden, and it is probable that they will pay this higher tax by reducing their consumption disproportionately.

This redistribution within income groups should, itself, raise aggregate savings significantly. Could it go up too much? I very much doubt it, Mr. Chairman. Saving is so low in this country right now that a huge, proportionate increase in the savings rate implies a very, very small fall in consumption that can easily be handled by the Federal Reserve System.

Thank you.

[The prepared statement follows:]

TESTIMONY OF RUDOLPH G. PENNER
BARENTS GROUP, LLC OF KPMG PEAT MARWICK

Mr. Chairman, members of the committee, thank you for the opportunity to testify on some of the economic impacts of the USA tax. I shall confine my remarks to our efforts to design the tax to impose the same personal income, payroll, and business tax burdens on different income classes as are imposed by the current tax system and to assess the effects of the tax on private saving and the macro economy.

Distributional Questions

It should first be noted that there is nothing sacred about the distribution of the tax burden implied by current law. Whether it is judged to be too progressive, too regressive or just right is largely a matter of political values. There does, however, seem to be a very broad consensus that our tax system should contain a considerable degree of progression. Even the so-called flat tax is highly progressive, because its generous exemptions and tax-free amounts cause the average tax burden to rise rapidly over a wide range of the income distribution.

On the other side, it is widely recognized that a tax system that is too progressive can sap economic incentives and be difficult to administer as taxpayers try mightily to avoid and evade very high marginal rates of taxation.

There is, however, wide disagreement as to the relative importance that should be attached to the goals of equity, economic efficiency, and administrative feasibility. Consequently, there are intense conflicts over the appropriate degree of progressivity of the tax system.

In the hope of muting that argument initially, the USA tax attempts to start where we are now and to design a system that approximates the current distribution of the tax burden. It must be emphasized, however, that the most important conceptual reform contained in the USA tax is the redefinition of the tax base that allows the deduction of saving from income. Technically, there is no problem with combining the new definition of the tax base with a great variety of tax rate structures including a flat tax.

Any effort to design a new tax to emulate the distributional impact of the current tax system is fraught with a number of severe conceptual and empirical difficulties. The Committee should clearly understand that the distributional tables that play such an important role in the political debates over any tax reform are largely based on black magic. Saying that our proposed system has the same distributional effects as the current system presumes that we understand the distributional impact of the current system and that is a statement more of faith than reality.

The most difficult challenge is understanding the impact of the current corporate tax. We know that there is not an abstract being called business that can bear a tax burden. Tax burdens must be borne by living, breathing people. But which people bear the current corporate tax? Is it shareholders, owners of all capital, employees, all wage earners, or buyers of corporate products?

The current corporate tax is difficult to analyze, because it is difficult to characterize. Economists generally regard it to be a tax on capital invested in businesses adopting the corporate form of organization. However, the corporate tax is so monstrously complicated with its many credits, excess deductions, limitations on credits and deductions, and the alternative minimum tax that it could contain elements of a consumption tax within its structure. Even if it were a pure tax on corporate capital, its effects would not be crystal clear. The most important issue is how mobile capital is internationally. If capital were perfectly mobile, it would flee any U.S. tax, thus reducing U.S. worker productivity. It would ultimately turn into a tax on wages.

In our analysis, we assume that capital is highly mobile internationally, but that international capital markets are not quite perfect. However, it must be noted that they are becoming more perfect every day from a U.S. perspective as the institutions involved

in moving capital around the globe improve their efficiency and the United States sinks in relative importance as a supplier and demander of capital.

Because of our belief that capital is highly mobile internationally and that the current corporate tax contains some elements of a consumption tax, we distribute its burden to wages and capital incomes in proportion to their importance in the economy. We think this a reasonable judgment, but would not be surprised to find that others make other judgments. We do not, however, think it reasonable to assume that the current corporate tax rests entirely on capital income.

It should be noted that because of the conceptual problems involved in trying to distribute the corporate tax, the Joint Tax Committee has given up trying and just ignores it. We do not believe that we can do that since we are substituting one important business tax for another.

In designing the rate structure for the new tax, we were also hampered by our ignorance regarding the saving behavior of different income groups. This is obviously crucially important in deciding the distributional implications of a tax reform that allows the full deduction of saving from the tax base.

The distributions of saving by income group shown by the Bureau of Labor Statistics Consumer Expenditure Survey (CES) and that implied by balance sheet data in that survey and in the Federal Reserve s Survey of Consumer Finances (SCF) are very different. All these surveys contain highly implausible results for particular individual records. The CES indicates that consumption exceeds income by huge amounts at the bottom of the income distribution. Some dissaving is quite plausible when income declines temporarily, but the amounts of dissaving shown in the CES defy the imagination. In contrast, data from the SCF imply that some individuals save more than 100 percent of their income and we know that is logically impossible.

In determining the distribution of saving by income class that we would use, we relied heavily on balance sheet data to distribute saving across income classes while using the CES information to distribute saving within income classes. The latter distribution was important in making revenue estimates.

I have noted but two of a very large number of problems involving the estimation of the distributions of the tax burden implied by current law and the USA tax. Other analysts may claim that the results of the tax structure based on our assumptions and analysis may be more or less progressive than that implied by the current system. That is understandable, but beware of anyone claiming to have found truth in these matters.

Because distribution analyses and the tables that they produce are so unreliable, it may be better to ignore them and start afresh when designing a new tax system. Admitting the distributional uncertainty, one might simply ask whether the new tax structure seems, on the surface, to have found the proper tradeoff between equity, efficiency and administrative feasibility. In other words, does our top rate of 40 percent pass this test and do our exemptions and family allowances seem reasonable? We think that they do, even though their distributional consequences cannot be estimated with precision.

The Impact on Saving

Tax reforms, such as that implied by the USA tax, are often criticized for two opposite reasons. Many economists are skeptical that there will be a significant improvement in saving and they, therefore, conclude that the tax reform is not worth it. On the other hand, non-economists often argue that the increase in saving and the implied reduction in consumption will be so large that the economy will be shocked into recession.

The skepticism of economists rests, in part, on the disappointing results of various marginal rate cuts and saving incentives tried in the 1980s. However, there is little similarity between those policies and the reform implied by the USA tax.

There are good theoretical reasons for the apparent failure of the initiatives of the early 1980s. Initiatives such as IRAs were limited in scope applying only to the first $2,000 of saving and that had to be for retirement. Most saving comes from people who save more than $2,000 and for them, the IRA provided no extra incentive to save.

Moreover, because the incentive only applied to one type of saving, it was easy to enjoy by moving funds from one account to another. I do not mean to imply that the incentive was totally ineffective. Academics still argue over that issue. However, it is not surprising that the success of IRAs was not overwhelming. In contrast, the IRAs provided by the USA tax are unlimited and provide incentives for all savers regardless of the amount that they save or the purpose of their saving.

The marginal rate cuts of the early 1980s were straight tax cuts. As such, they had two effects that would be expected to have opposite impacts on saving. They increased the reward to saving, which would be expected to increase it. They also increased people's after-tax income and that might make them wish to consume more, both in the present and the future. To the extent that they wanted to use their increased income to consume more immediately that would tend to reduce saving. Put another way, individuals did not have to save more to get a tax cut.

The USA tax proposal does not provide an overall tax cut. It substitutes a new tax for the present system and the new tax raises the same amount of revenue. The average taxpayer is no better off than before, and therefore, he or she cannot consume more in both present and future. The only change in incentives that an average taxpayer faces is a higher reward for saving and the only way to get a tax cut is to save more.

Since the same tax is extracted from each income group, there will be some redistribution of after-tax income within income groups. Those with a higher than average propensity to save within an income group will gain relatively and they can be expected to save a disproportionate share of this gain. In contrast, those with a higher than average propensity to spend will face a relatively higher tax burden and it is probable that they will pay this higher tax by reducing their consumption disproportionately. This redistribution within income groups should itself raise aggregate saving significantly.

What about the fear that the tax will be too successful and raise aggregate saving so much that the implied fall in the production of consumption goods causes a recession and rising unemployment? It is important to remember that the USA tax not only provides an increased incentive for saving. The business tax reforms provide an increased incentive for investment as well by allowing expensing. Consequently, the increased production of investment goods will make up for the decreased production of consumption goods. The planned increase in investment and reduction in consumption need not match exactly, but any residual net impact on the economy should be relatively small and well within the capability of the Federal Reserve to smooth out.

The net shock is likely to be small because saving is today such a small portion of disposable income. It has risen recently and let us optimistically assume that saving is running at 5 percent of disposable income when the new tax is implemented. A 20 percent increase in saving would then translate into less than a 1.1 percent fall in consumption, a tiny shock even if investment did not increase at all.

It seems clear that fears that saving will not go up or will go up too much are both misplaced. It does not seem unreasonable to forecast a Goldilocks effect. That is to say, the increase in saving will be just right .

Mr. CHRISTENSEN. Thank you, Dr. Penner.
Dr. Rogstad.

STATEMENT OF BARRY K. ROGSTAD, PH.D., PRESIDENT, AMERICAN BUSINESS CONFERENCE

Mr. ROGSTAD. Thank you, Mr. Chairman. On behalf of the members of the American Business Conference, may I congratulate the Committee for holding these hearings and for the opportunity to appear before you today.

In expressing my support and the support of my members for S. 722, I do not suggest that we see S. 722 as somehow in competition with other proposals for fundamental tax reform. This is not a horserace or a beauty contest; this is a serious discussion about our economy and its tax system.

As an economist, I find much to admire about all the major proposals that this Committee is in the process of examining. We are at the beginning of a national discussion, not at the end. We should not foreclose any possible avenue for intelligent tax reform.

I have been involved in the S. 722 proposal for over 5 years, and I have never been more convinced of the merits of a properly conceived tax reform proposal than I am at the present time. If I could, I would just like to limit my comments to three aspects of the proposal.

First, with respect to the all-important issue of saving. Everyone else that has appeared before you on this panel, and Senators Nunn and Domenici, have noted that part of our saving problem is tax driven. The current income tax is biased against saving in favor of consumption. S. 722 removes that bias by seeking to tax every dollar once and only once.

S. 722 does not, and I think this is the key point, offer a subsidy to saving. It merely removes the double taxation on saving that now occurs. Please note that in offering an unlimited, unrestricted tax deferral on saving, S. 722 would give wage earners a control over their tax liability now enjoyed only by the rich. Simply by saving more, all people can control the size of their tax obligation each year, and because the deferral is frontloaded, that is, the tax advantages of saving are enjoyed when the saving occurs, S. 722 addresses the cash flow restrictions of middle-income citizens who now believe they do not have enough money to save.

I think that if we are to improve the level of personal savings, the act of saving itself must be more than an afterthought, it must become a higher priority.

I also believe that there is a critical link between the U.S.A. individual tax proposal and entitlement reform. As Congress considers reducing the rate of growth in nonmeans tested entitlement programs, it is fair to ask whether citizens are adequately empowered to do more to provide for themselves. The unlimited, unrestricted deferral of saving offered by S. 722 would provide a powerful tool with which responsible citizens could more ably provide for future requirements such as health care, education expenses, or retirement.

I do not say that Congress should replace nonmeans tested entitlement programs with S. 722. I do say that S. 722, with its sav-

ings deferral, might make slowing the growth of such programs as politically feasible as it is economically desirable.

If I could make a comment with respect to capital gains. I represent growth companies that are very dependent on equity financing. This is so because they tend to be knowledge intensive, which means they have little collateral upon which to borrow. That raises the cost of capital for growth companies because the current Tax Code favors borrowing over equity investment.

This is not news to this Committee. You have long recognized that equity investment is handicapped. You have urged enactment of a substantial capital gains differential to correct this problem. You have quite properly recognized that a differential would lower the cost of equity capital, facilitate the "unlocking" of current investment, thereby encouraging a more efficient allocation of saving, and promote a long-term perspective on the part of savers and investors by encouraging rollover of assets.

We support a capital gains differential. Nonetheless, we believe that S. 722 would provide a more comprehensive framework to deal with the capital gains issue.

Finally, if I might, I would like to just comment on its feasibility. In introducing S. 722, Senators Domenici and Nunn have proven that their concept for fundamental tax reform is technically possible. The very gratifying reaction to their legislation may already suggest that it is politically feasible as well. Beyond business groups such as my own, other organizations that in the past have defined their tax ideas largely in opposition to the business community have found much to praise in S. 722.

I am hardly the person to make political prognostications, but it does seem to me that S. 722 is promising specifically because it scrambles the usual battle lines on tax reform. It is instead a proposal to create an efficient and intelligent tax system, and it takes advantage of a very rare confluence in public policy of individual and national interest. It is imperative in my judgment that we not lose sight of the opportunity for large and constructive change that faces us at this moment.

I would be happy to answer any questions you may have. Thank you.

[The prepared statement follows:]

TESTIMONY OF BARRY K. ROGSTAD
AMERICAN BUSINESS CONFERENCE

Mr. Chairman and Members of the Committee:

I am Barry Rogstad an economist and president of the American Business Conference (ABC). ABC is a nonpartisan coalition of chief executives of fast-growing midsize companies. As you may recall, three of our members, Dr. George Hatsopoulos, James Hoak, and James Mann appeared before this Committee earlier this year.

I applaud your decision to hold three days of hearings on fundamental tax reform. May this sort of open and honest forum, dedicated to public education, be replicated in other committee rooms of Congress and in towns and cities across the country.

I am here today to discuss a comprehensive tax reform proposal to stimulate economic growth: S. 722, the USA Tax Act of 1995 which was introduced by Senators Pete Domenici and Sam Nunn last April 25.

In expressing my support and the support of my members for S. 722, I do not suggest that we see S. 722 as somehow in competition with other proposals for fundamental tax reform. This is not a horse race or a beauty contest; this is a serious discussion about our economy and its tax system. As an economist, I find much to admire in all the major proposals that this Committee is in the process of examining. We are at the beginning of a national discussion, not at the end. We should not foreclose any possible avenue for intelligent tax reform.

In that regard, I believe Senators Domenici and Nunn have performed a service by offering their proposal in a form that is fully articulated and therefore susceptible to sustained and detailed inspection.

S. 722 specifies a rate structure and the assumptions behind it, tackles the thorny problem of transition, and addresses the inevitable complexities inherent in our enormous and dynamic economy. To their credit, the Senators wrote their bill in plain English. The bill's first title provides an explanation to the American people of why the Senators think fundamental tax reform is necessary. It is an excellent introduction to the macroeconomic problems the nation faces and deserves a large readership.

S. 722 sets a standard of openness and comprehensiveness that proponents of other proposals must match if this Committee is going to be able to decide the appropriate direction for tax policy. Otherwise, comparisons across proposals are not of much use. In S. 722, Senators Domenici and Nunn have provided detailed blueprints for change. It is not a criticism of the ultimate worth of other proposals to note that they, in contrast, remain pinned to their architects' drawing boards.

I.

Any proposal, such as S. 722, to replace the current income tax code with a better alternative immediately raises the old question from World War II: "Is this trip necessary?"

All Americans understand the frustrations inherent in fundamentally changing the way we tax: the difficulty of communicating new ideas, the resistance, including from within the business community, to change, and the ever-present anticipation that good proposals will be sidetracked or stopped entirely. Advocating comprehensive change is to risk death by a thousand cuts.

In my opinion, the rewards of a properly conceived and fundamental tax reform merit the effort. Without offering a comprehensive exposition of the USA Tax System, I would like to touch on aspects of the proposal that demonstrate its great promise for the country.

Saving In its essence, the Domenici/Nunn proposal is an integrated tax that defers all new saving by individuals and permits immediate expensing for all new business investment.

Saving and investment, are the indispensable seed corn with which we create future growth and, therefore, a higher level of future consumption. We need a tax system that does not penalize saving and investment and that insures the best possible allocation of our saving for productive investment.

As you know, the United States has an abysmally low level of national saving. That low level is in part the result of our chronic federal budget deficits, which we all hope the current budget process will address.

But part of our saving problem is tax-driven. The current income tax is biased against saving in favor of consumption. S. 722 removes that bias by seeking to tax every dollar once and only once. S. 722 does not -- and this is a key point -- offer a subsidy to saving; it merely removes the double taxation on saving that now occurs.

Please note that in offering an unlimited, unrestricted tax deferral on saving, S. 722 would give wage earners a control over their tax liability now enjoyed only by the rich. Simply by saving more, people can control the size of their tax obligation each year.

Because the deferral is front-loaded -- that is, the tax advantages of saving are enjoyed when the saving occurs -- S. 722 addresses the cash-flow restrictions of middle income citizens who now believe they do not have enough money to save. If we are to improve the level of personal saving, the act of saving itself must be more than an afterthought. It must become a higher priority. In terms of changing saving behavior, the up-front deferral of taxes on saving seems to me a far more promising approach than patronizing lectures to John and Jane Doe regarding how they should use their money. It is also more consonant with our national idea of individual economic freedom.

I believe that there is a critical link between the USA Individual Tax proposal and entitlement reform. As Congress considers reducing the rate of growth in non-means tested entitlement programs, it is fair to ask whether citizens are adequately empowered to do more to provide for themselves.

The unlimited, unrestricted deferral of saving offered by S. 722 would provide a powerful tool with which responsible citizens could more ably provide for future exigencies such as health care, education expenses, or retirement. I do not say that Congress should replace non-means tested entitlement programs with S. 722. I do say that S. 722, with its saving deferral, might make slowing the growth of such programs as politically feasible as it is economically desirable.

Capital Gains I represent growth companies that are very dependent on equity financing. This is so because they tend to be knowledge-intensive which means they have little collateral upon which to borrow. That raises the cost of capital for growth companies because the current tax code favors borrowing over equity investment.

This is not news to this Committee. You have long recognized that equity investment is handicapped. You have urged enactment of a substantial capital gains tax differential to correct the problem. You have quite properly recognized that a differential would lower the cost of equity capital, facilitate the "unlocking" of current investment, thereby encouraging a more efficient allocation of saving, and promote a long-term perspective on the part of savers and investors by encouraging rollover of assets.

ABC supports a capital gains tax differential. We nonetheless believe that S. 722 would provide a more comprehensive framework to deal with capital gains. Under the Domenici/Nunn proposal, capital gains would not be taxed until they were realized and used for consumption. All returns on investment would remain untaxed for as long as those returns remained in saving. Selling a share of stock of one company and using the proceeds to buy stock in another would thus not be a taxable event.

S. 722, because it does not distinguish between equity and debt financing ends the bias in the current code. Its saving deduction does not tax the "unlocking" of existing assets for the purpose of new investment. It allows unlimited rollover. And, most important, it does not limit the tax advantages of saving to capital income. It allows wage earners with a savings account to enjoy the same deferral as those with extensive stock portfolios.

Investment Investment is the mirror-image of saving. Absent inflows of foreign capital, the amount of investment that can occur is dependent upon the amount of available saving.

Like other proposals before this Committee, S. 722 does not tax business investment. To that end, it would allow the immediate expensing of all real business investment. Such investment is necessary to raise employee productivity. Productivity gains are the only way over time to raise our standard of living.

To insure balance in the treatment of capital and labor, Senators Domenici and Nunn recognized that they had to provide some allowance for investment in people. That is why they included on the individual side of S. 722 a deduction for tuition paid for higher education. That deduction acknowledges that people are more productive with higher levels of education and training much as they are more productive when working with new and better equipment.

International Implications The USA Business Tax is territorial. An American-based business would not include in its gross tax base the proceeds from sales made by subsidiaries outside the United States. It would also not deduct the purchase of goods or services outside the United States. For their part, foreign businesses with a commercial presence in this country would include in their tax base amounts received for goods sold or services provided in the United States and would subtract amounts paid for goods acquired and services provided in the United States.

For an American company, territoriality would free entrepreneurs to base their international strategies on business opportunities rather than on tax considerations. From a public policy standpoint, it would rid the code of such vexing issues as the tax implications of transfer pricing and PFICs, vastly simplifying the tax structure and, not incidentally, your agenda.

The USA Business Tax is also border adjustable. Goods made here and shipped abroad would receive a tax rebate. Goods made abroad and imported and sold in the United States would be subject to tax. This provision would align the tax system of the United States with that of most of our major trading partners while insuring that all products sold in this country carried their appropriate share of the tax burden.

Complexity Questions about the complexity of the USA Tax System invariably beg the question, "Compared to what?" When contrasted to the current individual and corporate income taxes, the USA Tax System clearly and unequivocally offers large gains in simplicity.

By taxing all businesses -- corporations, partnerships, limited liability companies, and unincorporated proprietorships -- the same, the USA Business Tax eliminates the false and unwieldy distinctions the current code makes among business enterprises. By moving from accrual accounting toward cash flow accounting, the USA Business Tax eliminates the maze of complexities and the high compliance costs which businesses now face. And because the USA Individual Tax permits an unlimited and unrestricted deferral for saving, the USA Business Tax would not have to deal with nonproductive or superfluous business arrangements designed to avoid the personal income tax.

For its part, the USA Individual Tax requires no new tax bureaucracy. Taxes would continue to be due on April 15 and there would be withholding. The individual tax form, while vastly simplified, would still be familiar to taxpayers. There would be no new record-keeping burden since information about net changes in saving behavior is already collected to permit the interest calculations in Form 1099.

Now, it is true that the Individual Tax's progressive structure is inherently less simple than a flat rate structure. And, beyond the saving deduction, the USA Individual Tax does include several other deductions such as one for home mortgage interest. I happen to believe that a progressive structure is desirable but would add that, in any event, S. 722 could easily accommodate a flat rate structure if Congress thought it wise. As for the deductions, they are few in number and again, if Congress so chose, could be eliminated.

As for comparisons of the USA Tax System with the avowed simplicity of other major tax reform proposals, I am not sure such contrasts are at this point possible. Only until those alternative proposals are fully fleshed out, complete with transition measures, will we be able to draw meaningful distinctions.

Feasibility In introducing S. 722, Senators Domenici and Nunn have proven that their concept for fundamental tax reform is technically possible. The very gratifying reaction to their legislation may already suggest that it is politically feasible as well. Beyond business groups such as my own, other organizations that in the past have defined their tax ideas largely in opposition to the business community, have found much to praise in S. 722.

I am hardly the person to make political prognostications. But it does seem to me that S. 722 is promising specifically because it scrambles the usual battle lines on tax reform. This is not a conservative or a liberal proposal. It is instead a proposal to create an efficient, intelligent tax system. It takes advantage of a very rare confluence in public policy of individual and national interest. I think this latter point was made best by Senator Robert Kerrey when he and Senator Robert Bennett announced their decision to be co-sponsors of S. 722:

> Mr. President, to be clear, there are not very many situations where the interest of the individual and the interest of the Nation intersect, where they are the same....With savings, there is an intersection. It is in the interest of American families to acquire and accumulate wealth. It is in the interest of the Nation to do the same. Unless both the individual has an incentive to save and the Nation has the discipline to save, then the standard of living of the United States of America simply will not rise. (Congressional Record, April 25, 1995, p. S. 5671)

This, it seems to me, is the essential matter. It explains why fundamental tax reform is both necessary and possible. As this Committee and the Congress address the merits of the various tax reform proposals, it is imperative that you not lose sight of this opportunity for large and constructive change.

I would be happy to answer any questions you may have.

Mr. CHRISTENSEN. Thank you, Dr. Rogstad.

My question would be for Dr. Weidenbaum.

We heard Senator Domenici and Senator Nunn say that their U.S.A. tax did not address the underground economy issue. How important do you believe it is that we find a solution to raising revenue from that sector, or is it something that we should not worry about because a couple of the proposals don't address that area?

Obviously, the consumption tax proposal goes after that 20 to 25 percent or do you have a solution on how we could fold that into a Nunn-Domenici U.S.A. tax proposal?

Mr. WEIDENBAUM. No, I don't. And, very frankly, I am skeptical of expecting much change in the underground economy from any of the tax plans that have been or will be presented later this week to this Committee. I think that the fundamental incentives to go or stay underground are still very much there, and if you raise the tax on legal purchases, if anything, you are going to increase the incentive for shady characters to go underground more than they do today.

Mr. CHRISTENSEN. Any other comments? Mr. Christian, a comment on that?

Mr. CHRISTIAN. I would agree with Dr. Weidenbaum. I don't think the U.S.A. tax or any tax on income addresses the underground economy any more than the present tax system addresses it. As Mr. Gibbons and I and others have talked about for many years, it may be that some portion of the present corporate income tax is embedded in the price of goods.

No one knows what it is. If it is there, the people who are buying things, whether they are legal or illegal, are paying it. Other taxes have various portions of them that are embedded in the price of goods. Other portions go back to labor factors that produce things, and other portions go back to capital factors. Again, no one knows what those proportions are.

I would share in what Dr. Weidenbaum says. I am not at all sure, either administratively or as a matter of fundamental economics, in the end that there is any way to deal with the concern about the underground economy.

Mr. CHRISTENSEN. So you would disagree with the premise, then, that the consumption tax or the national sales tax would pick up a significant portion of that underground economy or would you have any other thoughts on that? Because, I mean, there has been testimony already that the national sales tax would pick up a significant portion of that economy.

Dr. Penner, Dr. Rogstad.

Mr. ROGSTAD. I would just observe that I think over time that that premise may not stand up.

I have another concern here that I would like to surface. I think our entire system of government and our payment of taxes is based on voluntary compliance by our citizens, and whatever we do in terms of fundamental tax restructuring, we should not lose sight of that underlying philosophy that is so key to our system of government. This is a very important perspective to keep in play here.

Mr. PENNER. I would just point out, Mr. Chairman, that there is, in fact, a lot of evasion of State sales tax. There is enormous evasion of the VAT in Europe, particularly in Italy where they don't

seem to want to pay any taxes at all. So that certainly is not a sure-fire solution to the problem.

Mr. CHRISTENSEN. One of the aspects of the consumption tax that has been touted is that it would pick up that part of the economy. That is one of the things that has been touted highly over the flat tax.

I like the flat tax idea because of the simplicity. I think the U.S.A. tax doesn't match the flat tax when it comes to simplicity. It may when it comes to fairness and efficiency. What would you, in your opinions, believe that the main drawback of the flat tax would be? We will be having testimony tomorrow on that issue. What are some things in your opinion that cause the flat tax to be second or third in your ranking?

Mr. WEIDENBAUM. A couple of things. First of all, it doesn't give a direct incentive to saving the way the U.S.A. tax does where a dollar saving is a dollar less of taxable income. It is only the interest and dividends on your saving that gets the benefit of being exempt from the flat tax. And also, as I understand it, not one tax return, but 12 monthly tax returns are due under the flat tax, together with 12 checks from each taxpayer a year. That I think presents a difficult enforcement challenge to the IRS.

Mr. CHRISTIAN. Mr. Christensen, I think that the flat tax would be vastly better than present law, but in answer to your question, I would list the following: Under the flat tax regime, if that became the tax law of the United States, there would be no line on the individual tax return, for all of the vast number of American people, for interest, dividends or capital gains. The only line on that tax return would be for wages. I question whether that would be viewed favorably by everyone.

I would reiterate what Dr. Weidenbaum said about the "yield exemption approach," as we call it. Excluding the return on capital is one way of dealing with the bias against savings.

You talked earlier about transition. If you enacted the flat tax today, as it stands, the returns to capital—all existing capital in the United States, all interest, dividends and gains in the future would be outside the tax system insofar as the individual tax under the flat tax is concerned. That is unrelated to new savings occurring in the United States.

Mr. PENNER. I think I would add, Mr. Chairman, that because, as Mr. Christian said, the only thing that appears on the individual's tax return is wages, there would be enormous pressure to try and convey compensation using other means. I think that would immediately make the flat tax very much more complicated than it appears as it is now structured. You would have to worry about what to do with stock options; you would have to worry a lot more about payments in kind of various types. So I think technically it is much harder than it appears on the surface.

Moreover, I just don't think the politics are good. I know that I would get one heck of a big tax cut if this tax were put in effect, and I would enjoy that. But I suspect for everyone that gets a very large tax cut, like me, there will be a very large number of people who get a small tax increase, and I think that is just very bad politics.

Mr. CHRISTIAN. To follow up on what Dr. Penner said. Mr. Gibbons and many others will also perhaps remember this. I remember at the Treasury Department a long time ago when we had distinctions between earned income and unearned income. Now, this flat tax will again reinstitute, in effect, that same distinction. I remember having struggled at the Treasury Department to determine what is the difference between earned income and unearned income.

The famous example, which was in the funny papers for a few years as Mr. Gibbons perhaps remembers, was about a radiologist. The radiologist was in business for himself. Now tell me, what is he earning? Is it capital income or is it his own earnings?

I also share your view about marginal rates. One of the appeals of the flat tax is the low marginal rate. I would point out that the marginal rate under the flat tax, let's say it is 20 percent as now proposed, is not 20 percent on earnings, on work effort as was talked about earlier. The marginal rate under the flat tax is 27.65 percent on earnings, because you must count, in determining the marginal rate of tax on work effort, the employee payroll tax.

Mr. CHRISTENSEN. OK. Mr. Gibbons.

Mr. GIBBONS. Well, I want to start off by saying, first of all, I appreciate the enormous effort that each of you at the table has contributed to the whole discussion and thought of what we do about a future revenue system for the United States. You know, you may go down as unsung heroes in this battle, but I know you have all contributed to it.

Mr. Christensen asked an important question, what is the fatal flaw in the flat tax? And the fatal flaw in it is that it is classified as an income tax and therefore, you cannot adjust it at the international border, and as long as you continue to tax exports and not tax imports, you are going to be exporting jobs from the American economy. Mr. Armey recognizes that. It is a fatal flaw in the flat tax.

You know, you can love the flat tax all you want to, but if you are going to adopt it with a fatal flaw, you just cannot—under the rules that we established starting back in 1947 for world trade, you cannot adjust a flat income tax at the international border. And you are just going to export all of your job opportunities as we are already doing under the income tax.

Now, Dr. Penner and all the rest of you, I need some help. I need to find out how regressive and what is the real tax burden under the current system? Because in step 3 of the revenue system that I propose—you know, in step 1 I repeal all of the income taxes, personal and corporate, and I also repeal all of the FICA payroll tax. That is a lot of—I have repealed a lot of taxes there, almost 1.2 trillion dollars' worth of taxes I have repealed right there; and I have to replace it with a tax. In step 2, I replace it with a value-added tax, raising most of the money. But in step 3, I have got to do something about adjusting the tax burden among income classes.

Now, where is my best information about what the current burden is, and how would you adjust the burden outside of the value-added tax? I wouldn't want to adjust the burden within the value-added tax, because you would get a horribly complicated,

unadministrable value-added tax. You best do it outside of the tax, completely divorced from it.

I think that is really the mistake we made back in the beginning on the income tax; we tried to do social engineering and economic engineering through the income tax, and it became so screwed up, nobody can understand it today. There are a couple of people around here, but that is about all, that can understand it.

How—where do I get my information about what the current burden is? I am using in my calculations the Congressional Budget Office figures. You are familiar with the Congressional Budget Office—I assume you are familiar with the burden figures. What is wrong with them, if anything?

Mr. PENNER. Well, I think the major problem is knowing the distribution of the corporate tax. It has become such an extraordinary monster, so complicated that it defies human understanding. It defies human understanding in knowing what its efficiency effects are, and I think the same with the distributional effects.

The Congressional Budget Office has reacted to that problem by often distributing the corporate tax two different ways—one, putting it entirely on capital; the other, spreading it 50-50 between wages and capital. But those are just guesses. They just give you a range.

The Joint Committee on Taxation recently has decided not to distribute it at all. So that is an extremely difficult problem.

We do distribute it. The burden is distributed according to the importance of different kinds of factor income in the economy. Doing it various other ways doesn't result in a huge change in the kind of marginal tax rates you need under our individual tax to emulate the distribution of the current burden, but it does result in some considerable change.

In answer to your second question, how do you achieve the kind of distribution you want, limited by our ignorance of the distribution of the current tax system, you do have to remember that you can do it on both sides of the ledger. That is to say, if you are not satisfied with the distribution of the tax burden, you can adjust the expenditure side to achieve certain distributional results.

Mr. GIBBONS. You mean through the appropriations process?

Mr. PENNER. Well, it could be through the appropriations process, it could be through entitlements, it could even be through refundable tax credits. For example, Bradburne, one variant of the kind of tax reform that he suggests would simply have essentially all of the tax levied at the business level, but then some portion of that would be taken and distributed to individuals using basically a refundable credit.

Mr. GIBBONS. That is essentially what I do in my proposal. But I am not satisfied with it.

I have to determine what the burden is now, and I realize the corporate tax has always been debatable about who pays the burden of it. In my own thinking, I allocate the whole burden of the corporate tax to the consumer, because I never saw a corporation that stayed in business very long that did pass on all of its expenses on its product. And so I look upon the corporation primarily as a tax accumulator that gets it out of the cost of its product. If it didn't, I reason that it will end up in bankruptcy sooner or later.

Now I see Dr. Weidenbaum shaking his head on that. But the corporate taxes, first of all, are not a large part of all of the taxes we are discussing here, and I don't think we ought to wrangle over the distribution of the corporate tax in the burden figuring. But Dr. Weidenbaum, do you want to comment?

Mr. WEIDENBAUM. Well, Mr. Gibbons, I think you have raised the dilemma in choosing among any of these alternatives for comprehensive tax reform. They have all got some warts, and I think when you get down to the wire, you are going to have to choose the one with the least number of warts, and really go for—for the VAT, for example, or national retail sales tax. I think you just have to accept the fact that it is somewhat regressive, because whether you go the route of some countries' exempt categories—and you have indicated that is an excessive complication—or you go with some kind of refundable credit, you are back—as I point out in my testimony, you are back with IRS auditing tax returns for millions of taxpayers. So that none of these, none of these is going to be perfect.

If you go for a transaction-based tax, whether it is retail sales tax or VAT because of simplification, because of the focus on consumption, I am saying, by definition, then I think you are just going to have to accept the fact that it doesn't help you on income distribution or fairness or equity. But you have no perfect tax alternative.

Mr. GIBBONS. Well, essentially I reason that selling the American public and the Congress any massive tax reform, you are going to have to limit the number of fights you start in all of this. One fight I don't want to get into is massively changing the tax burden between the income categories. So right now I am trying to find out what is the tax burden? Where do I—CBO has issued a burden table, Treasury has a burden table, and the Joint Committee has got a burden table. Who is right?

Mr. WEIDENBAUM. They are all right and they are all wrong, because each of them has a set of reasonable assumptions—not facts, but assumptions—on which the numbers are based; and you could take six honest, competent analysts, put them in six different rooms, and they will come up with six different sets of assumptions, and therefore, come up with six different sets of burden tables, even though each of them is doing as honest a job as they can.

The bottom line here, every analysis that I have ever seen, whether it is done by private organizations or by government agency, convinces me that, on balance, the Federal revenue system is mildly progressive.

Mr. GIBBONS. Yes.

Mr. WEIDENBAUM. So that is the starting point.

Mr. GIBBONS. It is not nearly as regressive as some of the radicals think it is, and it is not nearly as progressive as some of the very conservatives think it is.

Mr. WEIDENBAUM. Yes, sir.

Mr. GIBBONS. It is just mildly progressive.

Well, thank you. Maybe the best solution is to take all of those tables, add them all up, and divide them by three.

Mr. PENNER. Or to ignore them altogether.

Mr. GIBBONS. Or ignore them altogether.

You can't ignore them altogether, because if you do, you are going to have a political battle around here over shifting burden. You have to have some authoritative decision as to what is the current burden.

You know, as I say, I used CBO's burden table. But—yes?

Mr. ROGSTAD. To just add on to your point, Congressman Gibbons, that these tables are sufficiently tenuous that they should not drive the choice of which tax reform proposal you are looking at.

Mr. GIBBONS. I agree with you on that, and I agree with you, how we distribute the corporate tax shouldn't drive the whole thing because it is not that great a part when you compare it to the FICA tax and the personal income tax. Those are huge taxes.

Mr. PENNER. And for what it is worth, Congressman, on those two taxes, economists feel reasonably confident that the personal tax is borne by the people who actually pay it, and both sides of the FICA—employer and employee—are borne by labor.

Mr. GIBBONS. Yes. I think there is general consensus that in the FICA tax—am I correct when I state this—that it all comes out of the cash payment of wages to the employee? Is that right?

Mr. PENNER. That is the general consensus, yes.

Mr. GIBBONS. That is the general consensus amongst economists. OK, fine. Thank you very much.

Mr. CHRISTENSEN. Ms. Dunn.

Ms. DUNN. Thank you, Mr. Chairman.

Gentlemen, I have just one question, and it is late in the day, but I really need to ask you this question.

I really like this S. 722 proposal. What I need to know for my constituents is, do you believe that the proposal is going to be enough simpler than the current system so that when folks look forward to April 15, or whenever it is, they don't do it with horror; and that they can fill out their own returns, and they can do it without lawyers and CPAs. I am not talking so much about corporations, but individuals. Are we doing the folks a favor processwise as opposed to substantively?

Mr. CHRISTIAN. Yes. I have spent 35 years struggling with the Internal Revenue Code. This, for example, as I hold it up, is the entire income tax of the United States under the S. 722 approach, triple spaced, narrow margins, great big type. I couldn't even lift the present income tax printed in this same way. It would be stacked high up to here.

More directly, the U.S.A. tax has very few moving parts; it has few exceptions and no exceptions to exceptions. I think that the U.S.A. Tax Code is about 30 percent the size of what it is today, in the Internal Revenue Code. A charitable contribution is not complicated. A home mortgage interest deduction is not complicated at all. You take one number off a statement provided to you annually by the mortgage lender and you transfer that one number to a line on a tax return.

I have been for many years one of the most vociferous critics of the Internal Revenue Code of the United States. I have described it in very colorful terms at times, "absurd" being one term that is on the public record quite often. I am confident that the reality of the U.S.A. tax—as it operates with people, as opposed to a percep-

tion—will be quite simple. Filing tax returns is never going to be pleasant, but it is not going to be the annual agony that it is today.

I would make two points, if I may, about dealing with the Internal Revenue Service. Again, I have been very critical, but there are two different kinds of things that happen. One is contact with the Internal Revenue Service, simply filing a return; that is one thing. Some people seem to think that is bad. My concern about the tax law is not just contact; it is what the present tax law does to society and what it does to people's lives. That is, the reason I emphasize so strongly meant I fundamentally believe and know to be the fact—that the U.S.A. tax system will essentially have zero substantive impact one way or another on shaping what people do or don't do. It will let them alone to make free, efficient economic and personal choices.

Ms. DUNN. I thank you for that answer.

Would anybody else like to comment on that, agree or disagree?

Mr. ROGSTAD. I would answer, Congresswoman, yes, again in the strong affirmative. In addition to what Mr. Christian said, I think that taxpayers will not only understand the basis on which they are paying taxes, I think that this is a system that will allow them to understand the basis on which their fellow citizens are paying as well. And I think the notion of raising the level of saving through an unlimited deferral, which is the core of this proposal, will reinforce for people that saving is at the core of our future economic growth. And I think once that becomes the frame of reference, this will be viewed not only as appropriate to ourselves from a compliance standpoint, but one that will facilitate all of us feeling a little more comfortable about the basis on which the whole economy and all of our citizens are being taxed.

Ms. DUNN. It sounds to me—I worry a lot about the disconnect that people feel with government, and I think our current tax system adds to that and doesn't detract from that; and it seems to me that this would be a great big step in the right direction.

I just returned from a trip to some South American countries, including Chile, and on your comment on savings, I mean it is just stunning. It is very good to get out of the country and become a little less nationalistic, and that 25 percent savings rate that they have created for themselves in a brief number of years through the revision and privatization of the pension system is stunning and a great example for us. But it brings home loud and clear how it can make a nation such as Chile self-reliant and not need to go outside for the majority of its capital; and I think we could be doing the same thing if we make the proper choices in the next year or so as we consider this new tax system. Thank you.

Mr. CHRISTENSEN. Mr. English.

Mr. ENGLISH. Thank you, Mr. Chairman.

Gentlemen, earlier today I asked Secretary Samuels his opinion of the border adjustability of the business side of the U.S.A. tax, and he answered that Treasury hadn't drawn any conclusions on that. Are you confident that the U.S.A. tax is going to be border adjustable?

Mr. Rogstad.

Mr. ROGSTAD. Yes, I am. There are a number of technical issues involved. A basic that we undertook in the fundamental design of

the system with respect to wage deductibility at the business level was directed to ensure border adjustability would stand up in the WTO.

Mr. ENGLISH. Mr. Penner, do you agree with that?

Mr. PENNER. I am certainly not the lawyer here, Mr. English, and I wouldn't want to venture an opinion.

Mr. ENGLISH. Mr. Christian.

Mr. CHRISTIAN. I am absolutely certain of it. If you would like me to explain, I will.

Mr. ENGLISH. Certainly.

Mr. CHRISTIAN. As Senator Domenici said and Senator Nunn said, the U.S.A. tax has been worked on by them for a number of years. That work includes the same issue about border adjustability of this type of a tax which includes at the business level both the labor component of production and the capital component of production. You notice that Les Samuels at the Treasury didn't tell you this morning that he concluded that the U.S.A. tax couldn't be adjusted at the border.

Mr. ENGLISH. Well, he didn't tell me very much, so I——

Mr. CHRISTIAN. In any event, not to prolong the day, but the GATT is a flexible, international instrument of comity as well as a piece of black letter law. I don't have any real doubt. I don't even think there will be a challenge when the U.S.A. tax is enacted, and I am very confident that it would prevail.

Even back in the seventies, to give you an illustration, when the European VAT first came in, there was a real question about whether on a black letter of the law basis the VAT qualified. I would be happy to discuss that with you at some time if you would be interested.

Mr. ENGLISH. I would be delighted.

Mr. CHRISTIAN. The GATT is a flexible instrument, and I think, as a practical matter among adults, that there is no question about it.

Mr. ENGLISH. One of the interesting features of the U.S.A. tax to me was the FICA credit. How important do each of you feel that is to the design?

Mr. PENNER. I think it is extremely important, Mr. English, because, as Mr. Christensen pointed out earlier, if you don't have some kind of credit for the payroll tax, it is a marginal rate on top of whatever else you have. And in our system, you in essence subtract it from the statutory rate. So you get some very low marginal rates at the bottom, which is very important.

Mr. WEIDENBAUM. May I add to that?

Mr. ENGLISH. Certainly.

Mr. WEIDENBAUM. For an awful lot of modest-income, working people, the main Federal tax they pay is not the income tax, but the FICA tax. I think you will do more to ease the financial burden on working people of modest means by enacting this FICA credit than any of the other changes in any of the plans.

Mr. ENGLISH. Well, that is powerful. One of the other issues that I was impressed with in this bill was the effort it makes to make a transition from the existing tax system to the new tax system. Are all of you satisfied that this bill addresses all of those transitional issues, and which ones do you feel are the most important?

Mr. CHRISTIAN. The U.S.A. tax does address them all. It addresses them all adequately. Before Senator Domenici and Senator Nunn began their work on this, there were many people who had thought about the issue of old savings and who thought that it would not be possible to avoid taxing yet again income that had already been taxed. There were many publications in the academic literature to the effect that they didn't think this could be done.

Senators Nunn and Domenici did do it, and I will tell you that their system is very good and it is not a complex system.

On the business side, there are issues with respect to old investment, that is to say, existing investment, that have to be handled. They have a very good way of handling that which is not complex. There is no phase-in here. This tax goes in effect immediately with respect to a taxable year. The only issue is a set of straightforward, highly workable and efficient rules for dealing with the transition you are talking about. The U.S.A. transition rules work like a watch.

Mr. ENGLISH. Thank you, Mr. Chairman.

Mr. CHRISTENSEN. I thank the panel for staying late into the day. The Committee will stand in recess until 10 o'clock tomorrow morning.

[Whereupon, at 5:45 p.m., the hearing was adjourned, to reconvene at 10 a.m., Thursday, June 8, 1995.]

REPLACING THE FEDERAL INCOME TAX

THURSDAY, JUNE 8, 1995

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, D.C.

The Committee met, pursuant to call, at 10 a.m., in room 1100, Longworth House Office Building, Hon. Bill Archer (Chairman of the Committee) presiding.

Chairman ARCHER. The Committee will come to order, and I would ask that our guests and staff take their seats and give us an opportunity to be heard.

Today we begin the third and final day of hearings on concepts to replace the current Income Tax Code, and during the balance of the 104th Congress I do intend to hold additional hearings on various aspects of this fundamental exercise.

Yesterday we heard from advocates of two of the alternatives to our tax system, the value-added tax and the U.S.A. tax, and today we are going to hear from those who believe a flat tax is the answer, led by Majority Leader Dick Armey, and those who believe that we should have a national sales tax.

We will also hear from our former colleague Jack Kemp who is chairing the Economic Growth and Tax Reform Commission, but before we do that, we are going to lead off and hear from our colleague, the Ranking Democrat on the Committee, the gentleman from Florida, who has spent a number of years developing an alternative to the current income tax, and has his own plan, and, Sam, I don't know what label you would put on it.

I will let you make that decision. But we are really happy to have you here to make your presentation to the Members of your Committee, so I don't have to welcome you, you are always welcome here.

Mr. GIBBONS. Thank you.

May I yield to the Senator?

Chairman ARCHER. Oh, all right.

Mr. GIBBONS. Would you like to go first, Arlen, because I realize your time is very short.

Chairman ARCHER. Well, we are happy, and of course honored, to have Senator Specter here with us because you have taken the lead in wanting to replace the income tax in your candidacy for the Presidency, and you have an approach that is your own, and we welcome you to the Committee because you are very, very important in developing this debate across the country, and we are pleased to hear your comments and you may proceed.

Senator SPECTER. Well, Mr. Chairman, thank you very much. I am indebted to my colleague for yielding, but I decline. I want to listen to Chairman Gibbons and learn a little before I offer my testimony.

STATEMENT OF HON. SAM GIBBONS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF FLORIDA

Mr. GIBBONS. Well, I am flattered.

Mr. Chairman, thank you for opening this subject matter. It is something that this Committee should have examined years ago, and I want to apologize to all my colleagues on the Committee for having harassed them for a number of years.

Most recently, I spent a long time harassing the Members at the Austin, Tex. retreat 2 years ago when I finally got some time to explain what I thought ought to replace the current revenue system.

Let me make it clear that I speak only for Sam Gibbons. I do not speak as a spokesman for the Democratic Party or the Democrats on this Committee or the Democrats anywhere. It is not that they have told me they are opposed to this, it is just that I have not tried to seek any specific endorsements from them or from anyone else.

I think we need a discussion, a national discussion, about the situation we are in, and I think we need a solution, and it can only come about if we develop a national consensus. In developing that national consensus, I think we ought to keep our attention focused on some principles.

The first principle I would like to mention is that we ought to seek revenue neutrality in all of this. We should not allow this to become a debate over how big government should be or how much government should spend, and so we ought to hit the test for neutrality. There is a time for that debate, but this is not the time. We are talking about process here.

Second, amongst the fundamental principles of neutrality of revenue is neutrality of burden. In my testimony you will find there on page 4, and I wish you would turn to that page and look at the current tax distribution burden table there. Only with great deference should we attempt to change that burden table. I say that because for about the last 30 years the tax burden amongst Americans as far as income categories is concerned has been approximately that shown on page 4. You will find on page 5 what the burden has been over the last 20 years in those same categories.

You will see there has been very little fluctuation in the burden. Now, I am not saying that the burden that is there exhibited in those Congressional Budget Office tables is magic, but it is the best measure we have of tax burden that I know of. Essentially there are three different versions of this table: One put out by Treasury, one put out by Joint Committee, and one put out by Congressional Budget Office. They are slightly different, but only slightly different, and that is the best I have been able to determine what the current burden is. So we should be neutral on that burden.

Third, we ought to try to make our tax system much more simple, and I think the system I am about to describe to you is the ultimate in simplicity.

Fourth, we ought to be competitive in the international marketplace.

Our current system—and anybody that advocates an income tax-based system is walking right into this trap—is penalizing America heavily. Let me give you a simple illustration.

Take this pair of eyeglasses that I am wearing. If you manufacture them in the United States and you try to export them, here is the burden you run into: These glasses, when they leave the United States, will carry the full cost of government, and that is a substantial part of the cost of these glasses.

When they get to a foreign country, almost any foreign country with the exception of Australia, they will stop them at the border and they will add their cost of government to these glasses. As a result, these glasses now have the U.S. cost and the foreign government cost. When they are sold to the consumer in the foreign country, they carry those two costs of government. If you manufacture these glasses in any other country other than Australia, any industrialized country, when it gets to their border, they strike out practically all of their cost of government in these glasses, and when these glasses arrive at the U.S. border, we have nothing that will intercept these glasses and place the cost of government on them.

So these glasses when sold in a foreign country manufactured in the United States have two costs of government in them. When you manufacture them in a foreign country and put them back in the United States for sale to the consumer, they have got no cost of government in them.

Where are you going to manufacture these glasses? You are not going to manufacture them in the United States.

And the same applies to every product and every service that we create in the United States. That is because since 1947, the world trade agreement, the General Agreement on Tariffs and Trade has said you cannot adjust an income tax at the international border. Lord, we have tried.

Mr. Archer and a lot of the rest of us here have tried to adjust that international burden at the border, the U.S. burden at the border, and we have been struck down every time by it. You can't do it. It is impossible.

So anybody that comes to you and says we can reform the tax system and make it a lot simpler is overlooking one key factor, and that is you are going to lose jobs in the United States if you stick to an income tax-based system, and you are going to gain competitive opportunity if you go to a consumption tax.

Everybody on Earth understands that except the United States. Let me drive that home again.

Everybody on the Earth understands that except the United States, and the travesty is we put it in the General Agreement on Tariffs and Trade in 1947. We are stuck with it. We might as well adjust to it.

Now, let me describe the system I have proposed. Let me just show you in my testimony in front of you, the most important page of the whole statement is the VAT form. That is all you need to collect the necessary amount of revenue.

Now, there are essentially three steps that I would like to see us carry out.

First, I want to repeal the income tax, the personal income tax and the corporate income tax, and then I want to go further.

Second, I want to repeal the FICA tax, and that is a whale of a lot of repealing. That is most of the revenue in the United States. I don't want to start a debate about excise taxes, estate taxes and things like that. We can—that is not a lot of money, we can attack that at another period of time in the history of this Committee.

But we ought to repeal the income tax, the personal and corporate, and we ought to repeal the FICA tax, and we ought to replace it with a consumption-type tax, and we can do that without changing the tax burden and without increasing or decreasing the revenue that we collect. We ought to do it cold turkey.

There is going to be a little blood on the table when we do it cold turkey, but there will be a lot more blood on the table if we have to try to phase all this in. On January 1, 199*x* or 200*x*, we ought to bite the bullet and get it done. We can. It is just going to take understanding; it is going to take cooperation; and it is going to take debate.

Now, the third step in all of this is that we would have adjusted it, as far as American taxpayers are concerned, we would have slid the burden of taxation down if we go to a straight consumption tax. We are going to have to have some kind of burden adjuster in the system.

There are many ways we can do it, but we should not do it within the value-added tax that I advocate because it will make the value-added tax very, very complicated and impossible to administer.

We are essentially going to have to give back to some very low income—go to page 4 and look at the problem we face there. I would imagine that we would for all practical purposes probably have a value-added tax rate, if we repeal all the taxes I have talked about, of around 20 percent.

Now, we could have a lower rate than that if we don't repeal as many taxes, but if we repeal all the taxes I have talked about, the value-added tax rate would be around 20 percent. Just look on that table and see where the tax burden falls above and below 20 percent.

Look down at the bottom and you'll see the current effective tax rate is 23.9 percent, so we are going to have to do some adjusting. We can do that very simply by using perhaps, but this is not an exclusive method, the earned income credit, we could have a lower earned income. We could have an increased income credit for the low-income individuals and we could have a higher income credit or negative income credit for the upper income people. We could do it all in one short piece of paper, and just do it that way, very simply. There are lots of other ways we could do it, but we should not do it within the structure of the value-added tax.

Now, how do you collect the value-added tax?

First of all, only businesses would be involved in collecting the tax. The consumer would pay the tax, the consumer pays the tax today.

Anybody who tells you the consumer doesn't pay the tax today doesn't understand how the system works, but the consumer would pay the tax and the business would collect it.

What would the business do?

The business at the end of the tax paying period would simply add up all of its sales, everything it sold that had been used in its business, whether it sold a piece of its—what we now call capital equipment, or whether it sold its consumer goods, but just add them all up, and from that they would subtract all of the value of the goods that they exported.

Bang, there goes your cost of government on these glasses right there. We become much more competitive by that simple step.

If you export goods, you subtract it from the total amount of goods that you report as income. And then you subtract from all of that the total purchases that your business made during the same tax paying period, and you then multiply that times the tax rate.

If you had more sales than you did purchases, you pay a tax. If you had less sales than you do purchases, you get a check back from the government.

I know that is going to shock some of you, but that is the way all other value-added taxes in the world work. If the purchases exceed the sales, the taxpayer gets back a check. That is all there is to it. Individuals, nonbusinesses, individuals would not be involved in this at all.

We now harass through the IRS about 130 million Americans every year. If you go to the value-added tax you would be harassing something less than 12 million businesses, and you would only harass them with this very short and very simple form. Anybody could fill this out.

My 8-year-old grandson could fill out this form. He could read it and he could do the mathematics on it, and he could fill it out, and that is all of the intervention that we would have to do to raise the amount of money of the taxes that I think we ought to repeal.

We ought to repeal the personal income tax, the corporate income tax, and all of the FICA tax. That would make America competitive internationally, we would begin to save jobs in America and rebuild our worker employment here.

We would have a little unemployment based in the tax industry—and those are fine people, and I want to say they are fine people and well educated people who are spending most of their life now making substantial livings. We had a tax expert here with us yesterday that did that, manipulating the income tax. That is one of the finest paying jobs. One of the best trained work forces in America tries to figure out how do you manipulate, get out of paying this cotton pickin' income tax we have got now. Those people are smart enough, they would find other employment.

But Americans by and large would profit by this. We would save.

You know, we are now spending at least $300 billion a year to collect the $1.4 trillion we spend. We are probably spending as much as $6 billion—$600 billion a year. I would imagine that on the foreign tax provisions alone, we now spend more money trying to collect the tax than we collect in revenue.

On the income tax we are probably spending 50 percent of what we collect, just to collect the tax. On the personal income tax, it is less than that, and on the FICA tax it is a steal. It is the greatest ripoff that we have ever done as far as collecting.

It is real simple. Everything except the nanny tax, that is the most complicated thing that we ever imposed on the world. At least it was up until I think we corrected it last year, but—so that is what I advocate. In principle, I don't want to change the amount of revenue we collect. I don't want to change the tax burden that we collect from, and we ought to get on with it and we ought to do it cold turkey.

[The prepared statement and attachments follow:]

TESTIMONY OF
THE HONORABLE SAM M. GIBBONS
RANKING DEMOCRAT
COMMITTEE ON WAYS AND MEANS
BEFORE
THE COMMITTEE ON WAYS AND MEANS
ON
REPLACING THE FEDERAL INCOME TAX
JUNE 7, 1995

Mr. Chairman and my colleagues,

In my 26 years on this esteemed Committee and during my tenure as Acting Chairman and now as Ranking Democratic Member of the Committee, I have thought a great deal about the best way for our government to raise the revenue it needs and about the impact of the various alternatives on taxpayers, on our national economy, on our competitive position worldwide, and on our future. I am very pleased that Chairman Archer is committed to taking a serious look at alternatives to our revenue system.

More than a decade ago, I came to the conclusion that the current system should be replaced and that one particular alternative is preferable to others. As most of you know, I have developed and refined over the years my version of a single-rate subtraction-method value-added tax as a replacement for our current personal and corporate income taxes as well as most of our payroll taxes.

I have attached to my testimony and submit for the record a description of my value-added tax proposal. I have designed a sample tax form, which, as you can see, is the cover sheet of this testimony. I will take you through this form line by line. I am gratified that national attention is now focused on the tax system that I have worked so hard on for so many years.

Major Change in Our Federal Revenue System

First, I want to take this opportunity to talk with you about why I think fundamental tax reform is important.The current income tax should be repealed. It has become a maze of complexity. It is widely perceived as unfair. It has not kept pace with the economic realities of the modern global marketplace. It creates economic distortions, thus interfering with economic efficiency and growth. It does not reach the huge underground economy. It has become burdensome to many taxpayers, particularly small businesses who must struggle through a pile of Federal tax forms every quarter.

My proposal represents a major change in our revenue system. There are three basic steps:

Step 1. Repeal of the individual and corporate income taxes and most payroll taxes. Wage-earners would no longer be subject to FICA (social security) taxes on their first dollar of earnings. They would not see their gross paychecks shrink, as they do today because income and FICA taxes are withheld today. Their net paychecks would equal their gross earnings. Businesses would no longer pay the corporate income tax.

Step 2. Imposition of a single-rate, subtraction-method value-added tax on businesses. This would be collected at the business level only. Every incorporated and unincorporated business would be subject to this system.

The rate would be set to raise only sufficient revenue to replace the current income and payroll taxes. Businesses only would collect and remit the tax, as I illustrate in the attached "Description of Value-Added

Tax Form" beginning on page 8. Most of these calculations required would be made anyway in the ordinary course of their businesses.

It is important to point out that this system is not a national retail sales tax. A sales tax is applied as a set percentage of the *retail* price of goods and services. On the other hand, a value-added tax is levied at each stage of production only on a firm's *net* value-added.

Step 3. Adjustments to the resulting tax burden would be necessary to maintain the current distribution of the Federal tax system. Any new tax system should result in the same tax burden on each income group as the current tax system imposes. The distribution of the current tax burden is presented in Table 1, and the historical stability of the tax burden over the last two decades is presented in bar-graph form (see pages 4 and 5).

Fundamental Principles

This week's hearings focus on several different consumption tax alternatives. These differ in design, in administration, and in impact. I believe that they and any other alternative must satisfy four fundamental criteria. I am unwilling to entertain proposals that violate these principles.

Revenue Neutrality. The debate about the best method by which the government raises revenue should not be confused with the issue of how much revenue the government should raise. As we did in 1986, we should maintain a standard of revenue neutrality. This is not the debate about how large our government should be, about what the proper role of government in society is, or about what the priorities of government spending should be. All those issues can be and should be discussed, but not in the context of tax restructuring.

Fairness. Equitable distribution of the tax burden is of paramount importance. I believe in a progressive tax system. I believe in some relief for the least well-off among us. I believe in a society that worries about all of its citizens, not just the successful ones. I will not advocate any alternative revenue system that fails to address the question of fairness by including measures to maintain the current distribution of the tax burden.

Simplicity. Both individuals and businesses resent and complain about the level of complexity of the current tax system. Taxpayers worry that they are being unfairly taxed and that others have found ways to avoid the tax. Extensive and lucrative industries of lawyers, accountants, and tax preparers spend countless hours and unbounded energy helping taxpayers through the maze of complexity to minimize their tax liabilities. A simpler tax system would free up these resources to engage in more productive economic enterprises. A simpler system would be better understood by the average citizen and, thus, would avoid the ill will and skepticism generated by the current system. A simpler system would improve compliance and streamline administration.

Many alternative tax systems purport to be simple, but a close examination of the details belies that claim. One of the reasons I believe my proposal is preferable to others is that it has almost no special exemptions or deductions and it has only one rate. This is very important to achieving the simplicity for which we all hope.

Economic Efficiency. A good revenue system should minimize interference in economic markets. It should result in the least amount of distortion and bias, should encourage economic growth, and should promote the vigor and competitiveness of American companies. Complying with a good revenue system should be straightforward and not too costly. A simpler, less burdensome, more neutral tax system would provide opportunities for more efficient use of our Nation's resources. That would be to the benefit of all Americans and would improve the future standards of living of our children and grandchildren. In our examination of alternative tax systems, we must keep this goal in the forefront and make sure that every decision we make along the way furthers this goal.

International Competitiveness. The current income tax is an impediment to maximum competitiveness of American companies in international markets. The income tax simply has not kept up with the many changes that have occurred in the global marketplace. The current system penalizes exports because under the rules of the World Trade Organization (WTO), formerly the General Agreement on Tariffs and Trade (GATT), only indirect taxes, such as a VAT, can be adjusted at the border. Income taxes cannot be removed from the price of goods when they cross the border to be exported. I believe that a border-adjustable tax system would promote the competitiveness of American companies and invigorate American exports.

Conclusion

I believe that we must be open-minded when we consider alternative revenue systems. There are many competing ideas. No proposal has the inside track.

Any final decision about restructuring our tax system is a long way off. I agree with Chairman Archer that none of these alternatives is going to become law in this Congress. The effort to reform the tax system will take time. It should be the subject of much careful thought and planning. It cannot happen without exhaustive study by this Committee and its Senate counterpart.

The implications of replacing large elements of our current system must be understood and dealt with. We need to educate ourselves and the public about the advantages and disadvantages of our current system and of the many alternatives. We need to hear expert opinions and openly and objectively debate the issues. The public must understand the choices and knowingly signal its readiness to embrace a new system. As with all successful legislation, a new revenue system must evolve from an deliberate, ongoing exercise in education and serious thought. It cannot be a flash-in-the-pan solution -- if it is, it won't work.

I encourage thorough review of the issues. I am sure that my colleagues, who care about the American people just as I do, will see the wisdom of the four principles I have outlined here. I believe that each alternative proposal must be assessed against these criteria.

After years of study and review, I have come to the conclusion that my single-rate subtraction-method value-added tax is the best way to satisfy these criteria. I welcome the discussion in the coming months about fundamental tax reform. I hope that the research and thought I have devoted to this issue over many years will help to further the discussion and will be of use to my colleagues. A description of my proposal begins on page 6.

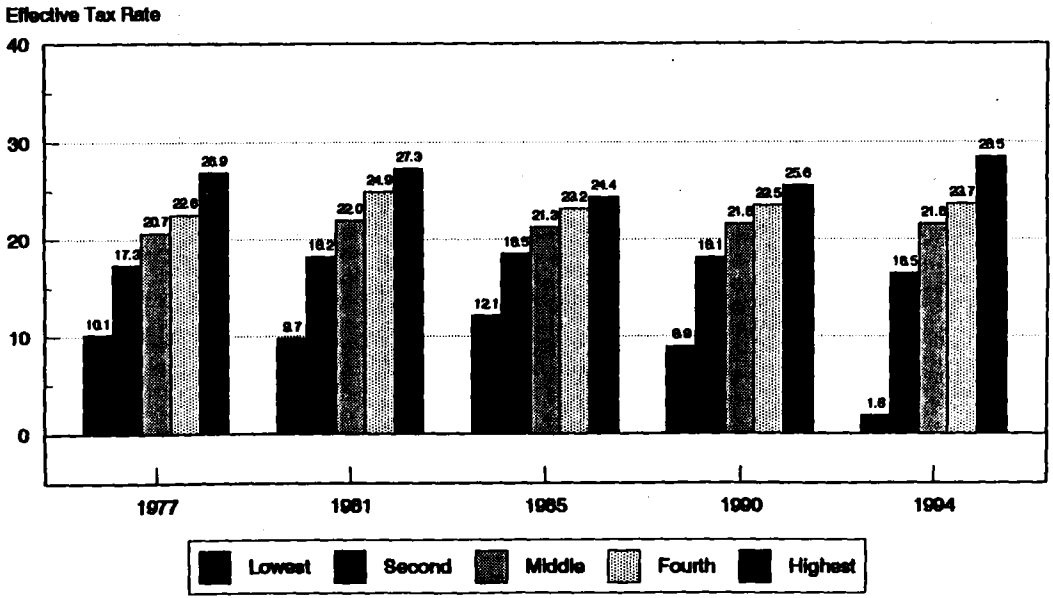
TABLE 1

DISTRIBUTION OF THE CURRENT FEDERAL TAX BURDEN
(1996 INCOME LEVELS)

INCOME RANGE	NUMBER OF FAMILIES (in millions)	AVERAGE INCOME (in dollars)	EFFECTIVE TAX RATE (in percent)
Less than $10,000	14.6	$6,009	6.7
$10,000 - 20,000	18.5	$14,794	10.4
$20,000 - 30,000	16.6	$24,941	16.5
$30,000 - 40,000	13.5	$34,841	19.4
$40,000 - 50,000	10.8	$44,808	21.7
$50,000 - 75,000	17.7	$61,278	23.6
$75,000 - 100,000	8.6	$85,637	25.4
$100,000 - 200,000	7.0	$129,788	26.7
$200,00 or more	1.9	$486,031	32.0
ALL	110.8	$48,165	23.9

SOURCE: Congressional Budget Office, January 1995.

Effective Total Federal Tax Rates, by Income Quintile, Selected Years 1977-1994 (in percent) Families With Children



NOTE: Families ranked by adjusted family income (AFI), equal number of people per percentile. Projected rates for 1994 reflect the fully phased-in effects of OBRA93.

SOURCE: Congressional Budget Office

DISCUSSION DRAFT OF A NEW REVENUE SYSTEM: A VALUE-ADDED TAX

The centerpiece of a comprehensive program to reform the Federal Government's revenue system should be a broadly based and uniformly applied value-added tax (VAT). The following is an outline of the principal features of a potential tax system:

- BUSINESSES ARE TAXPAYERS

  Businesses (i.e., corporations, partnerships, and sole proprietorships) would be required to collect the tax. The business itself would be responsible for filing periodic returns and remitting the tax. For sole proprietorships, the individual owner would be responsible. Other individuals would not be subject to collecting or remitting the VAT.

- ONE TAX RATE

  There would be a single tax rate applied to all businesses (including government businesses). The rate would be a function of the desired revenue level to replace the repealed taxes.

- BROAD TAXABLE BASE

  The taxable amount for each business would be its economic "value-added," which equals the excess (if any) of its receipts from sales of goods and services over its payments for purchases of goods and services from other businesses. Sales of all goods and services by businesses would be included in the system (except exports, as discussed below), including all professional services, financial services, food and beverages, medical services and products, new houses, and rental housing. No businesses would be "exempted" from the system.

- SUBTRACTION METHOD OF COMPUTING TAX LIABILITY

  The tax would be computed using the subtraction method. Gross receipts from sales of goods and services would be the tentative taxable amount. Gross costs for purchases of goods and services would be deducted from that amount. The balance would be the business' value-added base, which would be multiplied by the tax rate to determine the tax liability. If the balance is negative because purchases exceeded sales for that period, the business would receive a refund equal to the balance multiplied by the tax rate.

- BORDER ADJUSTMENTS

  Imports. The tax would apply to sales of imported goods and services. This should be done in a manner which imposes the least administrative costs while assuring the highest rate of compliance. For goods, the options include:

  (1) payment by the seller or purchaser when goods enter the country at customs locations, with a subsequent deduction by the purchaser for the cost of the goods, or

  (2) denial of a deduction by the purchaser for the cost of the goods.

For imported services (with the possible exception of transportation services for imported goods), the only workable option probably is (2) above.

Exports. The tax would not apply to sales of goods or services for export. A business which sells goods for delivery outside the U.S. (or, in general, services for use outside the U.S.) would exclude such sales when computing its taxable base while still deducting all purchases.

- TREATMENT OF PARTICULAR BUSINESSES

Housing Sectors. Sales of houses by businesses such as builders, developers, renovators, etc., would be included in the system, just like sales of all other goods by businesses. Renovation and remodelling services would also be included. Rentals by landlords would be included. Resales of houses by homeowners would not be subject to the tax.

Financial Intermediaries. The financial intermediation services of businesses such as banks and insurance companies would be included in the system, just like all other services. In general, their gross sales of services would be limited to the "spread" between the sum of interest, premiums, and investment income received (from borrowers, insureds, and investments) and the sum of interest and claims paid (to depositors and insureds), plus identifiable fees for specific services and other sales receipts.

Governments. Sales of goods and services to governments would be included in the system. Governments should not be exempt from the tax for their sales of goods and services.

Non-Profit Entities. Sales to non-profit entities would be included in the system. These entities should not be exempt from the tax for their sales of goods and services.

Agricultural Enterprises. Agricultural enterprises would be included in the system.

Leasing Companies. Receipts of businesses which lease and rent goods would be included in the system.

- TREATMENT OF PARTICULAR GOODS AND SERVICES

Used Property. The receipts from sales of used machinery, equipment, and other property that has been previously deducted by a business would be included in that business' gross sales receipts.

Leased Property. Payments for leased property would be deductible by the lessee business.

Intangible Assets. The receipts from sales of intangible assets such as patents, copyrights, trademarks, etc., would be included in gross sales receipts. Purchases of such intangibles would be deductible by the purchasing business.

DESCRIPTION OF VALUE-ADDED TAX FORM

The value-added tax that I am outlining today would be an extraordinarily simple tax form for businesses to fill out. The VAT would be collected and remitted only by businesses and would require fewer than a half dozen simple computations, many of which would be made whether or not there was a value-added tax.

First, on line 1, the business would be required to compute its gross business sales. It is impossible to conceive of a business that wouldn't make this computation, whether or not it was subject to a value-added tax. In determining this amount, the business would only have to take into account the following amounts:

- Sales of goods and services produced or sold in the course of its business;
- Amounts (such as rents or royalties) received for granting the right to use property (whether tangible or intangible); and
- Amounts received from sale of assets which were used in the business.

From the amount of the gross business sales, a business would subtract the following amounts:

- The amount of <u>returns</u> and allowances made during the taxable period and the amount previously included in gross sales that becomes uncollectible during the taxable period; and
- On line 2, the portion of the gross business sales received for export of property or services.

The subtraction for exports is the simple way of making the value-added tax adjustable at the border for American exports.

After computing its net business sales, a business would have to compute its total business purchases on line 4. Again, the computation would be quite simple, and it is a mirror image of its computation of gross business sales. It would consist of the gross amount spent for the following amounts:

- Goods and services to be used or sold in the business;
- Rents and royalties for the right to use property, whether tangible or intangible, in the business; and
- Acquisitions of property to be used in the business.

The only adjustment to the gross amount of business purchases would be made on line 5: a reduction for the amount of purchases of property or services imported by the business. This is a very simple adjustment to carry out the policy of having the value-added tax adjustable at the border.

Finally, the tax on line 8 would equal a specified percentage of the excess of the net business sales over business purchases. If the business purchases exceed the net business sales, the business would be entitled to a refund equal to such percentage of that difference. This again carries out the policy of having the tax adjustable at the border. In all cases, businesses would be entitled to a refund of the value-added tax imbedded in their business purchases used in producing exported property .

It is far easier for me to set forth what a business must do to comply with my proposed value-added tax than to enumerate the many things required under existing law that businesses would no longer be required to do.

Many companies file consolidated income tax returns for purposes of the existing corporate tax. This involves elaborate record keeping for inter-company transactions. Complex rules govern the extent to which the losses of a subsidiary can be used to offset income of the other members of the group. Under my value-added tax, the only computations on a consolidated basis would be computations of gross sales and business purchases. This could simply be accomplished by not taking into account sales and purchases between members of the group.

Under existing law, many companies are required to maintain inventories. They must keep records of amounts in inventory and allocate expenses between amounts that have to be capitalized as part of inventory and those that can be expensed as overhead. In addition, companies using the LIFO method must maintain elaborate records as to the various layers of its inventory. None of this is required under my proposed value-added tax.

Under existing law, businesses are required to capitalize and then depreciate acquisitions of plant and equipment. They are required to distinguish between items such as repairs, which can be immediately expensed, and other items which are betterments or improvements and must therefore be capitalized and depreciated. They must maintain records as to the depreciable basis of each asset. None of this would be required under the value-added tax. All amounts for acquisitions or improvements of property would be immediately expensed.

All of the enormous complexity involving the foreign tax credit would be eliminated.

A Revenue System for America's Future

Form VAT	U.S. Value - Added Tax Return (For Businesses Only For taxable period beginning ____)	1995
Check if a consolidated return (attach schedule) ☐	Business Name: Every Business in USA Address: 1234 Main Street City, State, Zip: Anytown, USA 12345	Business ID # _____

1. Gross Receipts from Sales Net of Returns	1. $
2. Less Receipts from exports	2. ($)
3. Total taxable receipts . . . . *subtract line 2 from line 1*	3. $
4. Gross purchases	4. $
5. Less import purchases	5. ($)
6. Total business purchases . . *subtract line 5 from line 4*	6. $
7. Total value-added . . . . . *subtract line 6 from line 3*	7. $
8. Total tax . . . . . (??% x line 7)	8. $
9. Tax due if line 7 positive - Refund due if line 7 negative	9. $

Please Sign Here	*I declare that the information given above is true and complete.* X_____ *Signature of Officer* *Date* *Title*

Mr. GIBBONS. Senator?

I am ready for questions about it. What do you say, Mr. Chairman, do you want to go through the question session now?

Chairman ARCHER. Sam, if it is OK with you, I would like for you to stay where you are and if Senator Specter would grace us with his statement, maybe we could release him and send him back to other things. I know you must have a few other things to do. We would be pleased to hear from you, and then we will inquire of Congressman Gibbons.

Senator Specter.

STATEMENT OF HON. ARLEN SPECTER, A U.S. SENATOR FROM THE STATE OF PENNSYLVANIA

Senator SPECTER. Thank you very much, Mr. Chairman. I very much appreciate the opportunity to testify before this very distinguished Committee in this very beautiful room. This is the first time I have ever had a chance to testify here, and we don't have one to match it on the Senate side, so I am delighted to be here.

I very much appreciated an opportunity to listen to Congressman Gibbons' testimony, and there is one unifying feature which I believe is emerging from all corners. That is that we need a reform of the current tax system, and I saw you, Mr. Chairman, on television on Tuesday evening to the same effect, and the question is where we go from here to achieve such reform.

When Congressman Gibbons testifies about the intrusiveness of the current tax system on 130 million Americans, I think he perhaps even understates a bit to the extent that the statistics show that we spend 5.4 trillion hours on tax returns, and so many of us have received these computer printouts saying we owe $111.17.

It takes a tremendous amount of time to figure out that the government is wrong, and that the computer is inaccurate, and so we desperately need a change.

My own view is that the best system is the flat tax, and I say that because of its tremendous progrowth capabilities and its simplicity and its fairness. The legislation which I have introduced in the Senate, S. 488, is modeled after a program designed by two distinguished professors at Stanford—Hall and Rabushka. They have worked on it for a long time.

Their first publication was put out in 1981, and they have revised it since, and it is a hard matter to get a comprehensive handle to see to it that it turns out to be tax neutral, revenue neutral, and also turns out to be fair.

When we talk about a balanced budget, we are talking about a long overdue objective of government, but that is one side of the economic coin. The other side is stimulus in order to have progrowth. And the Hall-Rabushka projections show an increase in the gross national product of $2 trillion within 7 years and a lowering of the interest rate by 2 percent, which is very, very substantial.

The tax rate which Hall and Rabushka propose is a 19 percent flat tax which is tax neutral. The Majority Leader, Congressman Dick Armey, has modeled his legislation after Hall-Rabushka.

He has it slightly different than I do. He projects 20 percent to start and down to 17 percent, but there may be an issue about rev-

enue neutrality with Congressman Armey's plan. I have added one point to the 19 percent flat tax of Hall-Rabushka, and I do so because I believe there needs to be just a little bit of deductibility to have a practical alternative to get the legislation passed.

I leave very limited deductions for interest on home mortgages, up to $100,000 in borrowing, and deductibility on charitable contributions limited to $2500. Congressman Souder, who is listed as a witness later today, has advised me that he intends to introduce a companion bill to mine with one modification. He does not want to limit charitable contributions.

I think that it is difficult to have a tax which is entirely flat, but I think that these two concessions still leave it reasonably flat, and I see the intermediate light is on, so I would come to a close here by showing the tax return under my tax proposal. I hope you won't mind if I defer to C–SPAN to show the return.

It is a postcard tax, can be filled out in 15 or 20 minutes, would save tremendous amounts of time, and I agree totally with what Congressman Gibbons has said and what you have said, Mr. Chairman, and others have said about the need for a national consensus, and I will confess to having done quite a bit of traveling recently, and wherever I go I am never without my American Express or my flat tax postcard, and I show it on all the television interviews and perhaps one of the best tests is that invariably the cameraman wants a copy.

There is a lot of interest in the flat tax, a tremendous amount of interest, and I compliment you, Chairman Archer, for these hearings. I have had the pleasure to appear with Congressman Armey on three other hearings; on the Senate side, the House side, and the Joint Economic Committee, and I believe when there is sufficient public understanding that there will be a demand, an avalanche on the Congress to change the system. And I am prepared to listen to Congressman Gibbons or to variations of Congressman Armey or other proposals, but I think debate is very healthy and after a lot of analysis I have come down in favor of the flat tax.

I thank you very much, Mr. Chairman, and Members of the Committee.

[The prepared statement and attachments follow:]

Testimony of Senator Arlen Specter
House Ways & Means Committee
Flat Tax Hearing
June 8, 1995

Mr. Chairman, I appreciate this opportunity to appear before the House Ways & Means Committee to testify regarding flat tax legislation and my bill, the Flat Tax Act of 1995, S.488. I am also pleased to recognize the efforts of Congressmen Mark Souder and Gerold Solomon who are introducing companion legislation to S.488 in the House of Representatives today.

Over the past several weeks, Congressman Armey and I have testified before the Senate Finance Committee, the House Small Business Subcommittee on Tax and Finance and the Joint Economic Committee regarding the incredible complexity of the tax code and the fact that very few people understand our tax laws, much less the implications of a dramatic reform of these laws. I firmly, believe, however, that the more Americans learn about the flat tax, the more they like it. A recent poll by Newsweek magazine demonstrates the breadth of this support already, with 61% of the respondents indicating they favor a flat tax and a majority of these supporters expressing their preference for my flat tax plan, S.488.

This groundswell of support has extended to the halls of Congress, as more and more Members of the Senate and the House of Representatives are expressing their interest in the flat tax. This support has increased after our recent Easter and Memorial Day recesses, when many Members of Congress travelled to their home states and districts and heard first-hand the demands of their constituents for simplification and reform.

The tax system that we use in America today is a national disgrace, with a dedicated deduction for every interest group and a loophole for every lobbyist. Our current system is bizarre, burdensome, and biased against growth. The flat tax will give the American people a system which is simple, fair and pro-growth.

My flat tax bill would scrap the vast majority of IRS rules and regulations, with the myriad rates, deductions and instructions, and replace them with a 20% flat tax under which Americans could file their tax returns on a simple 10-line postcard. Thus, instead of spending billions of dollars every year on high-priced tax attorneys or accountants who are a virtual necessity for anyone seeking to fill out tax returns, and billions of hours, Americans could devote their energies to more productive pursuits.

The basic model for my legislation comes from a plan created by Professors Robert Hall and Alvin Rabushka of the Hoover Institute and a flat tax bill introduced in the House of Representatives by Majority Leader Richard Armey. These other plans, however, would eliminate all deductions.

I have included limited deductions for home mortgage interest on up to $100,000 in borrowing and charitable contributions up to $2,500. While these modifications limit the purity of the flat tax principle, I believe that those two deductions are so deeply ingrained in the financial planning of American families that they should be retained as a matter of fairness -- and also political practicality. With those two deductions maintained, passage of a modified flat tax will be difficult; but without them, probably impossible.

For example, I have had several meetings with representatives of the real estate industry, including the National Association of Realtors, and they have expressed their strong opposition to an outright repeal of a deduction which many low and middle income Americans desperately need in order to afford the homes they live in or to maintain the hope of eventual home ownership. According to the Congressional Research Service, however, my flat tax will accommodate over 80% of taxpayers who have home mortgages under $100,000 and the remaining taxpayers will reap the benefits of lower borrowing costs by a drop in interest rates of up to two points.

In this Congress, we have been concerned with the work of reducing the size and cost of government, and this is work which is vitally important. But the work of downsizing

government is only one side of the coin. What we must do at the same time, and with as much energy and care, is to promote economic growth. As we reform the welfare programs and government bureaucracies of past administrations, we must replace those programs with a prosperity that extends to all segments of American society through private investment and job creation -- which can have the additional benefit of producing even lower taxes for Americans as economic expansion adds to federal revenues. Just as Americans need a tax code that is fair and simple, they also are entitled to tax laws designed to foster rather than retard economic growth.

Under my tax plan, individuals would be taxed at a flat rate of 20% on all income they earn from wages, pensions and salaries. Individuals would not be taxed on any capital gains, interest on savings, or dividends. The flat tax will also eliminate all but two of the deductions and exemptions currently contained within the tax code. Instead, taxpayers will be entitled to "personal allowances" for themselves and their children: $9,500 for a single taxpayer, $14,000 for a single head of household and $16,500 for a married couple filing jointly; and $4,500 per child or dependent. These personal allowances would be adjusted annually for inflation. Thus, a family of four would be entitled to $25,500 in tax-free income before any taxes were assessed on their wages.

Businesses would also be taxed at a flat rate of 20%. My legislation would eliminate the intricate scheme of depreciation schedules, deductions, credits, and other complexities. Instead, businesses would only deduct wages, direct expenses and purchases. Businesses would be allowed to expense 100% of the cost of capital formation, including purchases of capital equipment, structures and land, and to do so in the year in which the investments are made.

The key advantages of this flat tax plan are three-fold: First, it will dramatically simplify the payment of taxes. Second, it will remove much of the IRS regulatory morass now imposed on individual and corporate taxpayers, and allow those taxpayers to devote more of their energies to productive pursuits. Third, since it is a plan which rewards savings and investment, the flat tax will spur economic growth in all sectors of the economy as more money flows into investments and savings accounts, and as interest rates drop. By contrast, there will be a

contraction of the IRS if this proposal is enacted.

Simplicity

The first major advantage to this flat tax is simplicity. According to reliable studies, Americans spend approximately 5.4 billion hours each year filling out tax forms. Much of this time is spent burrowing through IRS laws and regulations, which, according to the Tax Foundation, have grown from 744,000 words in 1955 to 5.6 million words in 1994. Even those IRS forms which are intended to be simple are not. The IRS notes proudly that it should take taxpayers "only" 2 hours and 54 minutes to complete and file the 1040EZ form, which is supposedly the most simple tax form available.

Whenever the government gets involved in any aspect of our lives, it can convert the most simple goal or task into a tangled array of complexity, frustration and inefficiency. By way of example, most Americans have become familiar with the absurdities of the government's military procurement programs. If these programs have taught us anything, it is how a simple purchase order for a hammer or a toilet seat can mushroom into thousands of words of regulations and restrictions when the government gets involved. The Internal Revenue Service is certainly no exception. Indeed, it has become a distressingly common experience for taxpayers to receive computerized print-outs claiming that additional taxes are due, which require repeated exchanges of correspondence or personal visits before it is determined, as it so often is, that the taxpayer was right in the first place.

My plan would eliminate these kinds of frustrations for millions of taxpayers. This flat tax would enable us to scrap the great majority of the IRS rules, regulations and instructions and delete literally millions of words from the Internal Revenue Code. Instead of billions of hours of non-productive time spent in compliance with (or avoidance of) the tax code, taxpayers would spend only the small amount of time necessary to fill out a postcard-sized form. Both business and individual taxpayers would thus find valuable hours freed up to engage in productive business activity, or for more time with their families, instead of poring over tax tables, schedules and regulations.

The flat tax I have proposed can be calculated just by filling out a small postcard which requires a taxpayer only to answer a few easy questions. The postcard would look like this:

Form 1	**Individual Wage Tax**	**1995**
Your first name and initial (if joint return, also give spouse's name and initial)		Your social security number – –
Home address (number and street including apartment number or rural route)		Spouse's social security number – –
City, town, or post office, state, and ZIP code		
1.	Wages, salary, pension and retirement benefits	1_____
2.	Personal allowance (enter only one) -- $16,500 for married filing jointly -- $9,500 for single -- $14,000 for single head of household	2_____
3.	Number of dependents, not including spouse, multiplied by $4500	3_____
4.	Mortgage interest on debt up to $100,000 for owner-occupied home	4_____
5.	Cash or equivalent charitable contributions (up to $2,500)	5_____
6.	Total allowances and deductions (lines 2, 3, 4 and 5)	6_____
7.	Taxable compensation (line 1 less line 6, if positive; otherwise zero)	7_____
8.	Tax (20% of line 7)	8_____
9.	Tax withheld by employer	9_____
10.	Tax or refund due (difference between lines 8 and 9)	10_____

Filing a tax return would become a manageable chore, not a seemingly endless nightmare, for most taxpayers.

Slash the IRS

Along with the advantage of simplicity, enactment of this flat tax bill will help to remove the burden of costly and unnecessary government regulation, bureaucracy and red tape from our everyday lives. The heavy hand of government bureaucracy is particularly onerous in the case of the Internal Revenue Service, which has been able to extend its influence into so many aspects of our lives.

In 1994, the IRS employed over 110,000 people, spread out over 650 offices across the United States. Its budget was in excess of $13 billion, with some $7.1 billion spent annually just to administer the tax laws, and another $4 billion for enforcement. By simplifying the tax code and eliminating most of the IRS' vast array of rules and regulations, the flat tax would enable us to cut a significant portion of the IRS budget, including the bulk of the funding now needed for enforcement and administration.

In addition, a flat tax would allow taxpayers to redirect their time, energies and money away from the yearly morass of tax compliance. According to the Tax Foundation, in 1994, businesses spent approximately $127 billion in compliance with the federal tax laws, and individuals spent an additional $65 billion, for a total of $192 billion. Monies spent by businesses and investors in creating tax shelters and finding loopholes could be instead directed to productive and job-creating economic activity. With the adoption of a flat tax, the opportunities for fraud and cheating would also be vastly reduced, allowing the government to collect, according to some estimates, over $120 billion annually.

Economic Growth

Another major advantage to a flat tax is that it will be a tremendous spur to economic growth. Recently, Congressman Armey and I testified before the Joint Economic Committee, along with two of the fathers of the flat tax, Jack Kemp and professor Alvin Rabushka, on how the flat tax will unleash up to $2 trillion in new economic growth and a drop in interest rates by as much as two points.

The economic principles are fairly straightforward. Our current tax system is inefficient; it is biased toward too little savings and too much consumption. The flat tax creates substantial incentives for savings and investment by eliminating taxation on interest, dividends and capital gains -- and tax policies which promote capital formation and investment are the best vehicle for creation of new and high paying jobs, and for a greater prosperity for all Americans.

It is well recognized that to promote future economic growth, we need not only to eliminate the federal government's reliance on deficits and borrowed money, but to restore and expand the base of private savings and investment that has been the real engine driving American prosperity throughout our history. These concepts are interrelated, for the federal budget deficit soaks up much of what we have saved, leaving less for businesses to borrow for investments.

It is the sum total of savings by all aspects of the U.S. economy that represents the pool of all capital available for investment -- in training, education, research, machinery, physical plant, etc. -- and that constitutes the real seed of future prosperity. The statistics here are daunting. In the 1960s, the net U.S. national savings rate was 8.2 percent, but it has fallen to a dismal 1.5 percent. In recent international comparisons, the U.S. has the lowest savings rate of any of the G-7 countries. We save at only one-tenth the rate of the Japanese, and only one-fifth the rate of the Germans, which is clearly reflected in the comparative growth rates of our economies over the last three decades.

An analysis of the components of U.S. savings patterns shows that although the federal budget deficit is the largest cause of "dissavings," both personal and business savings rates have declined significantly over the past three decades. Thus, to recreate the pool of capital stock that is critical to future U.S. growth and prosperity, we have to do more than just get rid of the deficit. We have to very materially raise our levels of private savings and investment. And we have to do so in a way that will not cause additional deficits.

The less money people save, the less money is available for business investment and growth. The current tax system discourages savings and investment, because it taxes the interest we earn from our savings accounts, the dividends we receive from investing in the stock market, and the capital gains we earn from successful investments in our homes and the financial markets. Indeed, under the current law these rewards for saving and investment are not only taxed, they are overtaxed -- since gains due solely to inflation, which represent no real increase in value, are taxed as if they were really profit.

With the limited exceptions of retirement plans and tax free municipal bonds, our current tax code does virtually nothing to encourage personal savings and investment, or to reward it over consumption. As William Schreyer wrote recently in the Harvard Business Review, "the budget deficit is only one part of a larger national problem: the U.S. saving deficit."

S.488 will change this system, and address this problem. The proposed legislation reverses the current skewed incentives by promoting savings and investment by individuals and by businesses. Individuals would be able to invest and save their money tax-free and reap the benefits of the accumulated value of those investments without paying a capital gains tax upon the sale of these investments. Businesses would also invest more as the flat tax allowed them to expense fully all sums invested in new equipment and technology in the year the expense was incurred, rather than dragging out the tax benefits for these investments through complicated depreciation schedules. With greater investment and a larger pool of savings available, interest rates and the costs of investment would also drop, spurring even further economic growth.

Critics of the flat tax have argued that we cannot afford the revenue losses associated with the tremendous savings and investment incentives the bill affords to businesses and individuals. Those critics are wrong . Not only is this bill intended to be revenue neutral, but historically we have seen that when taxes are cut, revenues actually increase, as more taxpayers work harder for a larger share of their take-home pay, and investors are more willing to take risks in pursuit of rewards that will not get eaten up in taxes. As one example, under President Kennedy individual tax rates were lowered, investment incentives including the investment tax credit were created and then expanded, depreciation rates were accelerated, and yet between 1962 and 1967 gross annual federal tax receipts went from $99.7 billion to $148 billion -- an increase of nearly 50%. More recently under President Reagan, after his tax cuts in the early 1980's, government tax revenues rose from just under $600 billion in 1981 to nearly $1 trillion in 1989. In fact, the Reagan tax cut program helped to bring about the longest peacetime expansion of the U.S. economy in history. There is every reason to believe that the flat tax proposed here can do far more -- and by maintaining revenue neutrality in this flat tax proposal, as we have, we can avoid any increases in annual deficits and the national debt.

As Professors Hall and Rabushka state it, the growth case for a flat tax is compelling. It is even more compelling in the case of a tax revision that is simple and demonstrably fair.

Fairness

In addition to increasing federal revenues by fostering economic growth, the flat tax can also add to federal revenues without increasing taxes by closing tax loopholes. Personal income in the United States totals about $5 trillion. Of this amount, however, only $2.4 trillion is reported as taxable income. Thus, over 50% of personal income is sheltered by legal loopholes, deductions, credits, exemptions or outright fraud. Under a flat tax system, all tax shelters will disappear and all income will be subject to taxation. With a broader tax base, we can then lower tax rates and ensure that all Americans pay their fair share of taxes.

The flat tax also promotes fairness by lessening the tax burden on working families. By eliminating loopholes and thus broadening the tax base, my legislation will force many higher income taxpayers to pay their fair share of taxes -- and it will allow us to lower the taxes paid by lower and middle income families. IRS statistics indicate that in 1994, over 50% of all tax returns were filed by taxpayers earning less than $30,000. The vast majority of these taxpayers would pay little or no taxes under my flat tax, because of the $25,500 income exclusion for a family of four and the continuation of limited deductions for home mortgage interest and charitable contributions.

Mr. Chairman, no one likes to pay taxes, and no one likes the billions of dollars in additional hidden taxes and costs they incur every year simply seeking to comprehend and comply with the tax code. My 20% Flat Tax Act will dramatically restructure the IRS by eliminating most of its rules and regulations and firing most of its employees, and, as a result, it will change the way Americans feel about the tax code. I believe that all Americans would be willing to pay their share of taxes under a system that they believe is fair, a system that they can understand, and a system that they recognize promotes rather than prevents growth and prosperity. My 20% flat tax bill affords Americans such a tax system.

The flat tax is an idea whose time has come. I am committed to working with Majority Leader Richard Armey, Congressmen Mark Souder and Gerold Solomon, and others to ensure continued progress in the flat tax debate, both in Congress and throughout this country. In this regard, I am also encouraged by the formation of the Dole-Gingrich Flat Tax Commission, to be headed by Jack Kemp, which will work toward promoting passage of flat tax reform.

Therefore, I urge this Committee to bring the flat tax to the floor of the House of Representatives at the earliest possible moment so that all congressmen may be allowed to express their support for this fundamental reform. I look forward to working with you in this endeavor.

Thank you Mr. Chairman and members of the Committee.

ADVANTAGES TO FLAT TAX PLAN

* SIMPLICITY	A 10-line postcard filing would replace the myriad forms and attachments currently required, thus saving Americans up to 5.4 billion hours they currently spend every year in tax compliance.
* CUTS GOVERNMENT	The flat tax would eliminate the lion's share of IRS rules, regulations and requirements, which take up 12,000 pages, and have grown from 744,000 words in 1955 to 5.6 million words in 1994. It would also allow us to slash the mammoth IRS bureaucracy of 110,000 employees spread out over 650 offices nationwide.
* PROMOTES ECONOMIC GROWTH	Economists estimate a growth of over $2 trillion in national wealth over seven years, representing an increase of $1900 in personal income for every man, woman and child in America.
* INCREASES EFFICIENCY	Investment decisions would be made on the basis of productivity rather than simply for tax avoidance, thus leading to even greater economic expansion.
* REDUCES INTEREST RATES	Economic forecasts indicate that interest rates would fall substantially, by as much as two points, as the flat tax removes many of the current disincentives to savings.
* LOWERS COMPLIANCE COSTS	Americans would be able to save up to $192 billion they currently spend every year in tax compliance.
* DECREASES FRAUD	As tax loopholes are eliminated and the tax code is simplified, there will be far less opportunity for tax avoidance and fraud, which now amounts to over $120 billion in uncollected revenue annually.
* REDUCES IRS COSTS	Simplification of the tax code will allow us to save significantly on the $13 billion annual budget currently allocated to the Internal Revenue Service.

	1995 Income Tax		Specter Flat Tax	
Income	Taxes Owed	Effective Rate	Taxes Owed	Effective Rate
<$25,500	$1,105	4.5%	None	0%
$30,000	$2,018	6.7%	None	0%
$40,000	$3,300	8.3%	$1,300	3.3%
$50,000	$4,500	9.0%	$2,900	5.8%
$60,000	$5,700	9.5%	$4,860	8.1%
$70,000	$7,810	11.1%	$6,820	9.7%
$80,000	$10,050	12.6%	$8,780	11%
$90,000	$12,290	13.7%	$10,740	11.9%
$100,000	$14,530	14.5%	$12,700	12.7%
$125,000	$20,217	16.2%	$17,600	14.1%
$150,000	$26,531	17.7%	$22,600	15.1%
$200,000	$40,708	20.4%	$32,600	16.3%
$250,000	$57,088	22.8%	$42,600	17.0%
$500,000	$138,666	27.7%	$92,600	18.5%
$1,000,000	$303,006	30.3%	$192,600	19.3%

Chairman ARCHER. Senator Specter, thank you for your presentation. I certainly agree with you that we have got to generate a consensus throughout this country, and all of this debate is healthy, even though there may be some smaller disagreements or differences between us.

Your colleague from Pennsylvania, Mr. English, would like to inquire.

Mr. English.

Mr. ENGLISH. Thank you, Mr. Chairman.

Senator Specter, welcome, and we very much appreciate your advocacy on this issue.

I want to say I particularly appreciate the fact that as an advocate for the flat tax you have also been an advocate for retaining the mortgage interest deduction. As you know, home ownership has been a key cultural value in America, and has certainly been one of the central tenets of the Republican Party going back to the sixties in the Homestead Act. I would like your sense of how high a priority it is to retain the mortgage interest deduction in an alternate tax system.

Senator SPECTER. Thank you very much for the question, Congressman English. And it is a great pleasure to sit across this panel and see you in the House of Representatives, having worked with you, for you, and with your parents for many years. You have done an outstanding job representing the area in northwestern Pennsylvania.

To the point, I think it is important to retain the home mortgage interest deduction to a modest extent. I think we are going to have a hard time passing tax reform and if we have the homeowners of America against us, it is a block that we cannot win without.

There is controversy as to what the amount ought to be. When I was in Los Angeles a week ago Monday, everybody told me it was too little. In Beverly Hills you have to put an extra zero behind the $100,000 before you can buy anything, but I have pegged it at $100,000 because I think that addresses middle America, and I think it is a high priority.

Mr. ENGLISH. Thank you, Senator.

One last question. I know your time is limited here.

Your system provides for radically simplifying the income tax system in America. And I was wondering what do you anticipate will be the savings and compliance cost for these changes? And do you anticipate that given that 60 percent of filers currently need help when they prepare their tax return, we are going to be able to dramatically lower that under your tax system?

Senator SPECTER. The estimate of some leading economists is $200 billion. The estimate in the current issue of Fortune magazine is $595 billion.

I think it is very hard to really gauge what the compliance savings will be. I think in psychic savings, it is limitless not to have to fill out the tax return.

I do fill out mine so that I have an understanding as to what we are imposing on the American people, and it is an ungodly mess every year. Every year I take out last year's return, I go over all the forms. They are invariably changed.

I don't care what the circumstance is, that nothing has been done from the Congress, the form has been changed, there are different formulas, and you really need to hire a second Philadelphia lawyer to begin to start with the compliance.

Mr. ENGLISH. Well, thank you, Senator. You are a powerful advocate for change, and we appreciate your being here today.

Thank you, Mr. Chairman.

Chairman ARCHER. Are there any additional questions for Senator Specter?

Senator, I know you have other things to do, and again thank you for coming and appearing before our Committee.

Senator SPECTER. Thank you very much, Mr. Chairman. It is a great pleasure being here.

I thank you for your courtesy in expediting my appearance. Thank you.

Chairman ARCHER. OK, Bill Thomas, do you have questions for Congressman Gibbons?

Mr. THOMAS. Mr. Chairman, I don't know that I have a question other than just to indicate to Sam that I think as we listen to these other models and attempts to explain away the international trade competitive aspect, that somehow the circular flow of economic activity doesn't go through goods and services purchased and that there aren't adjustments, I believe his arguments are the most compelling, and that regardless of the change in system, his belief that we have to go cold turkey in a new tax system is absolutely, I believe, correct.

It is interesting that advocates of flat tax are already beginning to talk about carve-outs for mortgage deductions as the Senator just did and others. The term I dearly love is a modified flat tax because it depends on which end of the telescope you are looking through. Our current tax system could be argued to be a modified flat tax, and so given the years that the gentleman from Florida has spent looking at alternative models and attempts to make change, I come down finding myself virtually totally in agreement with him. The only possible downside—and perhaps you might want to talk to this a little bit because I think it is more in theory that every system slips—is the argument that the value-added tax is somewhat insidious as a tax because it is invisible and it is easy to increase and so people won't appreciate the ability of government in the shadows and at night out of view to increase the revenue that it extracts from the American people.

My brief response would be that if you are going to repeal the income tax, both personal and corporate, and you are going to repeal the FICA tax, I will take the other side as a possible negative.

But, Sam, how would you respond to it?

Mr. GIBBONS. I have thought a lot about what you put forward there, and about how it would be handled in this Committee.

Essentially, if the Congress wanted to increase or decrease the amount of revenue with the system that I have advocated, there would be one very straightforward debate. You have got to either increase the rate or decrease the rate. You know when we change the amount of money we collect from Americans on this Committee, you get the most convoluted debate about all of those ramifications

of the change of the Code, and when you get all through we have done a hoodwink job on America.

We have either increased their taxes by gobbledygook that we talk about around here or we have decreased their taxes with the same kind of gobbledygook talk, but the talk on the Committee when we want to increase the amount of revenue under a value-added tax that I have advocated here is going to be very direct. We are going to have to either vote to increase the rate or decrease the rate because we should not try to tinker with the tax.

It is going to be very obvious. It is going to be almost impossible to tinker with the base of the tax under the system that I advocate. We would be debating rates, and that is what we ought to be debating here in the Ways and Means Committee.

Very clearly, the American public ought to know whether we stand for raising more money or returning more money to them, and believe me, under the current system we have got around here now, you get a very mixed message, and I think that we ought to avoid that.

Mr. THOMAS. Just let me say also that the Chairman's argument that if we are going to deal with the income tax, we have to pull it out by its roots, clearly you are doing that with your proposal. To me, the idea of going to a flat tax or a modified flat tax is analogous to going to a block grant in terms of a Federal program because inevitably what has happened to virtually every one of us is that they erode back to categorical programs over time.

We inevitably give into the pressure of making adjustments in a Tax Code that can be adjusted, and a flat tax is kind of regrouping and going back to a more fundamental Income Tax Code, which in my opinion starts the process all over again.

Is that one of the reasons that you decided to talk about going cold turkey?

Mr. GIBBONS. Absolutely. You know, the transition rules, if you tried to work out transition rules, you could spend the rest of your life trying to work out transition rules from the current system to the future system. There is going to be a little blood on the table when we get through with going cold turkey, but there will be a lot more blood on the table if we try to go through transition rules.

All of you who served on this Committee know the terrible time we have with transition rules. So, you know, we just have to do rough justice as best we can by the taxpayer and by the government, but going cold turkey, frankly, is the only way to go in this.

Don't let anybody hoodwink you. There will be a lot of lobbyists out there who will make a fortune out of transition rules. They will come to your office and plead with you that we have got to have these kind of transition rules or not, but I would advocate, based on my experience, going cold turkey on the first day of January of some year in the future.

Mr. THOMAS. I want to thank you very much for your contribution.

I believe, as I said, you have got the structure that is the correct one with the approach that is the correct one. I happen to think the American people, when you lay out the options and you are honest with them, will agree with us and I appreciate very much the contribution that you have made, and I can only say that I will

contrast your presentation with the administration's, and I hope that we do not get into a partisan discussion, that we should talk about the key four principles that you talked about because it is a Tax Code for the American people, not Republicans or Democrats, and I want to thank you for your contribution.

Mr. GIBBONS. Thank you.

Chairman ARCHER. Mr. Cardin.

Mr. CARDIN. Thank you, Mr. Chairman.

Mr. Gibbons, I want to congratulate you for your testimony, for your efforts for many, many years in trying to simplify our Tax Code.

I want you to know that I agree with you that I think we should be replacing the income tax with a VAT tax, and I particularly appreciate the two standards that you mentioned and underscored: That we are talking about revenue neutrality so that we can talk about the most efficient and fair way to raise the revenues that we need for government and not to get into an argument as to how much revenue should be raised.

We should equate with the current revenues the substitute plan, and second—and here I think you have stood alone in the proposals that have been brought forward, and that is that we don't adversely affect middle- and low-income Americans in the distributional effect of any tax proposal and the impact that a tax change may have.

One of my deep concerns about the flat tax proposals that have been made is that I find it very difficult to understand how they can be implemented without imposing additional tax burdens on middle- and low-income taxpayers. No proposals have been brought forward that compensate for the distributional impact.

I must tell you, I don't agree with everything you have said. The transitional problems are very, very severe. If we don't have transition rules, we need to take a look at the impact we are going to have on various sectors.

Let me just mention one—State and local governments in the financing of their infrastructure. The cold turkey approach would have a dramatic impact on the ability of local governments to finance their projects, and it is something that we need to understand before we act, and we are going to need to take some compensatory action in order not to adversely affect the ability of our local governments to move forward with their infrastructure needs.

Let me just focus on one point. In order to achieve the distributional effects that you want under your value-added tax and which I want out of the value-added tax, it seems to me that you are going to have to have some relationship to income. You have mentioned it as perhaps an earned income tax credit or a negative earned income tax credit.

So we are going to still need to impose some form of income adjustment to the consumption tax in order to be able to achieve these levels. If I understand your testimony, your plea is don't make the value-added tax complex by trying to adjust which products are subject to the tax, let's work on it based upon the taxpayers' ability to pay and make adjustments for low- and middle-income taxpayers as well as for the wealthier taxpayers.

Is that what I understand you to be saying?

Mr. GIBBONS. Absolutely. You know, you can't escape the pure fact that for 30 years we have imposed upon classes of taxpayers different burdens of taxation in the United States, and page 5 shows you clearly and unequivocally for 20 years what the burden has been. These are CBO figures, not Sam Gibbons' figures.

That is what the burden has been. You can see what little change we made in it in 20 or 30 years, and that has taken on some kind of aura of respectability.

I am not saying it is perfect, I am not saying that if we actually voted on a burden sharing table we would come up with this table, but that is what we have done for 30 years. Now, I give you a snapshot on page 4 of what the burdens actually are.

That includes the burdens of all Federal taxes, all Federal taxes. You can't think of one Federal tax that is not included in that, and that is the CBO figures again about that, and there is nothing sacred about those figures, but we have got to look at them realistically and say politically can we change that burden table without—can we walk away from that, and when you go to flat tax, flat income tax you are going to shift that burden down.

If you go to the value-added tax without making some kind of adjustments outside of the tax for that, you are going to shift the burden down. I don't want to do that. I don't think this Committee will want to do it. That is the debate we ought to be having here in the Committee and in the Congress and in the Nation really.

Mr. CARDIN. Mr. Gibbons, very quickly, also on the issue such as State financing, I saw you shaking your head affirmatively. I take it you would also be amenable to considering changes to help State governments as long as we don't make the Tax Code more complex?

Mr. GIBBONS. That is correct. We ought to do it outside of the value-added tax. It can be done.

Mr. CARDIN. I thank you for your testimony.

Thank you, Mr. Chairman.

Mr. THOMAS [presiding]. The gentleman from Florida, Mr. Shaw.

Mr. SHAW. Thank you, Mr. Chairman.

I would like to voice my praise to you, Mr. Gibbons, along with Mr. Thomas and the others.

You have been, I know for the last 14 years, sort of a voice in the wilderness with regard to this because I don't think this Committee has really seriously considered alternative tax systems since Mr. Ullman left these halls.

Obviously, it is something we have to approach quite carefully. It is revolutionary—the income tax has certainly been built up throughout the years. Senator Specter was talking about how difficult and complicated the existing income tax level is.

I have to confess, unlike the Chairman of this Committee, I do not prepare my own tax return. I have a master's degree in accounting, I am a CPA, I am a lawyer, and I am on the Taxwriting Committee, and I hire a CPA to file my tax return.

That has got to tell you there is something drastically wrong with either me or the Code or perhaps both, but I think that when we look at these tables that you have produced for us, when we look through the massive tables that we require the citizens of this country to fill out, we lose so much of our income, so much of it is not reported, so much of it is in an underground economy where

there is cheating going on, and those of us who are conscientious about paying our full share quite frankly resent what is going on for those that do not pay their share.

The simplicity of the process of the VAT tax, once we get to know what it is, I think, would be far, far preferable and I think, as you very eloquently put forth, would certainly make us much more competitive abroad. How this is finally going to break down, how many people are going to come out to this Committee, how many industries are going to be affected by it, are things that we are going to have to wade through, and quite obviously the whole mindset of the way we do business, the way we give to charities, the way we pay taxes, the way we take out mortgages, all of those things are going to be affected by such a revolutionary change, and quite frankly before this Committee makes a decision and before I as a Member make a decision to support a value-added tax, it is necessary for us to have exhaustive and extensive hearings, and the Chairman has begun that process.

As to the flat tax, Congressman Thomas made reference to the fact that we did in fact put in a modified flat tax some years ago, and the question is if you are going to have a pure flat tax, that is one thing. However, as we get through the hearings and as we heard from Senator Specter, that process is going to begin to collapse.

In addition to praising you for your work on this, I ask for this time to have one simple question, and that is what would you do with the Constitution if we were to do away with the income tax? Would you leave the constitutional amendment in place that originally authorized the Federal Government to go forward with an income tax or would you repeal it?

Mr. GIBBONS. When I was talking to Chairman Archer a few days ago, one of my many conversations I have had with him, he asked me the same question, and I asked him to let me think about it a while.

I would like to get rid of all indicia of the income tax because I think it is a 17th or 18th century idea that we put the death knell to it in 1947 when we agreed to the General Agreement on Tariffs and Trade—we actually put in the GATT that you couldn't adjust the income tax at the border, but you could adjust a consumption or indirect tax at the border.

That signed the death knell for the income tax. I would like to get rid of it. If we had a good value-added tax system in place and working and if we had been able to maintain something closely approaching the burden table that we have got here in place, then I would be willing to sign on and abolish the 16th amendment, too, but I think I want to put some caveats in there. We have got a lot of steps to take along this road, and I want to get rid of it.

I believe history has already signed its death knell on the income tax.

Mr. SHAW. I believe that if we fail to do that, the American people would be suspicious of the value-added tax as simply an addition to the other tax.

Mr. GIBBONS. I agree with you. I agree with you.

Mr. SHAW. Thank you.

Thank you, Mr. Chairman.

Mr. THOMAS. The gentleman from Kentucky, Mr. Bunning.

Mr. BUNNING. Thank you. Sam, I appreciate your testimony and couldn't agree with you more that if we don't do something we are going to lose the respect and the confidence that the American people have in the Congress of the United States to do something about a problem when it presents itself.

I think the quicker we can get it done, the better off we will all be. I think I worry more about compliance, and if they lose confidence in the system, the compliance numbers seems to me that they will be dropping quicker and quicker, and I wonder if you feel that same way?

Mr. GIBBONS. Yes, sir. Mr. Bunning, that is a good point. I am glad you brought it up.

I think one of the things that has poisoned the well of American opinion about their government is the fact that they don't believe we have got enough sense to collect the revenue right. You know, this very intrusive tax system that we have, horribly complicated, everybody looks at their neighbor and says they are getting some break that I am not getting, it is not fair, it is too complicated, I don't understand it, I think that has poisoned the well.

This is a huge operation. Twenty-three percent of everything Americans do goes to taxes, goes to Federal taxes, just on an average, and the fact that the system is so unfair and so misunderstood and so unable to be understood has poisoned the well about our ability to govern.

Mr. BUNNING. I thank you for your contribution and look forward to working with you to get something done fast.

Mr. THOMAS. The gentlewoman from Connecticut, Mrs. Kennelly.

Mrs. KENNELLY. No questions, Mr. Chairman.

I have had the good fortune to discuss this with the Ranking Member, Mr. Gibbons, and I salute him on his testimony.

Mr. THOMAS. I thank the gentlelady.

The gentleman from New Jersey, Mr. Zimmer.

Mr. ZIMMER. Thank you, Mr. Chairman. I would like to focus on exactly how you would keep the distribution of the incidence of taxation the same under your proposed tax. Would individuals have to file a return to establish their eligibility for an earned income tax credit or their liability for an assessment on excess income?

Mr. GIBBONS. That is a good question, and let me say I would welcome any input you can have in this. I just point out that on page 4 that is the current version, and I point out on page 5 that is about what we have been doing for the last 20 or 30 years, so we have got to face that issue as to how to do it.

The Canadians in their tax have an adjuster for burden sharing, and we could follow their system. I just hit upon the idea that, you know, in adjusting the burden we could go to the earned income credit system and say for low-income people you get the same earned income credit you get today to bring you into this place and for the upper-income people you would get a negative earned income credit for that, so there would be the necessity of filing something every year to show what your income is.

We are going to have to do that anyway unless we make radical changes in the Social Security system. We are going to have to know what people earned in income so that we will know what

benefits to pay them in the Social Security system. I preserve the Social Security system just by making a permanent appropriation in the legislation to the Social Security Trust Fund.

That is the same way we pay the interest on the national debt today. It has to be appropriated. It is a permanent appropriation, and we would just appropriate through the Social Security Trust Fund that amount of money.

So you would have to have some system in which people annually reported their total income or we couldn't operate the Social Security system because we wouldn't know how much to pay the beneficiaries, so we are going to have to have that anyway.

Mr. ZIMMER. Mr. Gibbons, I can understand why you would want to do that, but it sort of undercuts much of the appeal of the value-added tax in the first instance. An accountant in my district gave me this button which says, "Simplify," which I intend to keep. By adding an income component you are essentially requiring taxpayers, individual citizens, to file a tax return every year.

I don't know how the Canadians do it, but it sounds to me like you are going to get into all the complexities of what defines "income," what deductions there are from income and the like, and I think it would make it impossible to repeal the 16th amendment because based at least on what Congressman Cox, a former law professor, told us yesterday, if you try to have a modified consumption tax based on income, that would not work without the 16th amendment or a new amendment to the Constitution that would make it possible.

Mr. GIBBONS. Mr. Zimmer, nobody ever said this was going to be easy, and I am sure you recognize that. But you have to face the fact that since the beginning of the income tax, there has been a tax burden imposed upon the American people—probably since the beginning of the country. I am just trying to show you here historically what the burden has been over the last 20 or 30 years.

Politically, and we are all in the political arena, we are going to have to either change the burden or we are going to have to adopt some mechanism for keeping the burden approximately the same. I don't say that this burden table is perfect, but it is the best I can find in exploring around. And we want to—as I say, we want to have revenue neutrality, we want to dismiss that argument right now, and I think we had better dismiss the burden neutrality thing unless we want to take on full scale political warfare about how you do it.

My admonition is, don't try to adjust the burden within the mechanism that is collecting 95 percent of the money in this system. If you do, you are going to end up with the same complex system that we now have for the income tax.

Mr. ZIMMER. On that point, I think we agree.

Mr. GIBBONS. We could do it. There is a way to adjust the burden, and I don't claim to be the final answer on that.

I think I am the final answer on the basic kind of tax we ought to have though.

Mr. ZIMMER. Thank you.

Mr. THOMAS. The gentleman from Texas, Mr. Johnson.

The gentleman from Massachusetts, Mr. Neal.

Mr. NEAL. Thank you. I have no specific questions, but let me ask you this. No matter what we do, aren't there going to be winners and losers in this debate?

Mr. GIBBONS. As far as individuals are concerned, no, because we are going to come right back to the same burden that we have now.

Mr. NEAL. Isn't the point that Mr. Thomas made essential when he said to Senator Specter on his proposal that we exclude mortgage deductions? Isn't that the point of this?

I remember the cheer across the country in 1986 that we were going to change the system once and for all. People got their bills the following year, and they were off the wall about it.

Mr. GIBBONS. Within the burden adjuster, we would take that into consideration. The last column on page 4, you can manipulate that any way you want to. I would point out on the home mortgage adjustment—and I don't want to make the homebuilders mad and the realtors—Mr. English, you ought to step across the border into Canada, right across Lake Erie—that is a big step——

Mr. ENGLISH. I do occasionally.

Mr. GIBBONS. They have pretty good housing and most look better than houses in the United States.

You know, the Canadians think we are nuts. They have never had a home mortgage interest deduction in the history of Canada, and they have got the same incidence of home ownership that we have in the United States. I am no economist, but I think the home mortgage deduction has had one ultimate impact. I have a home mortgage interest deduction even today, so I am in love with it. It has driven up the price of raw land.

I will give you a personal illustration. I bought the lot on which I have lived for 45 years in Tampa for $1,500. That same lot is now worth over $200,000. What has driven it up? All the stimulus that we have put into real estate on this Committee for the 30 years that I have been around here. We have stimulated real estate values, and it has run up the price of raw land and has made it impossible for a young family to buy a lot. For $1,500, I bought the same lot and it is worth $200,000; it is worth more than the house that is on it. That is what has happened with all these crazy stimuli.

I am in love with the home mortgage deduction. If you want to preserve that, I will go along.

It comes down to the right hand column on page 4, that is the burdens, and every time you mess around with it, you have to come back to it. It all comes back to that.

Mr. NEAL. How many votes do you think there would be in the House tomorrow to eliminate the home mortgage deduction?

Mr. GIBBONS. I don't know. I don't know. I think once Americans stop and think about it, they will realize—we could do it in the income adjuster. Only 30 percent of the people who file income tax returns even file a long form, so there are not a lot of people that take home mortgage interest deductions. Most of our crowd, you and I are in that last column, the bottom figure, the $100,000 to $200,000. We are in that category, and our friends have home mortgage interest deductions so we hear a lot from them. But 70 percent of the taxpayers don't even claim a home mortgage interest deduction because they don't file a form on which you can claim it.

So it is a big political issue around our set, but you can look right next door—as I pointed out to Mr. English, you can go to Canada, not far from Massachusetts, and look at their housing stock, look at the way they have done it; and they think we are nuts for having home mortgage deductions. They have never had one in Canada.

I am not here advocating elimination of the home mortgage deduction. That is a different debate. It will come out of the column on the right-hand side. I apologize to the homebuilders and the realtors and all the people that are out there peddling home mortgage interest deductions, but——

Mr. THOMAS. The gentleman from Pennsylvania, Mr. English.

Mr. ENGLISH. Thank you. Really, it is an enormous asset to have someone of your long expertise on this issue on this panel at a time when it is considering this issue.

I have a couple of questions and maybe a couple of concerns with the value-added tax. I think you can probably address them directly. Mr. Thomas skirted one and that is the issue of visibility. I have noticed that, as the VAT advocates have been before this panel, they haven't listed visibility as one of the virtues to be sought in a tax system. I am also aware many of the European countries that have adopted a VAT have experienced a growth in the size of government after adopting it, because it is a relatively easy tax to increase, it is so pervasive, it is an incredibly efficient revenue machine, and that gives me cause for concern. I would like your comments on those points and to the question, would you be supportive of a VAT if it included a provision that consumers see the price tag of the VAT at the point of sale?

Mr. GIBBONS. Sure. We could do that; that is simple. All we would require is that every sales receipt for everything you bought and all that business bought said, "This price contains a 20 percent value-added tax." That makes it visible. Every gasoline receipt you had, every meal receipt you had, every hospital bill you had, every bill that comes through your hands would have, This bill contains a 20 percent value-added tax. I use 20 percent because that is a good round figure. We could make it visible.

Two, is it easier to increase taxes in the convoluted way we have been going about it here in this Committee—I have been 27 years on this thing—or is it easier to vote on a simple, I am going to increase the rate from 20 to 21 percent? I would say you would get a lot more heat on going up 1 or 2 or 5 percent than you do in this conversation that we carry on about all the ramifications of the income tax that obviously confuses everybody but the lobbyists out here. They know what we are talking about, but the public doesn't know what we are talking about when we go into tax reform formation.

I think it would be much more difficult to increase the rate than it is to increase it the way we currently do now, by limiting the deductions and limiting the credits and limiting all the other things that—depreciations and changing the depreciation schedule—we raise a lot of money by just a little tinkering with LIFO and FIFO and things like that that only the audience in this room understands. The public on the other end of the camera doesn't understand all that tax language we throw out there.

Mr. ENGLISH. Do you feel that if we move to a VAT-like consumption tax it would increase our savings pool and have a positive effect on the economy? The reason I ask is, Secretary Samuels said something yesterday that sounded like the savings pool does not increase or doesn't change based on tax changes. Do you concur with that or do you think this could be a benefit to savings?

Mr. GIBBONS. I heard Secretary Samuels say that. I am not sure that I agree with him. I have looked at the savings rate of citizens. The first caveat is that we don't do a very good job measuring savings rates. I would encourage you not to put too much faith in the statistical data you get on savings rates.

Second, I don't think we really understand too well why people save or why they don't save. And I do think—this value-added tax system that I have does not tax savings. Savings do not get taxed in the value-added system, so if you don't spend it, you don't get taxed. I believe that would increase the savings rate, but that is just an intuitive thought that I have.

You certainly get rid of the double taxation on savings that you have now, or the triple taxation; you take away a lot of disincentives. But I am not sure I understand why Americans save. I imagine they do fail to save because of the disincentives now to save.

Mr. ENGLISH. I have great faith in your intuition, and I appreciate the opportunity to ask those questions.

Chairman ARCHER [presiding]. Mr. Christensen.

Mr. CHRISTENSEN. Thank you, Mr. Chairman.

Mr. Gibbons, assuming revenue neutrality, what do you think would be the most important if we were to rank in order of one through four the areas of simplicity, efficiency, equity and administration? In your own personal opinion, what do you think is the most important of those four goals that we are trying to achieve with a new tax system for the American people? Whether it is a VAT or a flat or a standard consumption tax system, what do you think is the most important, one through four?

Mr. GIBBONS. I think we would all intangibly gain something from it, and that is that there would be a greater trust in government, in its ability to conduct its business so that people understand what is going on. Frankly, they don't understand what we are doing now, as far as taxes are concerned, and I think that poisons the well for any positive feelings that Americans have about government.

As I go around the world, I find Americans distrust their government much more than, say, the Canadians distrust their government or the English distrust their government or the French distrust their government. There is nowhere in the world the level of hate that I have been able to measure toward government that is in this country. It goes back to the fundamental fact we have a convoluted, impossible to understand revenue-raising system that is very intrusive and very burdensome to the average American.

Mr. CHRISTENSEN. I agree.

Is simplicity number one, then?

Mr. GIBBONS. Simplicity and understanding of it. I think if Americans understand it, they can make the kinds of changes they need to make, but they do not understand this present system.

Mr. CHRISTENSEN. So simplicity would be number one. I agree, I think simplicity is probably the number one thing that we have to fashion a new tax system around.

Where would efficiency and equity fall?

Mr. GIBBONS. They are very important. I don't think that the U.S. economy can continue to pay as much out in overhead to collect its revenue as we are now paying out. I used $300 billion; it is probably much higher, around $600 billion out of the $1.4 trillion we are now collecting. It is an extremely expensive as well as convoluted, not understandable system.

Mr. CHRISTENSEN. In light of that, if simplicity would be number one of the four that we are after in ranking, I would think that the flat tax has an edge up on the VAT tax or maybe even the standard consumption tax because it is such a simple tax to understand, and the American people seem to be understanding the flat tax more than the consumption tax.

Mr. GIBBONS. The problem with any tax that classifies as an income tax is that you cannot adjust it at the international border. Remember these glasses that I wear. You can't get around that. Unless we decide to get around that, we are going to denude the United States of good jobs.

You know, I wish you to could get the AFL–CIO to understand that. Their love affair with the income tax is what is destroying their jobs.

Mr. CHRISTENSEN. When I am talking about a flat tax, I mean a pure flat tax. For example, when we talk about administration and elimination of the IRS, a consumption national sales tax, I think, has a leg up on a flat tax.

Mr. GIBBONS. No. A national sales tax is a national retail sales tax, and I am very experienced in that. My father drew up the first sales tax in Florida and I served on the legislative committee for 10 years that legislated on the thing. A retail sales tax is extremely complicated to administer because it depends upon identifying the last sale to the consumer, and when you get into that, that is a very complex thing.

That is the reason why a value-added tax is much simpler to administer. Every transaction carries with it the tax, but gives a credit for the tax that has already been paid. So it is spread through the whole system and you don't have to identify each particular sale. It is self-enforcing.

Mr. CHRISTENSEN. Thank you. I appreciate your testimony. I look forward to working with you on this truly historic issue. We are not trying to fix the old, but pull out the roots and start with a new program.

I couldn't agree more with the fact that we need to go cold turkey, and this transitional phase, I think you are right on the mark when we talk about going cold turkey and starting over from the start.

Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Lewis.

Mr. LEWIS. Thank you, Mr. Chairman.

Thank you, Mr. Gibbons, for being here. You have a long and rich history as a leader in support of reform of our present tax system.

I am concerned about whatever system that we are able to devise, that it is fair and it is revenue neutral. I would like for you to put on your thinking cap for a moment and be a person of vision like you are.

Do you think that we have the ability, the capacity or the will as a body to devise a system that would be fair and at the same time revenue neutral and would be embraced by the American people?

Mr. GIBBONS. We haven't had that ability yet, but Mr. Lewis, I think we are developing that ability. The very fact that we are having these hearings and that we are earnestly discussing a change, I think the message ought to go out that we are sincere in examining the mistakes of the past and going forward with the future with something not just because it is new, but because it is—we can make it just, we can make it understandable, and we can make it—and we can make it so people know what they are doing.

They are suspicious of us and of their friends and neighbors and everybody else because of the current system, and we need to dispel that.

You know, fairness, I can't tell you whether this burden table that I have on page 4 is what the burden table ought to be. I can only tell you that is what the burden table has been for 20 or 30 years, and we should come back to that as the first point of discussion. We should not get the American public all upset that we are going to change the burden table on them, that we are going to slide the tax burden down to the low-income people or slide it up to the upper-income people.

Let's use as a point of departure, what we have been doing for 30 years and say, that is kind of, de facto, accepted as to what is the appropriate burden, but we are not going to surreptitiously slide down to low-income people a heavier burden or slide up to high-income people a heavier burden. Start where we are and say, we can adjust it and have a debate about it. I think we could do it and far simpler than the current system.

Mr. LEWIS. We continue to discuss the need for reform of the tax system. I am concerned that we do not play into the hands of this mindset that we should downsize the National Government, the Federal Government, that something is bad and evil with the Federal Government and with the American society and that it must be overhauled from bottom up or from the top down.

Mr. GIBBONS. Yes. In taking on this really awesome burden that we are taking on here to change the revenue system, we ought to try to eliminate as many arguments from the overall argument as possible.

You remember in the 1984–85–86 Tax Reform Act we adopted the principle of revenue neutrality, that we would not include in the debate we carried on then the debate about whether government was too big or too little. That debate ought to be carried on, but not in this framework.

Page 2, the first thing I say, revenue neutrality. Let's agree that neither side in this debate or all the sides in this debate, that we are not bringing in a lot of extraneous material. We are really trying to correct the revenue-gathering system right now. We can argue about the other things at other times.

Mr. LEWIS. Thank you.

Thank you, Mr. Chairman.

Chairman ARCHER. Mr. McCrery. Mr. McCrery is not here.

Mr. Collins.

Mr. COLLINS. Thank you, Mr. Chairman.

Mr. Gibbons, you mentioned several taxes that would be eliminated—FICA, the personal income, corporate income. What about estate tax?

Mr. GIBBONS. I didn't tackle that. One, it is not a lot of money. I know it is important.

Let me say that this Committee has not had a lot of experience on the estate tax. I have been on the Committee 27 years, and I think only one time in 27 years have we spent time on estate tax. I didn't want to open up that argument at the time I opened up these other arguments.

I realize this Committee ought to get to that subject and pay a lot of attention to it. It is only about $6 billion out of $1.4 trillion, and I didn't want to throw that argument into this debate. That is the only reason I avoided that.

Mr. COLLINS. Let's go to the earned income tax credit. You spoke of that as adjust the burden?

Mr. GIBBONS. Well, if you have roughly a 20 percent value-added tax rate, bear in mind that most people, particularly people at the lower end of this chart I show you on page 4, every year they spend almost 100 percent of their income and so they would have roughly an effective tax rate of 20 percent. And if you look at that burden table that I showed you there, you will notice that the lowest income people really have an effective tax rate now of 6.7 percent.

So that is—there is some makeup to be done there. We can't increase their tax rate by 12, 13 percent without creating a whale of a political and social impact. Now I don't know how far up this revenue-sharing thing you have to come, the revenue table, before people start saving, but most of those people at the lower end are spending all of their income, and all of their income would be taxed. So we have to do something about them. That is a political necessity that you and I face.

I don't say that my system of burden sharing adjustment is correct, but somewhere along the line we have to in this Committee adopt something to make sure we are not just shooting the burden of taxation, the burden of government, down to those low-income people.

Those are shocking figures when you see that from the less than 10,000 people—there are 14 million families who have an average income of $6,000 a year. I am not sure I am psychologically prepared for that; and they have a current tax burden of 6.7 percent of their income. That includes FICA tax.

Mr. COLLINS. The earned income tax——

Mr. GIBBONS. The earned income tax credit is reflected in that 6.7 percent. That figure—if you look on the next page, you will see that that figure has dropped remarkably. You know, that figure in 1977 was 10 percent and look what it is in 1994. That is the same 10 million families. That is the impact of the earned income tax credit.

Mr. COLLINS. The earned income tax credit was originally designed to offset the FICA tax.

Mr. GIBBONS. It really has down there, yes, sir; you can see it.

Mr. COLLINS. One other question. You mentioned appropriations for Social Security. Some of this we do with a standing appropriation for interest. Would that not make the Social Security program a true social program rather than an intended pension program, as it was first designed?

Mr. GIBBONS. There are going to be people that will make that argument, and one of the ways that we could lower the VAT tax rate is not repeal the FICA tax. But the FICA tax is going to be embedded in these glasses if we don't. I want to get the FICA tax out of these glasses.

That FICA tax is big. I have the figures—it is almost as big as the personal income tax. It is a huge tax. And it is probably the most regressive tax that anybody on Earth ever invented.

Mr. COLLINS. I understand.

One of the things you mentioned——

Chairman ARCHER. The gentleman's time is about to expire.

Mr. COLLINS. There are two wells, one wet and one dry; the dry well is the one we keep pouring money into.

Mr. GIBBONS. I didn't hear you.

Chairman ARCHER. Sam, you have done an outstanding job in your presentation today, and I don't want to curtail the continued questioning.

We committed to the Majority Leader that we would receive him at 11:15, and unless there is anybody else on the Committee that has not inquired, that feels absolutely constrained that they must inquire, I would hope that at least we should try to shorten this as much as possible so that we don't keep the Majority Leader, who has arrived and is waiting.

Mr. GIBBONS. I don't want to do that. He is a good friend of mine and there are many things on which we agree on this. The only effect of his proposal is he can't adjust it at the border and you will have trouble with burden.

He has one fatal defect in his proposal; you can't adjust it at the border, or you are going get slapped down as we have been slapped down before by the General Agreement on Tariffs and Trade.

Chairman ARCHER. Mr. Rangel, do you have a very short inquiry?

Mr. RANGEL. Yes, Mr. Chairman, and I am aware of the direction in which you would like the Members to go.

My problem is that I don't think that we are seeking to change the system this year or next year, but we are prepared to define the issues for the Presidential election. But notwithstanding that, I am going to try to be as nonpartisan and openminded as I can on this question.

It seems to me if we are talking about flat taxes and consumption taxes and protecting savings, that basically what we are saying is that if you don't spend it, it is not going to be taxed. If you save it, or if you have income interest coming in, that is not going to be taxed; it is only when you spend.

I guess it is pretty well accepted that poor people and low-income people spend more of a percentage of their disposable income for

food, shelter, health care. But you are saying that even though you are not giving deductions and special treatments at one rate, that when it is all over between consumption tax and VAT tax, that you are now going to make adjustments so that we don't have a disparity based on the facts of the different ways we are going to do it, and so your tax will be flat in the middle, but when it comes to the poor folks that are out there that really don't come out ahead in this concept, that you make the necessary adjustment somehow so that they are not paying more of a percentage of what they are earning than the others who don't have to spend as much.

Then you make this up by eliminating FICA taxes and other types of payroll taxes by taking a look at the upper end of the high-income people, which would indeed include those who have the interest income, and somehow you would do what to them to make up for the difference?

Mr. GIBBONS. I propose three steps. Step 1: Repeal the income tax, corporate and personal; repeal the FICA tax. That is step 1.

Step 2: You impose a value-added tax, which is that form there, and only business would remit the tax.

Mr. RANGEL. I am with you.

Mr. GIBBONS. The third step, and that is the one you are talking about is table 1 on page 4 of my testimony. I want us to come out in the same way in the last column as we are today. I think that is what I want us to do. We can have a burden adjuster, that is—or any other thing, but it is essentially a burden adjuster. We have to do that, in my opinion.

Mr. RANGEL. Since all my colleagues over here have been complimenting you for your bipartisanship and the direction that you are going, I would like to join this group and ask my Chairman, do you agree in concept that the flat tax would be flat in the middle, that we make adjustments for the low-income people that, we all agree, don't have that much to save; and where you find the high-income people, that we have something there to eliminate the disparity between the higher incomes and the low incomes? If you think that is—in principle, and we can work out the details later—that is where you want us to go, then you would want you to compliment me as you do Sam Gibbons.

Chairman ARCHER. Charlie, I will be very happy to discuss this with you. Mr. Gibbons, as the witness, might like to respond.

But in the constraints of time, I would say, Sam, thank you for your presentation.

Mr. GIBBONS. Thank you.

I want to thank my fellow Committee Members for allowing me to do this. I have tried to do this individually with you for a long, long time; and I hogged the scene here today, so I apologize to you.

I want to apologize to the Majority Leader, who I have kept waiting here.

Chairman ARCHER. Sam, you have been paid the ultimate compliment by this Committee and that is that people have genuinely been interested in your presentation and have inquired in great depth, because you know when we go before other committees there are very few questions ever asked of us. We are sort of dismissed when we appear as witnesses. So I thank you very much.

Mr. GIBBONS. Thank you.

Chairman ARCHER. I see the Majority Leader is here. If the Majority Leader would honor us by stepping up to the witness table and taking a chair at the witness table: Mr. Leader, welcome to our Committee. For some period of time, we know that you have done considerable work on trying to replace the currently nonproductive income tax system by which we collect revenue; and we are here to listen to all approaches that can be alternatives to the current system—not reforms. We have been through too many reforms, and I think you and I both agree that the current income tax system is broken, it cannot be fixed, and we must replace it with something else.

We will be pleased to hear your testimony and you may proceed.

STATEMENT OF HON. RICHARD K. ARMEY, MAJORITY LEADER AND A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

Mr. ARMEY. Thank you, Mr. Chairman. I want to thank the Committee. Not only am I very pleased to see you holding these hearings, which I believe to be very timely, but it is a particular pleasure for me to follow Sam Gibbons. Of course, we all have enormous respect and admiration for Sam, so it is a privilege.

You did not keep me waiting; you kept me entertained and informed, so it was a pleasure to listen to you.

Mr. Chairman, I think it is clear there is no escaping an understanding that for some time now the American people have been telegraphing us a message that they will no longer tolerate the Tax Code as we know it today. Their resolve, I think, has solidified in this Nation; and I have to say to our credit across this Congress, we have many good proposals by people who have read the resolve of the American people and have said, let me offer my alternative.

Mr. Gibbons has just done a presentation on his value-added tax. We certainly can admire and respect the work that has been done by our colleagues in the Senate, Senators Nunn and Domenici. The Chairman, of course, has his proposal on a national consumption tax. Mr. Specter, who I understand was here earlier, offers a variation of a flat tax, and I offer mine.

Now, I must say that over a year ago when I began to read the will of the American people, I began to ask the question, What might I offer as a comprehensive tax reform that replaces the Tax Code as we know it? And I recall, my initial tenure, when there was during my campaign in 1984 and during the first couple of years of my tenure an enormous public debate about flat tax. So I took the time to go back and review that, as I reviewed others.

One, I asked, what was it the country found attractive about the flat tax? Two, why did it not happen earlier, when I remember the debate seemed to have some vitality attached to it? Having researched past efforts, I came to some conclusions and wrote my own bill.

In that process, of course, I rediscovered the works of Professors Hall and Rabushka and found that to be quite an inspiration to me. I managed to establish a contact with the professors, discovered them to be in the process of a reiteration of their work—it is, of course, now available to us—and in discussions with them and others created my variation on the flat tax.

I revealed my iteration of the flat tax on June 11, June 16 of last year, kicking it off with the editorial in the Wall Street Journal; other editorials followed. I had an interesting curiosity with respect to, how would the Nation respond to this offering? It was my view that if it is a good idea, it will be recognized and embraced by the American people and that will give it standing in the legislative process. I must say that I tried to encourage their understanding and acceptance of it by virtue of being on talk radio shows, approximately 15 a week for every week following June 16 up until mid-October last year when I became preoccupied with other matters.

I dare say that we have had a bigger, broader, more enthusiastic acceptance of a flat tax by the American people at large than what anyone would have dared to hope for on June 11. And I have gotten thousands of letters, phone calls, and had additional thousands of personal conversations with people as I have traveled across this country; and there is enormous enthusiasm.

I thought what I would try to do today is distill for you my understanding of what the American people have told me they have seen in the flat tax proposal that endears it to them. I should point out that there is a businesswriter in the Dallas Morning News named Scott Burns, for example, who wrote a single article on the flat tax. It was a syndicated article, and within 2 weeks Scott Burns received over 5,000 letters. He was quite impressed by that.

On a personal note, earlier this year I happened to be on a television show with Sam Donaldson. Sam Donaldson expressed his reservations about the flat tax, and I saw him 1 week later and he said he had never received so many letters from people who wanted to straighten him out. I found that a gratifying experience and enjoyed sharing it with Sam.

So I believe I have a great deal of testimony.

Why do the American people, if I dare say, "love" the flat tax? One, they see it as fair. In that respect, they recognize that the flat tax collects every dime that is earned in the U.S. economy, brings it in the tax base and taxes it only one time with a simple flat rate applied to every dollar of earning in the economy. That they believe to be fair.

The current Tax Code, as you know, exempts hundreds of billions of dollars from the tax base and compensates, of course, for the revenue shortage that arises from that exemption by double-taxing hundreds of billions of dollars' worth of income. That is patently unfair, especially if one takes it back to production theory and recognizes that for production to take place, efficiency with increasing productivity, there must be vitality and change in the provision, in necessary coordinates of both capital and labor to the production process.

It turns out that most of the income that is exempted from the tax base is income that derives from provision of labor; most that is double-taxed is income that derives from provision of capital, and that gives you an imbalance.

I like to point with some pride to Congress that it was Senator Douglas that gave us the Cobb-Douglas production function, which always reminds us of the necessary combination of capital and labor and their cojoint need in production, so we end that kind of bias against capital provision.

One of my favorite stories on the question of fairness comes to me from a fellow who parks cars at one of the hotels in Dallas where I was going to give a speech one day. A person in charge of parking cars is not a person of extraordinary income. He is an ordinary American wage earner with a family. As I parked my car 1 day, he said, Congressman, I love your flat tax. He said, the reason I love your flat tax is because it treats everybody the same. There is one rate for everybody and I don't have to listen to this class warfare baloney that I keep hearing.

I found that a gratifying observation. And I believe he spoke for a great deal of America. This is very important to me.

I believe that America today and in the 1996 Presidential campaign will give expression to the uniquely American definition of fairness; that is, fairness is when everybody is treated exactly the same as everybody else. I think the embrace of the flat tax reflects that definition of fairness which I happen to think is admirable in the American people.

The other thing that is often recognized and cited is, a flat tax will generate growth in the American economy. A flat tax, of course, does give a reduction in the marginal tax rate to most Americans and, of course, we know already that reducing the marginal tax rate provides an incentive to work more.

Jack Kemp illustrates that by saying, if in fact on Monday you paid a 20 percent tax rate, on Tuesday a 30, on Wednesday a 40, on Thursday a 50, and on Friday a 60, which day of the week would you not work? It is very clear the marginal day with the marginal rate is the day you take, and I frankly would take fridays off.

The other thing that helps us with growth is the treatment of investment, that in the flat tax, as I propose it, investment is immediately written off, that the time you put a machine online, you write that off as an immediate expensing.

We have a unique encouragement to savings in that interest earnings are not taxed to the individual, which will encourage more savings; and we end the estate tax, which on the incentive side, I think is another boon. The fact of the matter is that when you talk about the marginal years that I will work in my life, the marginal effort I will make to build my business stronger if I happen to own a corner drugstore, to build my estate larger if I happen to have a wage job, knowing that when I die, should I have something left, it will go to my children, gives me greater incentive to work longer and harder and build greater and larger than if I am afraid the government will run off with half of it. Given a choice of working to support my government and working to support my grandchildren, I will vote for my grandchildren, and I think the American people will; and they will make the extra effort for their grandchildren they will never make for the government.

Another thing often cited in letters I receive is neutrality. The flat tax, as I have written it, is completely neutral with respect to consumption, savings and investment. People understand they are a better judge of how to allocate their expenditure between these three activities; and within these activities, how I will consume, where I will invest and in which manner I will save is a decision

better made by me than one prompted by government tax treatment.

Simplification, of course, is adored by the American people and there is no doubt the poster child for tax simplification is the postcard size simple flat tax form with 10 lines, and that pretty well speaks for itself.

Also the flat tax promises honesty, visibility and directness. I take this as far as I can go with my proposal, which is to end withholding. First of all, I argue, and I will tell you as a matter of fact, all taxes are paid by people and all taxes are paid out of current income flows, so the most direct way you can show them what their tax bill is is the way to make them most aware of what the cost of big government is in their lives and will most prompt them to ask the question, am I getting my money's worth, so they will be more judicious in what it is they vote for.

In my proposal, I give them an opportunity which, in my vision, would afford them the opportunity at the first day of every month as they sit down at their kitchen table to write their bills for their rent, or their house payment, to the Penney store, wherever, that they will also write a bill and send a check to Washington. And each month I am sure they will realize that I have just sent a check to Washington which is more than I just wrote out for food, shelter and clothing combined, and I wonder if am I getting my money's worth, and there will be no doubt about it.

Furthermore, in addition to the insight that people get who pay their taxes, which incidentally I am prompted by my observation, the only thing that is worse than a nation that loves the IRS is a nation—I am sorry, the only thing that is worse than a nation that hates the IRS is a nation that loves the IRS—and in the current withholding system all too many people feel some misinformed sense of gratification when at the end of the whole process they get a check back without any realization of what they paid.

My final point is, if I could speak for every average man and woman, it is my money. I earned it. Why should the government preempt my right to take my own paycheck and make my own disbursements commensurate with my obligations? Some will say, if you give people that right, they won't honor that. But I would offer this. The enforcement power of J.C. Penney is considerably less than the enforcement power of the government. If people in their ordinary course of business and their ordinary life willfully pay their Penney's bill, I think we can dare risk that they will willfully pay their tax bill; and I have no doubt.

A flat tax, in summary, is a tax that bets on the goodness of the American people, not the guile of the Federal Government; and I think that is a bet that we ought to make.

I thank you. I ask that you put my formal statement in the record.

Chairman ARCHER. Without objection, your complete statement will be put into the record.

[The prepared statement follows:]

STATEMENT BY CONGRESSMAN DICK ARMEY
HOUSE WAYS AND MEANS COMMITTEE

June 8, 1995

Mr. Chairman and Members of the Committee,

Thank you for this opportunity to discuss the issue of tax reform. I would like to begin by complementing you, Mr. Chairman, for holding these hearings this week. I couldn't agree with you more that the current tax system needs to be replaced.

The hearings this week reveal more, however, than a recognition on your part of how counterproductive our current tax system is. These hearings also illustrate that you, Mr. Chairman, are a refreshing change, particularly for those who study Public Choice. Public Choice is a school of economics that seeks to explain the political process. A key premise in Public Choice theory is that politicians maximize votes by securing benefits to small segments of the electorate, the cost of which are largely lost on the population at large.

Public Choice theory tells us that a chairman of the Ways and Means Committee might use his position to disburse favors to narrow interests. We are here today, however, because this Chairman is committed to a neutral tax system which will advance the broader public interest. The tax reforms being discussed this week would give average Americans far more, and elected officials far less, control over resources in our economy. Make no mistake about it, the proposals before this Committee would expand freedom and opportunity for the American people. I want to take this opportunity to commend the Chairman for his eagerness to place the public interest over any other consideration.

Mr. Chairman, when you announced this week's hearings, you stated that any tax reform proposal should meet four goals. I agree with those goals, and my testimony today will focus on them. Before I explain why the flat tax meets those goals, let me begin by briefly outlining how my proposal would work.

How it Works

My plan, which is based on a 1981 proposal by Hoover Institution fellows Robert Hall and Alvin Rabushka, would scrap the existing tax code entirely. Instead, *all income would be taxed once and only once at the single low rate of 17 percent.* To minimize revenue loss, the rate would initially be set at 20 percent, then drop to 17 percent in year three. Income is defined as the total of wages, salary, and pensions. There would be no credits or deductions, although each taxpayer would receive a generous family allowance. Beginning in year three of the plan, this allowance, which is indexed for inflation, would be $13,100 for an individual, $26,200 for a married couple, and $5,300 for each child. A family of four would have to earn $36,800 before it

owed a penny of federal income tax.

Business income would be handled with equal simplicity. A corporation would simply subtract expenses from revenues and pay 17 percent on the remainder. Revenues are defined as corporate, partnership, professional, farm, and rental income. The base is gross revenue less purchases of goods and services, capital equipment, structures, land, and wage and pension contributions to employees.

Goal No. 1 -- Simplicity

Like you, Mr. Chairman, I believe the first goal of tax reform should make the tax code easy to comply with and reduce the role of the federal government in the American people's lives. Unfortunately, the current tax code is complex and intrusive. Each year Americans spend 5.4 billion man-hours preparing their taxes for the government. That's more time than it takes to build every car, truck, and van manufactured in the United States. The IRS now sends out eight billion pages of forms and instructions each year. Laid end to end, they would stretch 28 times the circumference of the earth. After seven decades of amendments, revisions, exemptions, loopholes and extensions, the code has become an incoherent mess.

Does the flat tax make this system more simple and less burdensome? It certainly does. By eliminating the various credits, deductions and loopholes, the flat tax makes the tax system so simple Americans could file their taxes on a form the size of a postcard. Not only would this dramatically reduce the time and resources devoted to complying with the tax code, it would also make the federal government far less intrusive. Americans would need to reveal far less information to the Internal Revenue Service, and under much less duress, than the current system.

Goal No. 2 -- Promote Saving

Tax reform should encourage greater saving and investment. Perhaps the worst feature of today's tax code is its discriminatory treatment of saving. Consider how the present tax code treats saving and investment. Today, we double tax business earnings, which places a strong bias against saving and investment. For example, we tax business earnings through the corporate income tax and then tax dividends -- which are, in fact, after-tax payments. This double taxation of the same stream of income creates a strong bias against saving and investing. Obviously, this makes saving and investing much less attractive relative to consumption. And the nation is poorer as a result.

Capital is the lifeblood of an economy. Without capital, workers cannot enhance their productivity and their wages stagnate. Today's double and even triple taxation of income discourages saving, reduces the pool of capital available to entrepreneurs and workers, slows productivity and wage growth, lowers living standards, and, as a side effect, reduces revenue to the Treasury.

Like the other alternatives the committee is considering this week, the tax base of the flat tax is consumption. By eliminating the double taxation of saving and providing for the full expensing of capital investment, the flat tax functions as a kind of consumption tax, much favored by economists. In this sense, the Domenici-Nunn proposal for a consumed income tax and my flat tax are trying to accomplish the same thing. They are blood brothers in spirit. This goal would be achieved, as well, by a national retail sales tax, or even a European-style value-added tax. All of these plans can lay claim to the title of "consumption tax."

Goal No. 3 -- Improve Competitiveness

Mr. Chairman, the third goal for tax reform you mentioned is to improve the international competitiveness of American workers and businesses. The flat tax would make the U.S. the most attractive nation in the world for investment, produce a higher economic growth rate and raise living standards. It would liberate America's businesses to be more efficient, replacing today's maze of politically targeted tax breaks with a system that is perfectly neutral as between types and sizes of business, between economic sectors, and between types of investment. America's entrepreneurs could make decisions based on what makes the best economic sense, rather than diverting talent and resources for tax avoidance strategies.

In other words, the flat tax would relieve the economy from what economists call "dead weight" or social welfare loss. According to James L. Payne, just the compliance costs of today's tax code add up to $232 billion. When other costs of the current system -- such as tax distortions which shift resources away from their most efficient use, thus lowering output -- are included, the cost to the economy is well into the hundreds of billions of dollars. These costs are pure waste and directly lower the standard of living of the American people. The flat tax would eliminate the vast majority of these costs and dramatically improve the performance of the economy.

The flat tax would also lower the burden currently placed on work, saving, and investment. It rewards *work* by lowering the top marginal income-tax rate from 40 percent to 17 percent. It rewards *saving* by ending the current double taxation of saving, sweeping away the estate tax, the capital gains tax, and the double tax on dividends. And it rewards *investment* by permitting businesses to immediately deduct all expenses, plant, and equipment. Thus, the flat tax would produce higher productivity and economic growth, leading to higher employment and wages.

When adding the effects of more work effort, a higher capital stock, and improved incentives for entrepreneurial effort, Professors Hall and Rabushka estimate that a flat tax would increase per capita income by $1,900 by the year 2002. In other words, a typical family of four in America would see its income increase $7,600 more than if we preserve the tax system we have today. Let me emphasize that while this is a truly astonishing number, it is based on the consensus of the economic literature and is a mainstream estimate. Many studies suggest the number would be even higher.

Border Adjustability

Some have suggested that our tax system should tax imports and not tax exports as a way of making U.S. businesses more competitive in the world market. Congress should make the tax code "border adjustable," as tax policy people put it. The sales tax, VAT, and the Domenici-Nunn USA Tax are all border adjustable, but the flat tax I have proposed is not.

Supporters of a border adjustable system say that it would increase U.S. competitiveness by taxing imports and not taxing exports. This way, American firms receive an advantage over foreign firms and that will favorably alter the balance of trade.

In my view, a border adjustable tax will not be effective in reducing the trade deficit. It's an immutable law of economics which says that trade surpluses and deficits are linked to the amount a nation lends or borrows. When saving is low, the trade deficit must be high. A tax on imports which is merely a substitute for another tax will not effect the amount Americans save. That means the trade deficit not only will stay the same, it must stay the same, as a basic principle of economics.

Economists might explain it this way: If there is more investing happening in our economy than can be financed by our saving, then foreign investors must be accounting for the difference. In effect, they are taking the money we give them for their cars and VCRs and using it to buy our stocks and bonds, thus supplying the investment capital that we don't supply ourselves. This difference is the "trade deficit."

The only way to change the deficit, then, is to change our savings rate. If we increase our saving relative to our domestic investment, we have less need for foreign cash. The trade deficit will then drop, as we spend relatively less money buying foreign goods and relatively more investing at home.

But anything we do to tax incoming foreign goods--including putting a sales tax on them--will have no effect on the amount of money Americans are putting into domestic stocks and bonds or even their own bank accounts. There is simply no relationship between them.

What will happen instead is this: Our exports will increase at first because of the new tax advantage. But since our saving will remain the same, the dollar will be artificially strengthened. This will make our exports more expensive and imports cheaper, and the original balance of trade will be gradually restored--along with the trade deficit. The policy will be self-defeating.

Even if a border adjustment were to work, I still believe it would be unwise. It would make goods Americans buy--whether produced here in America or abroad--more expensive, while foreigners could purchase American-made goods cheaper. It's hard to see how Americans benefit from paying higher prices than foreigners do to purchase American products.

Adam Smith makes a relevant point in *The Wealth of Nations*. Smith reminds us, "Consumption is the sole end and purpose of all production; and the interests of the producer ought to be attended to, only so far as it may be necessary for promoting that of the consumer." In a border adjustable system, however, to borrow from Smith again, "the interest of the consumer is almost constantly sacrificed to that of the producer; and it seems to consider production, and not consumption, as the ultimate end and object of all industry and commerce."

Goal No. 4 -- Diminish the Underground Economy

Your final goal, Mr. Chairman, is to increase revenue from the underground economy and others who currently do not comply with the tax laws. While by its very nature it is difficult to measure, the underground economy is estimated to be in the hundreds of billions of dollars. Of course, much of the underground economy is trade in illegal activities such as drugs and prostitution. This income will never be taxed under any tax system. However, most of the underground economy is trade in legal goods and services that goes unreported. Taxing this portion of the underground economy should be an important goal of any tax reform.

The issue of the underground economy is a very serious one because the computer revolution is fundamentally transforming our economy in a way that will make it much more difficult for the federal government to collect revenue. Personal computers, modems and fax machines have made it possible for greater numbers of people to work out of their homes instead of at large businesses. Many of these small businesses can avoid paying taxes far more easily than large companies because they can operate invisibly. The geometric growth of on-line services such as the Internet portends an era when more goods and services will be traded without a paper trail, making it more difficult for the IRS to audit. As these trends accelerate, our tax system is truly becoming more voluntary everyday. That's why it's especially important to develop a tax code for the 21st Century that Americans are willing to voluntarily comply with.

I am confident the flat tax would shrink the underground economy because it eliminates the three primary excuses for noncompliance. These are, first, the current system's maddening complexity; second, the low likelihood of getting caught; and third, the feeling that today's system is somehow rigged to favor special interests "at my expense" -- which, for the most part, it is. Stripped of these rationales for noncompliance, the great majority of taxpayers will find it much easier to pay their taxes and they will be more willing to do so because they will perceive the system as fair. Even for those who still wish to cheat, they will find it much harder to elude detection in a simple system. Therefore, the underground economy will actually shrink. After all, if you give the American people a tax system that is honest, direct, simple, low, and fair -- something they have not had in decades -- does it not stand to reason they would be more inclined to pay their fair share?

I should point out that many advocates of a sales tax have argued that it would more effectively tax the underground economy. The neighborhood drug dealer almost always serves as the illustration. Since the drug dealer declines to file a 1040 form, the argument runs, maybe we

would could at least recoup some of his income through a sales tax. The government may have no record that he exists, but when he buy a sports car, the government will collect tax from him.

That sounds compelling at first, but it doesn't hold together. The reason is this: Both systems will equally fail to tax the drug trade for the simple reason that the drug dealer will not play along in either one. If there is an income tax in place, he won't report his income. If there's a sales tax in place, he won't collect tax from his customers. Either way, the government loses exactly the same amount of money.

Consider the following example. Suppose there is a drug dealer and a drug consumer who each earns $50,000. Thus, the total income in the economy is--and the tax base should be--$100,000. Under an income tax system, we wish to tax the income of both people, while under a sales tax we wish to tax the purchases of both people. Under an income tax, we tax the income of the drug consumer (assuming he is law-abiding citizens besides his use of illegal drugs), but we don't tax the income of a drug dealer. Total tax base: $50,000. While under the sales tax we tax the purchases of the drug dealer, we don't tax the purchases of the drug consumer. Total tax base: $50,000. It has to be the case that neither system taxes the value of the drug trade because the amount people spend on drugs must equal the income of the drug dealer. And since the drug dealer will not report sales or income tax, neither system will capture the value of the drug trade.

The same would hold true for the underground economy in legal goods and services as well--which of course is much larger. The proverbial plumber who doesn't report his house call for income tax purposes today would not report it for sales tax purposes either. At best, it would be a wash. That assumes that the sales tax would not encourage more economic activity to move underground, which I believe it would. Historical experience demonstrates that a national sales tax of 20 percent would cause the underground economy to explode.

A Final Goal: Fairness

Let me briefly discuss another virtue of the flat tax that I believe is important. The flat tax is fair because everyone pays the same rate, with no special breaks going to politically favored groups. The plan I have proposed is true to the idea of fairness we all learned in grade school: Everyone should be treated the same.

At the same time, it is progressive, thanks to the generous family allowance. The plan is progressive because the family allowance is worth more the less you make. For example, a family of four making $36,000 would pay zero percent of its income in income tax, a family making $50,000 would pay 5 percent of its income, and a family making $200,000 would pay 14 percent of its income. I estimate the plan takes about ten million low-income taxpayers off the rolls entirely. This is the definition of progressive.

Conclusion

Mr. Chairman, as you have often pointed out, the current tax system is broken and must be replaced. I commend you for your leadership in holding these hearings and for outlining a set of criteria for the tax reform debate. I am proud to say that the flat tax meets each of your criteria. It would raise revenue efficiently with as little duress and paperwork as possible. It would end the discriminatory treatment of saving and investment and promote growth in the economy. It would make American businesses the most competitive in the world, creating jobs, boosting wages, and raising living standards. It holds the greatest promise for shrinking the underground economy by causing taxpayers to be more willing and able to comply with the tax system. And it is neutral--it would treat everybody the same.

For all these reasons, Mr. Chairman, I hope you will give the flat tax the close and thoughtful examination this increasingly popular idea deserves.

Thank you.

Chairman ARCHER. Thank you very much for your presentation. Mr. Gibbons will inquire.

Mr. GIBBONS. I thank you, too, Mr. Armey for your presentation.

I made some flat calculations as you were talking here. The 260 million people in America, they break down into 110 million families. As I calculate the impact of your flat tax, you would increase the taxes on 63 million families and lower the taxes on 46 million families—that is not quite 110, but that is as close as I can calculate on the back of an envelope here.

I don't know whether we can get away with that politically, and I am not sure that there is justice in that because you increase the tax on lower income families and you lower the tax on upper-income families. That is one of the problems.

The second problem, as we have discussed, I think we are in agreement that we both understand that you can't adjust your tax at the international border. So those are really the only two faults I have with your proposal. But I want to commend you for what you have done. You have started a good debate over what we ought to do for America's revenue system in the future. As I say, my only two faults with it are, one, you have shifted the burden downward to 63 million families while you have lowered it on 46 million other families, and two, we still have the problem of not being able to adjust it at the border.

Thank you.

Mr. ARMEY. First of all, knowing, of course, that the Gettysburg Address was written on the back of an envelope, I don't want to quickly discourage anything that was done on the back of an envelope.

Mr. GIBBONS. Well, thank you.

Mr. ARMEY. But to have a full understanding of the distributional impact will be a much more elaborate and difficult process, so I hope you will forgive me if I don't accept your back-of-the-envelope conclusions.

Mr. GIBBONS. I understand.

Mr. ARMEY. It is an important question. We are concerned with distributional impacts. The fairness issue is very much a paramount issue, and we are seeking additional distributional studies, and we are not insensitive to that point.

The question of border adjustability is, I think, a big question. There are many people who think it is necessary and desirable to have a new tax system that accommodates to a desired border adjustability. I am not one of those people.

There are two fundamental reasons why I don't share an enthusiasm for border adjustability. One, on the practical side, I don't think it will work; and my view that efforts at border adjustability to the Tax Code will not work are shared by a great many economists, not the least of whom are Dale Jorgensen, chairman of the Harvard department who testified before this Committee, and Michael Boskin at Stanford, who convened a discussion on this subject by a great many economists, in which they made that agreement. That, I think, is a question we will have to address in terms of its feasibility.

My other reason for not sharing the enthusiasm for border adjustability is, I don't think it is the right thing to do. I don't be-

lieve it is necessary, I don't believe it is right, and I don't believe it will work anyway.

Why do I think it is not the right thing to do? Because I don't think it is appropriate to make American-made products less expensive to foreigners than to American consumers. I am driven in my understanding of government policy; my concept of the public interest is given to me by Adam Smith in his great book "The Wealth of Nations," where he says consumption is the sole purpose of all economic activity, and to the extent that government attends to the affairs of the producer, it should only do so on behalf of the consumer. I believe that border adjustability doesn't comply with that definition of public interest.

And finally, I have to say in all candor, border adjustability smacks to me as dumping through the Tax Code, and I am not sure it is within the spirit of a free or even, for that matter, fair trade. So this is going to be a lively discussion. There are sincere, well-intentioned feelings on both sides, but I feel it is only right for me to be candid.

Mr. GIBBONS. Let me address border adjustability with you for 1 minute.

I realize it is controversial, but every industrial nation adjusts at the border except us and Australia. And for the life of me, I can't get through my skull the fact that if we remain out of step with everybody else that we are going to suffer from it by the loss of jobs and job opportunities and markets; and I made the same argument that you made, sitting almost in the same place you are sitting, 25 years ago about the fairness to American taxpayers of the goods that they are exporting should carry with them the full cost of government.

In that 25 years, I have examined over and over my argument for that. I still wish the world were organized that way, but unfortunately, as you and I know, the world is not organized that way. And unless we are prepared to pay the huge economic price in jobs and job opportunities and wages and all those things, we are going to have to get in step with the rest of the world.

Mr. ARMEY. I understand. This is a position that you have come to through a long time. Two observations: One, I would compare the growth rate of the U.S. economy and Australia with any of these nations across the globe that have, in practice, border adjustability, and I feel confident of what I would discover.

And two, insofar as we talk about we need do this because other nations do it, I would first say, yes, Germany for example wants to increase taxes on their citizens in order to give tax breaks to Americans; I would say as long as the German people let them get away with it, I want to encourage them to do so. Insofar as I should do it because they do—in an attempt to be humorous, I tried that line on my mama once, and she said—so we will debate this further, and I hope you will not think I am being just frivolous.

Mr. GIBBONS. I understand. Thank you.

Chairman ARCHER. Mr. Bunning.

Mr. BUNNING. Thank you, Mr. Chairman.

Mr. Armey, you quoted some other economists that happen to agree with you about the flat tax. I probably could line up 10 economists here and get 20 different opinions.

Let me ask you the question that I worry about on a flat tax. How do we try to capture the cash economy with a flat tax?

It seems to me that we have an economy in the United States that caters to those who may not comply with the laws, and sometimes there is an awful lot of bartering and trading done and direct cash that never appears as income and therefore is not taxed.

Mr. ARMEY. There is no doubt about it.

Mr. BUNNING. How do we get to that?

Mr. ARMEY. There are basically two types of cash transactions that we would like to try to capture. One, of course, is the illegal transaction, a perfect example being the drug dealer, and, of course, people who are criminals simply don't pay taxes.

Now, it is argued that if in fact you have a national sales tax, the drug dealer will pay taxes because that money he earns is spent for Cadillacs or automobiles whatever, and they pay the tax then, but every dime a drug dealer earns is a resultant dime from the purchase of drugs by somebody else. So the sales tax does not apply in the sale of the drugs, only in the purchase.

So in either case, if you have two people at $50,000 under an income tax, the person who buys the drugs pays taxes on $50,000, the person that sells the drugs does not. If you have a national sales tax, the person that sells the drugs pays $50,000 on income, the person who buys the drugs or those people who buy the drugs do not, so you don't do a better job one way or the other.

Now, the question is, how can you diminish the underground economy that is not criminal, if I may, that are not engaged in illegal activities, the plumber?

Mr. BUNNING. Well, I would say to my friend from Texas, even those are criminal.

Mr. ARMEY. Let me say a normal, everyday, law-abiding person that goes out and does a job on Saturday and takes cash payment, you know, he is not——

Mr. BUNNING. Doesn't claim the cash payment?

Mr. ARMEY. That is——

Mr. BUNNING. That is criminal.

Mr. ARMEY. That is criminal, I understand, but this is a person who is not criminal in the ordinary course of his life.

Let's say the plumber that does a weekend job on Saturday collects $1,500 from taxes. The fact of the matter is, again, the person that paid him the $1,500 under sales tax is not paying taxes on that; he is not going to collect the $1,500 to report $1,500 in sales, and submit the taxes.

So now the question is, I believe that most Americans want to obey the tax laws, but given the Tax Code as we know it today, believe this is a Tax Code that has a break in it for everybody but me, so I will give myself a break, and they go do that extra weekend job. Furthermore, they believe that the Tax Code is so complex and the IRS must track so many billions of data points they couldn't catch me anyway.

Now, most of us if we think we can do something that we are justified in doing and won't get caught doing it are probably going

to do it. Now, in the flat tax they know with a dead certain understanding, Hey, I am being treated fair, there is no break for somebody else that I am not getting, we are all getting the same breaks, so I have no justification, plus the fact that the IRS has so few data points to track, they would probably catch me anyway. And I am willing to argue flat tax will do more to eliminate the underground economy than anything.

We know by real experience that in the 21 nations that have put in the sales tax that tax evasion has become a national pastime, and that enforcement has become such a frustrating experience that in 20 of the 21 cases the sales tax has evolved into a value-added tax.

Mr. BUNNING. Well, Mr. Majority Leader, I am not going to get into the philosophic compliance or noncompliance and all that, but the fact of the matter is that the flat tax does not reach the underground economy.

Mr. ARMEY. Nor does a national sales tax.

Mr. BUNNING. I didn't say it did. We were talking about your specific proposal, and it does not get to the underground economy any better than any of the others.

Mr. ARMEY. Other than the fact that it takes away any incentive for doing so.

Mr. BUNNING. Thank you for your testimony.

Mr. ARMEY. Thank you.

Chairman ARCHER. Mr. Hancock is not here. Mr. Camp, Mr. Zimmer, Mr. Johnson.

Mr. JOHNSON. Thank you, Mr. Chairman.

Mr. Armey, would your flat tax be based on cash or accrual-type method of accounting?

Mr. ARMEY. Cash accounting. It is my judgment that the Federal Government is and should be on cash accounting. I think the summary statement, all taxes are paid by people and paid out of current income flows is a cash accounting.

Mr. JOHNSON. So that would cause some restructuring of current data collection systems?

Mr. ARMEY. Well, it simplifies that. For example, a business simply writes down its inventory at the time it purchases it, when it expenses capital at the time it purchases, and for business reporting basis, they could go more to a cash accounting basis and less to an accrual accounting basis.

Mr. JOHNSON. OK. I understand that.

What would be the estimated loss to American business from the absence of any transition relief relating to net operating loss carryover or carryover of previously unutilized foreign tax credits, AMT credits or other general business credits?

Mr. ARMEY. Can I preface my remarks by saying, Wow? The transition is, I think——

Mr. JOHNSON. I didn't want them to think I was going easy on a Texan.

Mr. ARMEY. No, I do understand. The transition as we know, especially from the 1986 experience where in fact the transition spawned a very wonderfully useful book called "Showdown at Gucci Gulch," transition irrespective of what change we make, and I am convinced a change will be made, is critically important. In recogni-

tion of that importance, I have put together a transition task force to study exactly these kinds of questions.

We must understand and we must premeditate the transition. It is not something that I think that can be left at the impulses of the moment in a workout session. It must be pretty well premeditated, worked out ahead of time, and I have a transition task force.

I cannot answer your question now, but I can tell you that is exactly the kind of questions we need to work out ahead of time.

Mr. JOHNSON. I am glad you don't know the answer, either. I don't, either.

Mr. ARMEY. You are obviously not a good lawyer, then.

Mr. JOHNSON. Do you intend to have other taxes along with your flat tax, that is, excise taxes?

Mr. ARMEY. No, I do not.

Mr. JOHNSON. So you would repeal everything?

Mr. ARMEY. At the Federal level there would be for general revenues a simple, flat, direct, honest, fair, lovable flat tax, and only that, and then of course we do not change payroll taxes, so they would remain in existence as they are.

Mr. JOHNSON. OK. Thank you very much. I appreciate your testimony.

Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Rangel.

Mr. ARMEY. Speaking of lovable.

Mr. RANGEL. Thank you.

Under this fair, honest, lovable proposal that you have, if my friend Sam Gibbons is right with his statistics that the way it ends up, not because you intended to do that, is that the low-income people find themselves paying more because they have to consume more of their disposable income than the more blessed people that have more money to save, what adjustments are you prepared to make, if that is true, to make it more fair and honest and equitable?

Mr. ARMEY. Let me just say we have worked very hard on the whole question of distributional impact. It is a matter we have been concerned about. The first thing I will say again, I don't think Mr. Gibbons is right, but we must study this.

Now, as I have written the flat tax, as we think we understand the distributional impact, first of all, you can make an observation that approximately 10 million low-income people are taken off the tax rolls. With the generous family allowance we give, a family of four must make over $36,800 before they incur any income tax liability at all. If you take that same family of four, then they pay zero tax at $36,800, they would pay about 4 percent of their total income in taxes at $50,000 a year, they would pay about 14 percent of their total income in taxes at $150,000, and they would pay about 16 percent at $200,000, so that——

Mr. RANGEL. Is that how you make up for the taxes that are lost by dropping the $36,000 people?

Mr. ARMEY. Well, with respect to, as it were, the total tax take, we think by broadening the base as we do, where in fact after the flat tax a greater share of total taxes will be borne by the business sector as opposed to the individual sector, that we can get within about $40 billion of the current tax rate on the first year.

Now, this is again a number that is being contested. My own view is we get that close, we can make up the difference with spending reductions out of a $1.5 trillion and growing Federal budget.

The other area that we need to better understand is, where can we utilize savings from compliance costs and enforcement costs in helping with the revenue enhancement? And finally, if we are not at the right number that makes it revenue neutral, we have got two points of adjustment, either the rate or the family adjustment.

Mr. RANGEL. How would you treat the charitable organizations, the not-for-profits?

Mr. ARMEY. In the flat tax there are neither itemized nor standard deductions. That playingfield is simply removed from the Tax Code, and of course along that, charitable deductions go as well as any other itemized deduction.

Mr. RANGEL. Well, how is that justified if it is agreed that the Federal Government should not be involved in providing too much assistance in terms of health and welfare and that those closer to the problem should have better answers, like mayors and Governors, and then if we don't mandate that they do it because that would be unconstitutional, I think ultimately we say that the people who don't get the services, that is what charitable organizations are for. I think that is where it ends up in the Contract.

Now, if the charitable organizations already feel and have substantial evidence and support that they are carrying a heavy burden as it is now, and if Mr. Gingrich is right that people want to take care of those who are truly needy by making contributions to them as traditionally we have, why would you not make it easier for people to contribute money to the last safety net that would be out there under your Contract?

Mr. ARMEY. Let me say, first of all, we studied on this. This was a very important question. We were worried about it a great deal. We have discovered a couple of things.

One, less than 50 percent of charitable contributions made in America today are declared on tax returns. That surprised us.

Two, during the eighties when the tax value of a charitable contribution was substantially reduced and understanding what the tax regulations related to it was severely confounded to the point where I am now in a position for the first time in my life to make a significant charitable deduction through the royalties of a book I have just written, all of which are pledged to charity, but I can't yet understand under the tax law how I can make those charitable deductions without paying taxes on those charitable deductions. I am working on it, I can assure you. But during the eighties, in fact——

Mr. RANGEL. You are working on trying to get a tax deduction for making a charitable contribution now?

Mr. ARMEY. You know, with all due respect, I don't mind giving away the money that I will earn on the book. I don't think I want to pay taxes out of my meager earnings elsewhere on that money.

Mr. RANGEL. You think this is a good thing to do, to encourage?

Mr. ARMEY. Under current tax law, I could do that. Of course I think it is a good thing to do. But the wonderful thing about the

eighties is that during the eighties charitable giving more than doubled even while the tax value of a charitable gift was reduced.

Now, I said earlier——

Mr. RANGEL. But in the eighties because—and I know that light is on so I have got to get out of here—but in the eighties we were providing all of these New Deal socialistic-type of programs as they do in Europe, and now that type of thing will not be existing on the Federal level, as it relates to my city and State, less than that. So that safety net is going to be really needed.

Mr. ARMEY. Well, let me again say, first of all, you are absolutely right, during a period of time when the Nation might have perceived less need for charitable giving because of the massive expansion of social services of the government, the charity in the heart of the American people still expanded by more than double.

Now, I would say given the nature and character of the American people as I know them, during the decades of the first 10 years, the first decade of the next century after we enact this tax, in a growing economy you are going to see that expansion of charitable giving even more so, if in fact there is a need for it.

If you are concerned that there is going to be a reduction in social services through government expenditure in the next decade, then obviously we would be concerned to have that Tax Code which would most encourage increased charitable giving. I think the flat tax is that Tax Code.

Chairman ARCHER. The gentleman's time has expired.

Mr. McCrery.

Mr. MCCRERY. Thank you, Mr. Chairman.

And thank you, Mr. Leader, for joining us today. You really have, I think, a well-thought-out plan—much better thought out than most critics would give you credit for.

The flat tax sounds simple, and it is in many respects, but the depth to which you have gone to explain how this is similar to a consumption tax and how it promotes economic growth are things that Members of this Committee are going to be vitally concerned with. So we appreciate very much your coming and explaining those things to us.

I would like to give you an opportunity to explain a little further, though, how this would impact on the economy, because, after all, if we are concerned about low-income people, if we are concerned about the poor, many of us believe the best way to address those concerns is to grow the economy and to create more and better-paying jobs in this country. Mr. Gibbons has talked about that today as one of his concerns. Would you explain to us how your flat tax would impact the economy?

Mr. ARMEY. Yes, and it is very important part of—Professors Hall and Rabushka, for example, estimate that under the flat tax the income of the typical American family would be $7,600 higher by the year 2002.

How would that happen? It seems to me one of the most important things we do, obviously we provide incentive for savings and investment, but one of the very critically important things we do is the expensing of capital purchases. Our most high-growth, dynamic areas of the American economy are in these rather mysterious worlds of electronics and computers where the rate of techno-

logical innovation is just mindboggling. To expense capital would make it more possible for more often a person to keep pace with the march of technology, knowing that they are putting on line machinery that in 2 years may be obsolete, but they expense it today, they can recover in time to keep that pace.

The fact of the matter is economic growth is born out of an expansion of capacity through capital accumulation, but more importantly, out of an expanding of the capacity of the capital through productivity increases, which is the growth of scientific and engineering knowledge as innovated in the capital which then brings the labor along. As the labor enjoys greater productivity, their wages go up, we get greater total output, national income goes up, and of course there accrues to the State greater tax revenues.

So this is very much savings-and-capital-accumulation friendly, and now, in addition to that, there are the incentive factors that we have in that. There is a greater encouragement on the part of the individual to save and to make investments and to continue to nurture investments because of the end of the estate tax, which I think is an incentive factor that I think should not be overlooked.

Many of us work all our life and just when we get to those areas where our productivity and our gains and our ability to push a $1 million concern to the $2 or $3 million level, we accept the tradeoff, we will quit now because if I do build this bigger, it will just go to the government. If, in fact, we are at that point, we say should we go on, and the answer is, Well, it will all go to our grandchildren, I think there will be an important incentive to cap off your work life with that growth thrust at the end.

Mr. McCrery. Will you very eloquently explain how your proposal would increase productivity? In the next century this is certainly going to be important as we compete with China and the European Community, and others.

Mr. Armey. My own view, incidentally, is that increased productivity and the ability to keep pace at a faster rate will do more to improve the balance of payments than border adjustability will.

Mr. McCrery. I think the support that you have among the economic community is substantial, more so than Mr. Bunning might have intimated.

One thing you left out in your analysis, though, is that we need more workers in the work force if we are going to compete in the next century. The only way to get more workers in the work force is to create more jobs. I think you have already stated that your proposal has the potential to create many more jobs in our economy.

One last question, would you, as briefly as you can, explain how your flat tax proposal is similar to the Nunn-Domenici proposal and similar to a consumption tax?

Mr. Armey. I believe that the one thing that I would congratulate all the proposals for is that they do a much more inclusive job of capturing the entire income flow of America in the tax base, and I think every proposal should be commended for that.

I think the Nunn-Domenici proposal is clearly pointed at encouraging savings. My own view is that we do that more directly, more effectively in the flat tax, but I think there is a similarity.

I think other than the similarity of the tax base that there is a fundamental difference between the income tax, flat tax, and the sales tax. I try to characterize that difference this way.

The flat tax is a tax that is levied on incomes generated from the production process. The sales tax is a tax that is levied on production outcomes, and I think they are remarkably different approaches to the Tax Code, so I dare say I see little similarity between the sales tax and the flat tax.

Mr. MCCRERY. But——

Chairman ARCHER. The gentleman's time——

Mr. MCCRERY. But Nunn-Domenici and yours——

Mr. ARMEY. In the sense that we are both very much interested in encouraging savings. Nunn-Domenici I don't think taps into the essential anger of the American people, which is "I don't like this Tax Code."

Chairman ARCHER. The Chair would like to be able to conclude the Majority Leader's presentation by the time that we leave for this vote because the Minority Leader is due to come very shortly. I don't want to cut anybody off, but we do have to move along.

Mrs. Kennelly, we will recognize you hopefully for a short inquiry and short answers, and then we will see where we are, whether we need to go to vote at that time and release the Majority Leader.

Mrs. KENNELLY. Thank you, and welcome, Mr. Majority Leader.

Mr. Leader, when I look at your proposal or as much as I have been able to see of your proposal, I see there are no deductions for State and local taxes. Now, I look at my own State of Connecticut which has high taxes, has a State income tax and has high property taxes, then I look at your State of Texas. It is well known that it is fortunate and doesn't have a State income tax, but you do get a great deal of revenue from oil and gas royalties.

In your flat tax, how would we avoid having a shift of resources to Texas from places like Connecticut or Massachusetts or New York? Is there a transition in your proposal that I haven't seen, or how do you address this that this won't happen?

Mr. ARMEY. Well, I don't really know what you can do to save any State from the construction of its own Tax Code, but I would say if I can, the State of Connecticut is a State that is going to be much better off as a State and as a people within the State if they are living in a growing, dynamic flat tax world than they will be if they live in the static, complex tax world we have today.

It strikes me that the manner in which the various States finance their State governments will always be a function of the resources available to that State to draw upon, and I am not sure how you can change that.

Now, if you are talking about the movement of people between States, there are many impulses that cause people to move from one State or another. For example, a right-to-work State is likely to attract business and industry from a State that doesn't do that. So I do think regional differences will have to be worked out by States as they pursue their most prosperous State configuration to meet their desires.

Mrs. KENNELLY. Thank you.

I think my point was there is no way we can figure out how we can get natural assets like oil and gas, and we worry about this as a flat tax comes.

One quick last one, Mr. Leader, since you are the Majority Leader and you have so much influence, when do you think we will be seeing this come up before us?

Mr. ARMEY. Again, the Committee will march at its own pace, there is no doubt. Certainly the same is true of the Finance Committee. Whatever is done in tax reform will be done through the normal workings of the committees of jurisdiction who have in fact not only the jurisdictional right and obligation but the expertise. So that my own personal prediction is that a major tax reform will probably be completed sometime in 1997 at the latest. That is just my guess.

Mr. RANGEL. Is that after the election?

Mr. ARMEY. Again, that is my best guess. I don't know. I mean, if the Committee decides to march to a faster drummer, certainly I will do my best to try to keep up.

Mrs. KENNELLY. Thank you.

Chairman ARCHER. We have time for one brief question from the gentleman from California, Mr. Herger.

Mr. HERGER. Thank you very much, Mr. Chairman.

Again, Mr. Leader, I want to thank you. I just have concluded a series of townhall meetings and again the enthusiasm at the thought of actually completely restructuring our tax system has a tremendous amount of support out in the heartland of America.

My question to you would be, would you consider—as I understand your plan, the flat tax, everyone is paying the same rate. There really isn't any incentive for someone to go out at a time when we are purposely moving away from the welfare state and attempting to encourage our people to donate more to charities, to go out and put his extra dollars into a luxury car or to, say, donate to his tithing or donate to some other charities.

Would you consider perhaps changing your plan to have a deduction for charitable contributions to encourage charitable deductions as opposed to buying a luxury car?

Mr. ARMEY. The short answer is I would not. The flat tax, you either—if you allow one exception, you have built the best excuse for the next exception.

Let me just say, finally, I profoundly believe that charity is found in the hearts and the sense of well-being of the American people, and if we give them a growing, prosperous economy, charity will flow at a much greater rate than it can ever be made to flow by tax incentives.

Chairman ARCHER. The Leader is excused. The Committee will stand in recess until after this vote. We will come back immediately and reconvene.

[Recess.]

Chairman ARCHER. The Committee will come to order.

Mr. Minority Leader, we apologize to you for not being able to take you earlier this morning as was originally expected. We have, obviously, a lot of Members who want to ask a lot of questions, and it has been difficult to move the process along, but we welcome you to the Committee. We are pleased that you could adjust your sched-

ule and come back and be with us, and we are delighted that you are going to present to us your ideas of what we ought to do to, what we like to call, replace this current income tax system. So you may proceed.

STATEMENT OF HON. RICHARD A. GEPHARDT, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MISSOURI

Mr. GEPHARDT. Thank you, Mr. Chairman. I fully understand the problems in a Committee like this. I served on the Committee, and I know that everyone wants to ask questions, and they should, and this is a very important issue, and I commend you and the Members of the Committee for taking on this big task, along with all the other big assignments that this Committee has right now.

I would like to offer my testimony. I may not say every word here, and if I don't, I would be happy if you would take my testimony as it is written.

Chairman ARCHER. Without objection, your entire testimony will be inserted in the record.

Mr. GEPHARDT. I thank the Chairman.

Mr. Chairman, Members of the Committee, I believe and have believed for a long time that we have a need to completely rebuild a very complex, a very confusing, and confounding tax system that is not serving the needs of average, hardworking Americans. We need to do it in a way that preserves the cornerstone not just of our tax system but of a decent, civil society, that those who have prospered the most have an obligation to shoulder more of society's burdens. It is a progressive principle that I believe is as old as the Bible itself.

As you all know, I am not a stranger to tax reform. Since my very first term in Congress, as a Member of this Committee, I have worked to make our Tax Code simpler and fairer, to end the sea of redtape that swamps our economy, overwhelms our taxpayers, and takes a veritable team of lawyers and accountants to navigate.

Without many of the people in this room, including the Chairman, the Ranking Member, and others, working in a broad, bipartisan fashion, we never would have succeeded in passing the 1986 Tax Reform Act, which at least tried—didn't succeed entirely—but it tried to make our system more accountable, more reasonable, and more understandable. But we have a long way to go and much yet to accomplish.

That is why I am grateful for this hearing and for the leadership of Chairman Archer, who is using Congress' oldest Committee to advance this Congress' most important new idea. We may disagree on certain principles and on certain details of the tax system that we want for this country, but we all agree that today's system is indefensible and unacceptable. By starting this debate, you are saying to the entire country that we can do a lot better, and I am confident that we will.

Let me be very clear about my purpose today. I believe we need a simpler and fairer tax system, and I believe we need to design that system to help average, hardworking families, not just the privileged and powerful corporations or special interests. The fact is, if you don't have a team of experts on your side, it is pretty hard to find your way through the maze that is known as our Tax Code.

Today, an astonishing 49 percent of Americans are forced to hire professionals to help prepare their returns. Nearly 1 million Americans using the 1-page EZ form feel they need professional help to fill out that supposedly simple form.

If you ask me, that is the most damning statistic about our tax system. For many people, even the EZ form is far from easy.

But if you look beyond the percentages, it is the perceptions of our tax system that are the most damaging. When I go door to door in my district in St. Louis, when I talk to the people who are working two or three jobs and extra part-time jobs to pay their bills, I find a deep anger and resentment at a system that favors the tax experts and insiders at the expense of average families. And I have to admit that I find that to be a legitimate anger.

Our tax system was intended to collect tax dollars fairly, simply, and broadly, to pay for crucial public purposes. Today it is a test of legal brain power, an accountant's decathlon, a treasure hunt for hidden deductions and arcane tax breaks.

We need a tax system that works for ordinary people. We need a tax system that doesn't require a CPA to fill out the forms, and we need a tax system that doesn't have so many inducements, incentives and restrictions that it tries to micromanage the economy to a point where I think it creates a drag on economic growth. And for all the problems with the current system, we need to make this a debate not about bashing government but about improving it.

Quite frankly, we are not going to achieve those goals by toying and tinkering at the margins, in my opinion, as we have done sometimes in the past. I think it is time for massive, radical change of our tax system.

Next month I will be offering a detailed proposal for a fundamental overhaul of our entire Tax Code so that we have fewer rates, fewer loopholes, less paperwork, and lower tax rates for all Americans. I look forward to comparing it with proposals such as yours, Mr. Chairman, and Mr. Armey's flat tax, and Mr. Gibbons' tax proposal.

We need an open and vigorous debate. As that dialog begins, let me simply focus, in closing, on a few broad principles that are shaping my plan because they differ in important ways from some of the principles behind the Republican plans that have been advanced.

The basic difference is this. My tax plan will be progressive, not regressive. My tax plan will maintain a longstanding tax tradition that those who have the most in our society, those who have prospered more than anyone else should pay a little more.

Given the choice between maintaining a balance where millionaires pay a little more in taxes or asking struggling families to pay more, I believe we should continue to ask the millionaires to shoulder their fair share of the burden.

Mind you, I am not talking about raising taxes on anyone, just maintaining the progressive principle that has always been at the heart of our tax system. That is my basic problem with the main Republican tax reform proposals. They do a lot to simplify the tax system, and that is good. But in the process, they offer a large tax break to the wealthiest Americans, making the overwhelming ma-

jority of Americans pay more taxes than they should, certainly more than they would under my and other plans.

With due respect, let me suggest that the flat tax proposed by Republican Leader Armey is actually an army of perks for the privileged. It doesn't tax what we call unearned income, which can amount to untold millions in dividends and capital gains. And by offering only one tax rate, 17 percent of earned income, it gives a huge break to the wealthiest Americans.

The only way to pay for this kind of tax break is to raise the taxes for working families and the middle class, or to significantly increase the deficit, both of which I think are unacceptable.

I feel that this approach is wrong. I think the tax breaks should go to people who need them: Working families and the middle-income people. And the notion that the benefits of this kind of tax giveaway will trickle down to the rest of the people has been so thoroughly discredited and disregarded by economic opinion that it is simply not a sound basis for public policy.

I have a similar problem with Chairman Archer's notion of a national sales tax, a tax on spending as opposed to earning. By definition, it taxes far less of the income of those who have the most and far more of the income of working families and the middle class because they spend a higher proportion of their total earnings to get through each week and each month. And Chairman Archer's plan, in my view, has none of the redeeming features of Congressman Gibbons' consumption tax, which shares the commitment to a progressive tax system and one which does not redistribute income among the various income classes.

We cannot go back and should not go back to a tax system that echoes the 19th century. I think we need a 21st century progressive tax. This is the central guiding principle of my plan. It will be staunchly and unapologetically progressive.

My plan will be dramatically simpler and easier than today's tax system. It will focus on collecting more of the taxes that are due because today's system, with its mind-numbing complexities, encourages tax evasion. It will not exempt unearned income because most Americans would agree there is no reason stock dividends should go untaxed while hourly wages are fully taxed.

It will be a plan that promotes economic growth and lets hard-working families keep more of what they earn without the kind of micromanagement and complex incentives that only take away more deductions from the marketplace and put them in the hands of the government.

It will be a plan that does not change the deficit, explode the deficit, increase the deficit, unlike some of the proposals that are on the table. This is an issue that we ought to discuss in every budget, but it should not be confused with a discussion of tax reform.

It will be a plan that does not redistribute income from the middle class to the wealthy or vice versa. My plan is not designed to raise taxes on any income group, period, but it will not give a large tax giveaway to the wealthy.

Finally, in my view, families will save more when they have more. If you are barely making ends meet and if you are saddled with debt such as loans, student loans, car loans, and a home mortgage, you can't save, no matter what the incentive. But by focusing

on letting these families keep more of what they earn, I believe we can do more to increase savings than any tax loophole or tax inducement.

In closing, I just want to leave one thought. We can and must work toward a bipartisan consensus on tax reform. We may begin in different places. We are certainly going to have some differences in our plans, but we must seek a common ground defined, in my view, by principles similar to those that we have outlined which can give us a Tax Code that is simpler and fairer. We don't have to choose between these goals. We have to pursue both.

To do that, we have got to educate the American people about the real consequences of each and every proposal that is on the table. When we do, I believe we will find an astonishing amount of support for a tax system that is flatter but not flattening for working families, a tax system that doesn't submerge its fundamental fairness for the sake of oversimplification instead of simplification, a tax system that takes what is needed to educate our children, pave our roads and care for our elderly and other essential public purposes that we can agree on, but leaves the rest right where it belongs, in the hands of the American people who earned the wealth.

I thank you for listening. I admire your Committee for again taking on this gigantic task. I remember how hard it was in 1986. It was a bear, but we did make the Code I think better, but we need to do more, and I am convinced this Committee and this Congress has the capability to do that.

[The prepared statement follows:]

NEWS FROM THE HOUSE DEMOCRATIC LEADER

For Immediate Release:
Thursday, June 8, 1995

Democratic Leader Richard A. Gephardt
H-204, U.S. Capitol

TESTIMONY BY HOUSE DEMOCRATIC LEADER RICHARD A. GEPHARDT
COMMITTEE ON WAYS AND MEANS
HEARING ON TAX REFORM, 1100 LONGWORTH H.O.B.

Chairman Archer and members of the Committee:

I thank you for the opportunity to testify this morning, to talk about one of the most crucial issues before this or any other Congress --

The need to rebuild a tax system that is simply too complex, too confusing, too confounding to serve the needs of average hard-working Americans --

And the need to do it in a way that preserves the very cornerstone not just of our tax system, but of a decent, civil society -- that those who have prospered the most have an almost sacred obligation to shoulder more of society's burdens. It's a progressive principle that is as old as the Bible itself.

As you all know, I'm no stranger to tax reform. Since my very first term in Congress -- as a member of this very committee -- I've worked to make our tax code simpler and fairer -- to end the sea of red tape that swamps our economy, overwhelms too many taxpayers, and often takes a veritable team of lawyers and accountants to navigate.

Without many of the people in this room -- working in a broad, bipartisan fashion -- we would never have succeeded in passing the 1986 Tax Reform Act, which at least tried to make our tax system more reasonable and more understandable. But it left us with a long way to go, and too much yet to accomplish.

That's why I am grateful for this hearing, and for the leadership of Chairman Archer, who is using Congress's oldest committee to advance this Congress's most important new idea. We may disagree on certain principles or details of the tax system we want for this country, but we all agree that today's system is unacceptable and indefensible. By starting this debate, you are saying to this entire country that we can do a lot better. And I'm confident that we will.

Let me be very clear about my purpose here today: I believe we need a simpler and fairer tax system. And I believe we need to design that system to help average, hard-working families -- not the privileged and powerful corporations or special interests.

The fact is, if you don't have a team of experts on your side, it's pretty hard to find your way through the maze of our tax code. Today, an astonishing 49 percent of Americans are forced to hire professionals to prepare their taxes. Nearly a million Americans using the one-page "EZ" form feel they need professional help.

If you ask me, that's a damning statistic. For many people, even the "EZ" form is far from easy.

But if you look beyond the percentages, it's the perceptions of our tax system that are the most damaging. When I go door to door in my town of St. Louis -- when I talk to the people who are working two or three jobs, and extra part-time jobs just to pay the rent and put food on the table -- I find a deep anger and resentment at a system that favors the tax experts and insiders at the expense of average families. And I have to admit that I find a lot of that anger legitimate.

Our tax system was intended to collect tax dollars fairly, simply, and broadly, to pay for crucial public purposes. Today it is a test of legal brainpower, an accountants' decathlon, a treasure hunt for hidden deductions and arcane tax breaks.

We need a tax system that works for working people. We need a tax system that doesn't require a C.P.A. just to fill out the forms and get a fair shake.

We need a tax system that doesn't have so many inducements, incentives, and restrictions that it tries to micromanage our economy, to the point that it creates a drag on economic growth.

And for all the problems with the current system, we need to make this a debate not about bashing government, but about improving it.

Quite frankly, we're not going to achieve these goals by toying and tinkering at the margins, as we have done so often in the past. It's time for massive, radical change. Next month, I will be offering my own proposal for a fundamental overhaul of our entire tax code -- so that we have fewer rates, fewer loopholes, less paperwork, and lower tax rates for all Americans.

I look forward to comparing it with proposals such as yours, Mr. Chairman, and Mr. Armey's Flat Tax." We need an open and vigorous debate. As that dialogue begins, let me focus today on the broad principles that are shaping my plan, because they differ in important ways from the principles behind every Republican plan that has been advanced.

The basic difference is this: my tax plan will be progressive, not regressive.

My tax plan will maintain a longstanding tax tradition in this country: that those who have the most in our society, those who have profited and prospered more than anyone else, should have to pay a little more.

Given the choice between maintaining a balance where millionaires pay a little more in taxes, or asking struggling families to pay more, I believe we should continue to ask the millionaires to shoulder more of the burden.

Mind you, I'm not talking about raising taxes on anyone -- just maintaining the progressive principle that has always been at the heart of our tax system.

This is my basic problem with the main Republican tax reform proposals. They do a lot to simplify the tax system -- and that's a good thing.

But in the process, they offer most of the breaks to the wealthiest Americans, making the overwhelming majority of Americans pay more taxes than they should -- certainly more than they would under my plan.

With all due respect, let me suggest that the Flat Tax proposed by Republican Leader Dick Armey is actually an army of perks for the privileged. It doesn't tax what we call "unearned income" -- which can amount to untold millions in stock dividends and capital gains.

And by offering only one tax rate -- seventeen percent of earned income -- it gives a huge tax break to the wealthiest Americans. The only way to pay for this kind of upper-income tax break is to raise taxes for working families and the middle class, or to significantly increase the deficit -- both of which are completely unacceptable.

I feel strongly that this approach is wrong. I think the tax breaks should go primarily to the people who really need them -- working families and the middle class. My guess is that most Americans don't even realize that the Armey Flat Tax is actually a major tax giveaway for the wealthy.

And the notion that the benefits of this kind of tax giveaway will somehow "trickle-down" to the rest of us has been so thoroughly discredited -- so completely disregarded by mainstream economic opinion -- that it is simply not a sound basis for any public policy.

I have the same problem with Chairman Archer's notion of a national sales tax -- a tax on spending, as opposed to earning. By definition, it taxes far less of the income of those who have the most, and far more of the income of working families and the middle class, because they have to spend a higher portion of their total earnings to get through each week.

And Chairman Archer's plan has none of the redeeming features of Congressman Gibbons's consumption tax, which shares the Democratic commitment to a progressive tax system, and one which does not redistribute income among the different income classes.

America cannot go back and should not go back to a regressive tax system that echoes the

19th Century. Instead, we need a new 21st Century progressive tax.

That is the essential guiding principle of my plan. It will be staunchly and unapologetically progressive.

My plan will be dramatically simpler and easier than today's tax system.

It will focus on collecting more of the taxes that are due, because today's system, with its mind-numbing complexities, almost encourages tax evasion.

It will not exempt unearned income, because most Americans would agree that there is no reason stock dividends should go untaxed, while hourly wages are fully taxed.

It will be a plan that promotes economic growth, and lets hard-working families keep more of what they earn -- without the kind of micromanagement and complex incentives that only take more decisions away from the marketplace, and put them in the hands of government.

It will be a plan that does not explode the deficit -- unlike some of the proposals that are currently on the table.

It will be a plan that does not redistribute income from the middle class to the wealthy, or vice versa. My plan is not designed to raise taxes on <u>any</u> income group, period. But it will not give a large and unaffordable tax giveaway to the wealthy, as several Republican plans would.

Finally, in my view, families will save more when they <u>have</u> more. If you're barely making ends meet -- and if you're saddled with debt, such as student loans, and car loans, and a home mortgage -- you often cannot save, no matter what the incentive. By focussing on letting these families keep more of what they earn, I believe we can do more to increase savings than any tax inducement or loophole.

In closing, I want to be very clear about one thing: we can and must work toward a bipartisan consensus on tax reform. We may begin in different places, but we must seek a common ground defined, in my view, by principles similar to those I have outlined -- which can give us a tax code that is both simpler and fairer. We don't have to choose between these goals; we have to pursue <u>both</u>.

But to do that, we have to educate the American people about the real consequences of each and every proposal that is on the table.

When we do, I believe we will find an astonishing level of support for a tax system that is flatter, but not flattening for working families --

A tax system that doesn't submerge its fundamental fairness for the sake of oversimplification, instead of simplification --

A tax system that takes what is needed to educate our children, and pave our roads, and care for our elderly, and other essential public purposes -- but leaves the rest right where it belongs: in the hands of the American people.

I thank you for listening -- and now I'm happy to take your questions.

# # #

Chairman ARCHER. Mr. Leader, thank you for your presentation. I want to compliment you on a number of counts. First, I want to compliment you for laying to rest any question whatsoever that might be in the minds of historians that this is the oldest Committee in the Congress of the United States. I am grateful.

Mr. GEPHARDT. The Members are not the oldest, the Committee is the oldest.

Chairman ARCHER. And second, I sincerely and genuinely want to compliment you for coming to us and saying that you will have a specific proposal that can be made a part of the mix, that you will be engaged in the process, because my sincere hope is that it can be bipartisan. I think it is too important to every American as to what we do with the method by which we raise the taxes to pay the government's bills.

There are many, many parts of your statement where you and I are in complete agreement, and I think we should build on the areas of agreement and see if we can't come out with something that will truly benefit America and give us a chance to see Americans have the opportunity to realize their hope and dream, which is greater real family income, and the opportunity for their children to do even better than they have done.

I think the way we tax can have a major impact on that, particularly in the next century, and as Sam Gibbons has so well articulated, in our ability to compete in a commercial global marketplace, because I am convinced that if we don't give ourselves the greatest opportunity to do that and to win that battle that we will see our standard of living decline in the next century for Americans. So we need to all roll up our sleeves and attempt to reach that halcyon position for this country.

Having said that, I would take just minor exception to your comment that I have endorsed a national sales tax. I have endorsed some form of tax on goods and services rather than a tax on income, and it may be that something similar to what Sam Gibbons has proposed could be the vehicle to accomplish that, but I want to look at all of the suggestions, and that is the purpose of these hearings.

Having said all that, I again am pleased that you, as Minority Leader, will be engaged. I was very disappointed that the administration does not wish to be engaged in this process by submitting a proposal, and I believe that it is very important, in our bifurcated form of government, that the President also be a participant with the Congress in something that is this important to the future of this country.

So I don't really have any questions to ask of you, and I would yield to the Ranking Minority Member, Mr. Gibbons, for any statement that he would like to make or question that he would like to ask.

Mr. GIBBONS. Well, I would like to make a little statement.

First of all, Mr. Chairman, Mr. Gephardt, I welcome you here. I remember your distinguished service on this Committee. You have joined a whole rank of distinguished alumni of this Committee, Presidents, Vice Presidents, Speakers, Chief Justices, and we are proud of you. Right now you are the oldest, most distinguished active alumnus that we have, and you are not very old, but of all

the people still in active political life, you are the most distinguished alumnus we have. We are proud of you.

Second, I want to express my personal appreciation for your having put our Democratic Party firmly in the position of wanting change in the system. I am sorry that that didn't come forward in the testimony of the Treasury yesterday, but we Democrats do stand for change. We are not defending the old status quo in this tax system. We are for change that is under the outlines that you presented.

I am glad that you are entering into the fray again, as you have always been in the fray in putting forward proposals. You have never been ashamed to put forward a proposal and you usually have well-thought-out proposals. So I look forward to that.

I think the thing that distinguishes your position from Mr. Armey's position is that I made some rapid calculations on Mr. Armey's position when he was here, and he disagrees with me, so I may be wrong. But I figured there are 110 million families in America, a little more, a little less. His proposal, and I am trying to be conservative now, raises the taxes on the lowest 63 million families, but lowers the taxes on the highest 46 million families. I don't know whether he intended to do that, but that is my rough calculation of what his does.

Now, yesterday, embedded in the Treasury's testimony, and they had gobbles of it, that is an analysis of it, their figures of Mr. Armey's proposal versus the status quo was even worse, but I don't remember those exactly. I think that unless we recognize that for the last 20 or 30 years we have sort of de facto established a burden sharing, that seems to be accepted as reasonable in the American system that any proposal that changes that is going to kick off one terrific debate about who we are requiring to pay for a greater share of government, and I think that we have to be careful about that.

I am not sure that the burden table that I have presented in mine is exactly right. I have presented the best that I could get my hands on. It may be wrong, but I think we have got to be careful as we enter that debate. We are dealing with a lot of people, a lot of families, and we are going to need the best guidance we can have.

As I see it right now, the principal defect of Mr. Armey's proposal is one that is not adjustable at the international border. There is no argument about that. And, two, it seems to shift the burden down markedly on low-income families.

Mr. GEPHARDT. Let me say that we all have, and you especially have two big, tough threshold questions that we have got to deal with as we talk about tax reform. The first one is, what activity or event to tax, and that is probably the first decision you have got to make. And obviously Mr. Archer and Mr. Gibbons you are thinking about, talking about, trying to intellectually deal with the idea of coming off of the income tax at least to some extent and moving to taxing other activity somewhere in the economy, and that is a very legitimate idea, one that we need to really think through.

The second tough question is, whichever way we go on that, is there a differing burden on people according to their means, and

that is a question that goes to the very existence of our tax system and has been debated and redebated through the years.

So you understand where I come from, I strongly believe that whichever way we go on the events that we tax, it ought to be according to means, at least to the extent we do it today. I am addressing the income tax in my proposal.

I am trying to get as close as I can to taking all the exceptions out, increasing the base to the greatest extent possible, and getting the rates as low as humanly possible for everybody, but having different rates for at least some people. And I am probably headed toward three rates as opposed to where we are today, and I would like to get those rates in every case as low as I can possibly get them.

Mr. GIBBONS. Well, may I add just one more caveat here, Mr. Chairman.

Chairman ARCHER. Certainly.

Mr. GIBBONS. The FICA tax, every economist that has ever testified before this Committee tells us that the FICA tax, although it appears to be paid half by the employer and half by the employee, all comes out of the employee's wages. So the FICA tax is borne entirely by the employee, and all of the tables we have about tax burden distribution distribute the FICA tax to the employee.

That means that when you deal only with the income tax in any of your calculations, you are overlooking a 15 percent tax on the first dollar earned by every person, 15 percent, and the earned income credit was designed to take away some of the burden of the FICA tax on the first dollar. So all calculations that you make in changing the tax system have in some way got to impact upon the FICA tax as well as the income tax because we are now collecting almost half, we are collecting almost as much in FICA tax as we are in personal income taxes.

That is just one of the characteristics of the very complex equation we have to solve here, and so I just throw that out as sort of an observation of the dilemma we face and the problem we face. We have got to take that into consideration as we try to distribute the burden equitably and fairly to the American public.

Mr. GEPHARDT. I agree.

Chairman ARCHER. Dick, can you give us some idea of the timeframe in which you will be able to submit your proposal so that we can begin to consider it in the mix here?

Mr. GEPHARDT. I am shooting to have it ready in the next 30, 35 days. That is what I would like to be able to do.

Chairman ARCHER. Excellent. Excellent.

Mr. Hancock.

Mr. HANCOCK. Thank you very much, Mr. Chairman.

That was the first question I had on my mind, is when we could anticipate some specifics. We have had specifics from Senator Nunn and Senator Domenici. Mr. Gibbons has given us a lot of specifics. Actually the value-added is in some foreign countries now so therefore we can kind of take a look and see what history has done on that.

Any plan that we do, I think you will agree, is going to have to have a lot of stroking and massaging, whether it is yours or whether it is a value-added or whatever we finally come up with. I am

even asking some of the people that are presenting to come up with a flow chart showing us where that money would be taxed, who would be paying it and that type of thing.

I do think, though, Dick, you and I have known each other real well, I think it would be beneficial to all of us to look at everybody's proposal since none of it is in concrete now, and not criticize the other person's proposal. I think for us to say that what somebody else is going to do before it has been stroked and massaged and worked around is unproductive. I don't think it benefits anything, anybody, but creates confusion on the part of a lot of people.

I don't know that I could support your plan, but I am not going to criticize your plan until I see it, and I just believe as a suggestion that we would all be better off if we got away from trying to talk about the rich and the poor and what have you and who is going to benefit under any plan and said, look, let's look at every possible option, yours included, Dick Armey's, Sam Gibbons', and get away from this class warfare type of approach.

I understand exactly where we are coming from. I also understand that the people that have worked hard and accumulated capital are also the employers, and we have got to make sure that individuals continue to have that opportunity to become wealthy and to keep enough of their wealth to where they can employ other people and give them the opportunity.

So with that suggestion, I hope you will concur that let's look at everybody's plan before we start being too critical.

Thank you.

Mr. GEPHARDT. I appreciate your thought, and I hope that it is possible for the Committee to come up with a common way of evaluating all of the plans so that we can get a good view of what is going on. At the end of the day, back, if I remember, in 1986, we wound up mixing and matching by the time we got down to really putting it together, so you are probably going to be taking features out of different plans before you are done. But I think it is important to have a good evaluation of each plan, I agree.

Mr. HANCOCK. I think you would agree that the easiest way to evaluate it would be through a flow chart approach, what is collected, who is going to pay, what have you. As of right now I have not seen any flow chart approaches to the tax. I just hope it doesn't come up with a flow chart like the health care plan had.

Mr. GEPHARDT. Right.

Chairman ARCHER. Well, I would also chime in very quickly and say this. My hope is that whatever we end up with, it will be not just reform. The term reform has been used over and over and over again in this Committee. And I also hope that we not simply end up clipping around the edges or pruning but that we end up with something that is a replacement for this system and that will really and truly get the IRS more out of people's lives.

Mr. Ensign.

Mr. ENSIGN. Thank you, Mr. Chairman.

Mr. Gephardt, you mentioned in your testimony about progressivity and the idea being as old as the Bible itself. I certainly hope you weren't referring to that concept being in the Bible as far as forced taxation and a progressive nature, because that certainly is not a concept that is in the Bible. But I want to address that be-

cause I think that is a fundamental issue that needs to be discussed in this whole tax system replacement that we are talking about here.

And I address this question, and perhaps you can, the administration wasn't very forthcoming in their answer yesterday. We talk about, obviously you are dealing with the issue of fairness, what is fair to pay, what tax rate depending on your income level. Where do you get your definition of fairness?

We had a definition by Mr. Armey today that said that fair is when you treat everybody the same. That is his definition of fairness. Where do you get your definition so that we can determine what rate is fair to pay?

Mr. GEPHARDT. Through the years we have had a progressive income tax system. We have made a decision as a country that if you are better off, you fairly should pay more of a burden to make the government——

Mr. ENSIGN. Under the same tax rates, don't you pay more of a burden? If everybody pays the same tax rate, don't they pay more of a burden because somebody makes $100,000 versus $20,000, they pay more of a burden?

Mr. GEPHARDT. It goes back to what Mr. Gibbons was saying, with the payroll tax today, everybody pays 6, 7 percent out of their income. Now, that is a different thing if you are earning $30,000 a year or $40,000 a year than if you are earning $4 million a year. It is much easier in your circumstance if you are making $4 million a year to afford to pay that amount of money, whether it is——

Mr. ENSIGN. Let's take that amount of money. Let's say someone is making $1 million a year—we will keep these figures nice and round—and that somebody else is making $10,000 a year.

Now, that person that is making $1 million a year could afford to pay a 90 percent tax rate much easier than the person that makes $10,000 a year could afford to pay a 90 percent tax rate. By your definition, is that true?

Mr. GEPHARDT. It is true, but it is a question of what is reasonable——

Mr. ENSIGN. That is why I am asking where you get your definition, so that we can find out.

Mr. GEPHARDT. From a consensus that I think we have had in our society for a long time.

Mr. ENSIGN. That consensus goes up and down. That is why we change marginal tax rates.

Mr. GEPHARDT. It is interesting—if you look back at history and look at how much of income we have taken with all taxes—State, local, Federal, payroll—and you put it in your income classes, you will see that there is a stunning sameness to the progressivity chart that we have had in existence; and I would call that a consensus. You can argue that it is not right, and I respect that argument, but I am arguing that that consensus has been in effect in this country for a long time.

Mr. ENSIGN. Let me take it from a different angle.

The basis of socialism is redistribution of wealth, bring everything into a common fund and redistribute it so that everybody is equal. If you have two farmers, farmer A is here, farmer B here, farmer A works 20 hours a week, produces enough to get by, farm-

er B works about 80 hours a week, produces a lot more crop, should farmer B be taxed at a higher rate than farmer A? Just because farmer B works harder, produces more, should that person be taxed at a higher rate? Or should they be basically taxed at the same rate?

Mr. GEPHARDT. Well, I don't accept socialism.

Mr. ENSIGN. Isn't that what progressivity is, it is just a form of——

Mr. GEPHARDT. There are a lot of factors that go into people being able to earn more. Some people work very hard and still don't make very much money. My dad was a milk truck driver. He worked very hard. I would say he worked as hard as anybody ever has in this country, but he didn't make a lot of money.

So the issue is, do we want to have a tax system that affects a lot of different people in different circumstances, most of whom are working very hard, but because of a lot of different things—lack of education, lack of having a wealthy family, they don't make much money——

Mr. ENSIGN. In socialistic countries, they basically start with that premise. Just because you are a farmer or a milk truck driver or whatever, you are just as valuable to a society as somebody that creates 1,000 jobs here; and therefore, they should make the same amount of money.

Mr. GEPHARDT. I am not arguing for socialism. I am arguing for fairness. There is a big difference.

Mr. ENSIGN. You haven't defined how you get your fairness other than a consensus of the population, but that is not a definition.

Mr. GEPHARDT. People who earn more—I think it is in the Bible, maybe not, but to those to whom much is given, much is asked.

Mr. ENSIGN. Voluntarily, not forced, not coerced.

Mr. GEPHARDT. We have a government that is requiring to have funds, to make it operate, to build roads, to do the things that we all agree need to be done. The question is, who pays what according to their means.

You can argue, and I respect the argument, that everybody ought to have the same right and that is a very respectable argument to make. I don't agree with it, and that is where our disagreement needs to be argued out, teased out, and the whole country needs to be involved, because if we are going to do basic tax reform, this is a major element that has to be discussed.

Mr. ENSIGN. I appreciate your testimony.

Thank you, Mr. Chairman. The reason that I brought up the issue is because I think it needs to be part of the discussion.

Chairman ARCHER. Mr. Leader, are you able to spend any more time? I was just informed that you needed to leave by 1:20. It is now 1:22.

Mr. GEPHARDT. I think they have the cane on me so I need to go to some meetings I am late for. I deeply appreciate the ability to be here and will be happy to come back at another time and engage in more questions and dialog.

Chairman ARCHER. We may accept that offer on your part. We thank you very much.

Mr. GEPHARDT. Maybe you will have another set of hearings, and by that time my specifics will be out there.

Chairman ARCHER. I anticipate that we will.

Mr. RANGEL. Mr. Chairman, as he leaves, may I ask one question and get an answer later?

Chairman ARCHER. I would hope that the gentleman would suspend in deference to his Leader, who has to leave.

Mr. RANGEL. You have taken plenty of time. I am trying to help you in being openminded about this and look at this in a very bipartisan way.

I was about to ask my Leader whether or not he knew of any proposals coming from the so-called "other side" that dealt with the question of—disparity, as you have indicated, must be in the bill that you would support. Because if you do know of it, whether it is in the Armey bill or any other, I would want to study it over the weekend.

Mr. GEPHARDT. I don't know, but that doesn't mean it is not there. I have seen some Republican Members on the floor this week in "1 minutes" saying they had tax reform proposals, and we ought to be looking at them all.

Chairman ARCHER. I expect we will be looking at a myriad of proposals. Thank you very much.

Congressman Souder is our next witness. Welcome to the Committee. We will be pleased to receive your presentation. We would appreciate it if you could limit your oral presentation to 5 minutes or less and your entire written statement can be inserted in the record, without objection.

Welcome and you may proceed.

STATEMENT OF HON. MARK E. SOUDER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF INDIANA

Mr. SOUDER. Thank you, Mr. Chairman, for the opportunity to testify before you. It is exciting to have a Chairman committed to radical tax reform and to changing our Code.

Before I begin, I also wish to thank our Majority Leader, Mr. Armey, whose untiring efforts have made a lot of our flat tax efforts possible, as well as the pioneer in tax reform, Jack Kemp, who has been a personal inspiration in my life. Without Mr. Armey's tax proposal, I would not be sitting here today with mine, and while Mr. Armey and I may disagree on some of the fine points, we do agree that the fairest and simplest way to collect revenue is a flat tax system.

Most of us here today would agree that our current tax system has failed. Chairman Archer, I agree with your assessment that it would be too easy to simply judge a tax proposal against our current tax system without setting certain standards. After all, the current Code makes anything look good and, if I may borrow from Congressman Armey's statistics, any system that forces its citizens to devote 5.4 billion hours and $232 billion only to comply with its Code must be a miserable failure.

A pure flat tax with personal allowances, such as what Congressman Armey is proposing, is the kind of system that will simplify the lives of all Americans by creating a flat rate and taxing income only once; it will cut down on the tremendous tax bureaucracy and it will boost the American economy because of its favorable treatment toward savings and investments.

I have studied this plan and listened to Mr. Armey with respect and admiration. I agree wholeheartedly with his flat tax premise. However, there are issues concerning a pure flat tax that concern me. That is why I, along with Congressman Solomon of New York, the Chairman of the Rules Committee, and Congressmen Doolittle and Baker of California, Foley of Florida, and Barton of Texas introduced a proposal yesterday that is similar to the one made by Senator Specter of Pennsylvania.

Our legislation is for a modified flat tax, and we have given it the name "McFlat." In what sounds like an unusual name for a serious tax proposal, we have incorporated the meat of Congressman Armey's flat tax proposal along with deductions for mortgage interest and charitable contributions—hence McFlat, "M" for mortgage and "c" for charitable.

Before I go into further detail about our plan, let me explain briefly why I included those two things. I realize that whenever you put deductions in, you could have creeping exceptions. I know that even in tax rates, whether it is a VAT, a sales tax, income tax, we will face bracket creep to some degree. If there is a continuing insatiable demand for government services, we must control spending. Any of these kinds of systems can change, but I believe the mortgage interest and charitable deductions are critical.

To incriminate myself a bit, when I came here in January, our family decided that we wanted to stay based in Indiana where our friends are, where our home is, where our schools are, where our family is; and it made a lot of sense. I live in a highrise apartment in the area called "Crystal City." For a long time, I didn't know whether it was in Alexandria or Arlington. I don't know the schools there. I don't know who is on the city council. I don't know my neighbors. Like most but not all renters, since I don't own my apartment, I do not have the same level of concern about my surrounding community. That is because I do not have a direct stake in that community.

Owning a home is one of America's greatest and oldest traditions. It is something that most people aspire to all their lives. The mortgage interest deduction in our current Tax Code enables many of those people to achieve that dream.

For similar reasons, I feel we must retain the charitable contribution deduction. Charities and the poor and disabled obviously benefit a great deal from the deduction available in the current Tax Code. In fact, I have also introduced legislation to increase the charitable contribution Peter Drucker proposed a number of years ago in the Wall Street Journal. I believe if we don't do the type of changes that are radical, we need to increase the charitable deduction in the current Code. We need to have our tax changes blend with the other policies we are doing. We are trying to reform government, back government off, move some services to the private sector; and to do that, we need to make sure there are incentives for people to keep giving. As a social conservative, I believe it is important to have values such as home ownership and charitable deductions included in the Tax Code.

Most of the other components of McFlat are very similar to Mr. Armey's and Mr. Specter's proposals, such as the 20 percent flat rate. Ours is slightly higher than Mr. Armey's because of the home

mortgage and charitable deductions. Mr. Armey's goes down to 17 percent after 3 years. There is a question whether his could really go down to 17; that is why we are proposing a flat 20 percent rate. We are keeping the businessowners' taxes. Like Majority Leader Armey's, it still goes on one card. There is just one additional line for mortgage and one additional line for charitable deductions. We cap the mortgage at $100,000 which, in effect, enables people to get started. If we go higher than $100,000, we run into questions of how to keep the 20 percent flat rate.

So I believe that while there are differences between the many proposals you have heard so far today and will hear—my distinguished colleague and Senator from Indiana, Senator Lugar, has a sales tax which he will be talking about later today—we agree with your basic point that we need to root out the current system if we are really going to make these changes.

I hope that McFlat provides the "arches," so to speak, between the different plans.

I know you have many witnesses. I will be happy to take questions if you choose.

[The prepared statement follows:]

Testimony of Representative Mark E. Souder
Committee on Ways and Means
June 8, 1995

Mr. Chairman, thank you for this opportunity to appear before the Committee on Ways and Means to testify on behalf of replacing the federal income tax. Before, I begin I wish to extend my thanks to our Majority Leader, Congressman Dick Armey, for his untiring efforts to show Congress and the American people that there is a better way than our current tax system. Without Mr. Armey's flat tax proposal, I would not be sitting here today with Senator Specter and my proposal. And, while Congressman Armey and I may disagree on some of the fine points, we do agree that the fairest and simplest way to collect revenue is a flat tax system.

All of us here today would most likely agree that our current tax system has failed. It has failed the middle class, failed the poor, and allowed outrageous loopholes for some of the very rich. Through the years, as Americans have suffered one tax increase after another, public satisfaction with the federal government has plummeted to all-time lows. While the government's appetite for spending has become insatiable, the public has cried 'uncle.' There has got to be a better way.

Chairman Archer, I agree with your assessment that it would be too easy to simply judge a tax proposal against the current tax system without setting certain standards. After all, the current code makes *anything* look good. And--if I may borrow from Congressman Armey's statistics--any system that forces its citizens to devote 5.4 billion hours and 232 billion dollars only to comply with its code must be a miserable failure.

A pure flat tax with personal allowances, such as what Congressman Armey is proposing, is the kind of system that will simplify the lives of all Americans by creating a flat rate and taxing income only once; it will cut down on the tremendous tax bureaucracy; and, it will boost the American economy because of its favorable treatment toward savings and investments. The Armey flat tax would provide taxpayers with the relief that they are looking for and, at the same time, lead to higher productivity and economic growth for all.

I have studied this plan and listened to Mr. Armey with respect and admiration. I agree wholeheartedly with his flat tax premise. However, there are issues concerning a pure flat tax that concern me. That is why I, along with Congressman Solomon, the Chairman of the Committee on Rules, have introduced a proposal similar to the one made by Senator Specter of Pennsylvania. Our legislation is for a modified flat tax and we've given it the name "McFlat." In what sounds like an unusual name for a serious tax proposal, we've incorporated the meat of Congressman Armey's flat tax proposal along with deductions for mortgage interest and charitable contributions. What results is the ease, efficiency, and equity of McFlat.

Before I go into further detail about our plan, allow me a moment to explain the necessity of preserving the mortgage interest and the charitable contribution deductions. I will begin by incriminating myself a bit. When I came to Congress in January, my wife and I decided that she and my three children would continue to live back in the district in Fort Wayne, and I would rent an apartment here and commute home on the weekends. It was an arrangement made mostly because we did not want to remove our family from the home, schools, and community which we are so attached to.

Now, I live during the week in a high rise apartment building in an area called "Crystal City." For a long time I had no idea whether my address was in Alexandria or Arlington, Virginia. I don't know much about the schools here, I don't know who is on the city council, and I don't know my neighbors. Like most, but not all renters, since I do not own my apartment, I do not have the same level of concern about my surrounding community. That is because I do not have a direct stake in it.

Owning a home is one of America's greatest and oldest traditions. It is something that people aspire to all of their lives. The mortgage interest deduction in our current tax code enables many of those people to achieve that dream. However, if we adopt a new tax code and

some kind of deduction is not preserved, then home ownership could be placed out of reach of many Americans.

It is for similar reasons that I feel we must retain the charitable contribution deduction, as well. Charities and the poor and disabled obviously benefit a great deal from the deduction available in the current tax code. It enables many people to give as generously as they can to help the neediest among us. Although large contributors will still give and some individuals will still tithe, the general population of givers will likely decline if the deduction is taken away. The Cato Institute estimates that spending on welfare programs runs over $35,000 for every family of four below the poverty line. But the bulk of this money is spent on bureaucratic overhead, not on poor people. As we seek fiscal responsibility in government, increased private giving and volunteer involvement can fill a need that deficit spending cannot--and with more success, efficiency, and compassion. Therefore, retaining the charitable deduction will give average citizens the opportunity to do more for those in need than the government ever could.

McFlat is a proposal for modified flat tax system with a 20 percent tax rate. For the individual and families that means they will be taxed on their yearly income less capital gains, interest on savings, and dividends. They will be entitled to "personal allowances" for themselves and their children. $16,500 for a married couple filing jointly, $14,000 for a single head of household, $9,500 for a single person, and $4,500 for each dependent. Then they can deduct their mortgage interest for the first $100,000 in borrowing and deduct all charitable contributions.

For business owners, McFlat means that they are not taxed for wages, direct expenses, and purchases. All revenue is taxed only once at the 20 percent flat rate. Businesses will be allowed to expense 100 percent of the cost of capital formation, including purchases of capital equipment, structures and land in the year in which the investments are made rather than dragging out the tax benefits for those investments through complicated depreciation schedules.

As our Leader, Mr. Armey and Senator Specter have already demonstrated, simplicity is one of the key elements of this plan. Individuals and businesses will fill out a postcard-size form with ten lines:

Form 1 **Individual Wage Tax** **1995**

Your first name and initial (if joint return, also give spouse's name and initial) — Your social security number — —

Home address (number and street including apartment number or rural route) number — Spouse's social security

City, town, or post office, state, and ZIP code

1.	Wages, salary, pension and retirement benefits	1. _____
2.	Personal allowance (enter only one)	2. _____
	☐ $16,500 for married filing jointly	
	☐ $ 9,500 for single	
	☐ $14,000 for single head of household	
3.	Number of dependents, not including spouse, multiplied by $4,500	3. _____
4.	Mortgage interest on debt up to $100,000 for owner-occupied home	4. _____
5.	Cash or equivalent charitable contributions	5. _____
6.	Total allowances and deductions (add lines 2, 3, 4 and 5)	6. _____
7.	Taxable compensation (line 1 less line 6, if positive; otherwise zero)	7. _____
8.	Tax (20% of line 7)	8. _____
9.	Tax withheld by employer	9. _____

No longer will American taxpayers have to spend all of their time and money on compliance with I.R.S. regulations. The twin burdens of unnecessary bureaucracy and red tape will finally be removed.

It is well known that the U.S. has an abysmal savings rate. This savings rate has a direct and chilling relation to our economic growth. In order to create the capital that is necessary to future U.S. growth, we must raise our levels of private savings and investment. Instead of discouraging savings and investment by taxing the interest from savings accounts, dividends and capital gains, as our current tax system does, McFlat removes the tax on growth by eliminating capital gains taxes on the sale of investments. With the implementation of McFlat, businesses will invest more because they will be allowed to expense fully all sums invested in new equipment and technology. With greater investment and a larger pool of savings, interest rates and the costs of investment will also drop, generating even more economic growth.

The increase in American savings because of McFlat will also help decrease our dependence on foreign investors to finance our federal budget deficits and our private sector economic activity. Now, foreigners hold nearly 20 percent of our publicly held federal debt--our highest level ever. The massive interest payments--at least $40 billion per year--are the principle source of U.S. capital flowing abroad. This increase in foreign investment in Treasury debt pushes America further toward a debtor nation rather than a creditor, weakening the dollar and our international trade position. With McFlat, our supply of capital can be renewed, and we can return to the position of international creditor rather than debtor.

Lastly, Mr. Chairman, I will mention the issue of tax compliance. Our current tax code wrongheadedly uses tax policy to direct economic activity. The tax breaks are typically used for tax shelters which have no valid economic purposes, or to the activities which the tax laws were meant to promote. Even when the I.R.S. catches onto certain loopholes, tax experts are still able to outfox the bureaucrats. McFlat will close the loopholes and put a stop to tax avoidance and never ending battles between tax lawyers and I.R.S. bureaucrats.

I would like to emphasize the importance to all of my colleagues here that when we consider proposals for reform of our tax system that all plans--in the words of Chairman Archer--tear the current income tax system "out by its roots." Although Congressman Armey, Senator Specter, and I have varying flat tax proposals, our common point is simplicity of design. Our proposals promote economic growth by removing all the disincentives to savings and investments while enabling the income tax return to fit on a postcard.

Chairman Archer, I wish to thank you for your leadership in promoting tax simplification. It is exciting--after years of complaining about the tax system as a businessman and parent--to now be here in Congress working with you on revising our outdated and unfair tax system. I hope the McFlat tax proposal can help provide the arches, so to speak, among the various plans.

Chairman ARCHER. Thank you for your presentation.

Are there any questions for Congressman Souder?

Mr. English.

Mr. ENGLISH. Thank you, Mr. Chairman. Thank you for joining us today for testimony, Congressman Souder. You have been probably the leading advocate in this Congress of the charitable deduction and its significance in the Tax Code. I wonder if you could comment on the importance of including an enhanced charitable deduction in any new alternative tax system that we consider.

Mr. SOUDER. Two of the biggest problems we have today are societal breakdown tied with the ever-increasing demand for expanding government. I believe that through the charitable deduction we will never totally replace government social programs, but we can replace part of them by giving incentives to the private sector, and that is important.

I also believe that the government shouldn't have a direct role in doing moral or other types of funding. It corrupts both churches and religious institutions, and I don't believe the government should take sides between different denominations. Because of that, we need to have other ways to make sure that our social fabric stays together, which I believe means much charitable giving.

Mr. Armey used a figure of 50 percent in some of the tax changes and many people tithing would do that, but much charitable giving would decline, both to the churches, which is important for us morally and spiritually, as well as for social welfare. We cannot, when justifying cutting government and talking about moral programs, I believe, gut those important financial incentives. It is a basic foundation that I think we need to have in our society.

Mr. ENGLISH. So your charitable deduction would be an incentive to people to contribute to local institutions in their community that provide services directly, and in a lean and very nonbureaucratic way; and it will be a tax deduction that will be broadly accessible to working families, the middle class and people throughout our society?

Mr. SOUDER. It is simple. It reflects what has happened in American history, like the fervor and effort made when starting the public school movement, foster care, and the prevention of child abuse. In 4 years, as a Republican staff director, the children and families showed me that the most effective programs, particularly in the urban centers and particularly in the black and Hispanic communities, are often religious based. Therefore, we need a charitable contribution because the government can't conduct religious-based efforts.

Mr. ENGLISH. Thank you. Your testimony, as always, is powerful, and we very much appreciate your efforts on this.

Chairman ARCHER. Mr. Christensen.

Mr. CHRISTENSEN. Earlier today Congressman Gibbons stated that Canada does not have any type of similar mortgage interest deduction to what we have in this country, and that they haven't had that stimulus and need to stimulate their housing industry and the first-time home purchases. Why do you believe that maybe we shouldn't adopt the Canadian model when it comes to their housing industry?

Mr. SOUDER. As we know, in health and other areas, different systems behave differently. I don't know a lot about the Canadian system, though we have vacationed there. I would guess that the city of Toronto behaves more like the American system. As you get a more urban population, rather than the traditional rural population that you see through much of Canada, you will see that.

Under our current system, we have an increasing rental condominium-type development. While I believe that in a free economy you should not stop that, I believe part of what we are seeing in the transients and the breakdown of the social system is because we don't have roots in the community. That is why Secretary Kemp, when he was at HUD, tried to promote home ownership in urban centers. We need to make sure that we don't accidentally accelerate social changes that have not been necessarily healthy for our economy. We are different enough and we also have a historic root in home ownership, which means you can't necessarily operate like Canada, even if we have the same demographics.

Mr. CHRISTENSEN. Which of the four—simplicity, equity, efficiency, administration—would you deem the most important in constructing a new Tax Code?

Mr. SOUDER. Politics is always the art of compromise. I believe the number one thing that is driving us now is simplicity. Because of the complexity, because the powerful always have more access to changing and getting amendments and doing the different things—that equity is closely related to simplicity. So those two things are both important, but in the process of achieving that, you can't throw everything else out. But that is why there is really more unity among the people presenting today. Hopefully you here on this Committee can help raise awareness and move us toward the simplicity, and the equity that comes from simplicity.

Mr. CHRISTENSEN. Thank you very much.

Thank you, Mr. Chairman.

Chairman ARCHER. Thank you, Mr. Souder. We appreciate your input, and we are glad that you will be working with us in trying to find a resolution to this issue.

Our next witness is a former Congressman, former quarterback for the Buffalo Bills, a former Secretary of HUD, Hon. Jack Kemp, who has been given a new assignment, along with all the other things that he has to do, to head up a commission to make recommendations to us.

We are delighted you have taken the time to come and present to us your ideas about this. I hope at this point they are not crystallized inasmuch as the duty that you have been assigned should be an objective one, to seek out the best alternative. Please proceed.

STATEMENT OF HON. JACK KEMP, CHAIRMAN, ECONOMIC GROWTH AND TAX REFORM COMMISSION AND FORMER SECRETARY OF HOUSING AND URBAN DEVELOPMENT

Mr. KEMP. Thank you. I wish you could have said a former Member of the Ways and Means Committee. I never quite made it to this halcyon, august body, but my respect for the men and women of this Committee, the work of this Committee, both sides of the aisle of this Committee—you, Mr. Chairman, you, Mr. Rangel, an

old and dear friend, both of you, and the newer Members, I am thrilled to be here.

I approach it with objectivity, may I say to the Chair.

A Chinese philosopher said one time, there is a lot of wisdom in the world, but unfortunately it was all divided up among people. I just come with a slice of that pie of wisdom—my experience, my feelings; and I am going to approach this commission in which I was appointed by Majority Leader Bob Dole and Speaker Newt Gingrich to do, Mr. Chairman, what you have been talking about, and that is to tear up the system, put a blank sheet of paper out there, a tabula rasa as it were, and try to design in a post-cold war world for America a tax system that is, as I think most men and women of good will on both sides of the aisle would like for America—as we enter the 21st century, fairness, simplicity, efficiency that can expand this economy, give people hope that they can have access to capital and jobs, and that can do away with the Byzantine structure of tax policy that grew up not out of malevolence but out of a genuine attempt by men and women of good will to come up with a system that could have taken us through two world wars, two regional wars, a cold war and a highly centralized bureaucracy with which the American people are frustrated and which needs to be rethought, redesigned, restructured.

And I want to say I think today, or at least these few days that you have designated for these hearings could very well be the start of the 21st century of the United States of America, because I don't believe that we can go into the 21st century with this Tax Code. I don't think it is fair, including Dick Gephardt—did you think, Mr. Chairman, albeit the questions that were given to Mr. Gephardt by particularly my friend John Ensign from Nevada—but I think we should celebrate the fact that the Minority Leader of the Democratic Party said it is time for massive radical change.

He wants to offer his own proposal, and I respect that, for a fundamental overhaul of the entire Tax Code, so we will have fewer rates. I would like to have one rate, but fewer rates is better than a lot of rates; fewer loopholes, that is a good goal; less paperwork, that is a consensus opinion; and lower tax rates for all Americans.

So I think, Mr. Chairman, you have and your colleagues in both parties have come to these hearings with an absolutely imperative mission from the American people and that is to give us what we desperately need.

We are going to have three objectives in the tax commission. I would like to submit the names of the distinguished people from around the country who are going to serve on the tax commission for the record. I would like to submit for the record the statement of Speaker Gingrich and Majority Leader Dole.

[The following was subsequently received:]

Congress of the United States
Washington, DC 20515

FOR IMMEDIATE RELEASE
Wednesday, May 24, 1995

ECONOMIC GROWTH & TAX REFORM COMMISSION
GINGRICH & DOLE NAME MEMBERS

WASHINGTON -- House Speaker Newt Gingrich and Senate Majority Leader Bob Dole today named 13 distinguished Americans to serve on the National Commission on Economic Growth & Tax Reform, chaired by Jack Kemp. The Commission was established April 3rd by Gingrich and Dole to examine overhauling the tax system to make it flatter, fairer, and simpler. The panel is expected to make its recommendations to Gingrich & Dole later this year.

Named to the Commission were:

Loretta Adams
-- Founder & President, San Diego-based Market Development, Inc.
Ken Blackwell
-- Ohio State Treasurer
Herman Cain
-- CEO, Godfather's Pizza; Former President, National Restaurant Association
Carroll Campbell
-- Former Governor of South Carolina; former member House Ways & Means Committee; President & CEO, American Council of Life Insurance
Pete DuPont
-- Former Governor of Delaware; Policy Chairman, National Center for Policy Analysis
Jack Faris
-- President & CEO, National Federation of Independent Business
Ed Feulner
-- President, Heritage Foundation
Matt Fong
-- California State Treasurer
Ted Forstmann
-- Partner, Forstmann-Little
Dean Kleckner
-- President, American Farm Bureau Federation
Shirley Peterson
-- Former IRS Commissioner; former Assistant Attorney General for the Tax Division; President-elect, Hood College, Frederick, MD
John Snow
-- CEO, CSX Corporation; Chairman, Business Roundtable
John Weiland
-- President, Weiland Homes, Inc.

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Contacts: Tony Blankley (Gingrich) -- 202-225-2800
Clarkson Hine (Dole) -- 202-224-5358

There will be three goals of the tax commission and progrowth commission—I should say, three steps. One is to inventory the problems, which abound. Two is to inventory the solutions, which equally abound. This is not a partisan effort albeit there are partisan issues. Senator Long has been a champion of tax reform. Ross Perot talked about tearing up the system and drafting a new flat tax system for America. He never got around to it, but he talked about it. John F. Kennedy talked about tax reform; Ronald Reagan; you, Mr. Chairman, Charlie Rangel and I have spent many, many hours of conversation about what we do about our cities and urban problems of poverty and how to use the Tax Code to incentivize the formation of capital and jobs and educational training for young minority and majority working men and women.

So after we have inventoried the problems, we will inventory the solutions including consumption and VAT and sales and flat income tax rate systems, and then try to have as our conclusion a—I don't want to say a "consensus product," because you cannot absolutely reach consensus, but I think we could come up with an answer that matches the problem and take this country into the 21st century.

One last thought. I mentioned growth. I don't think we can meet the social goals of America or the fiscal goals of this Congress, Mr. Chairman, without a progrowth Tax Code. I am frustrated by the attention that is given to the numerator, that is, the spending side of the budget. Not enough people are thinking about the denominator, which is the size of the economy. And my goal, our goal will be to give a Tax Code to—as a facilitator to your work, Mr. Chairman, that will advance the potential of this economy to grow and create jobs and entrepreneurial opportunities for people while being fair and simple and profoundly progressive.

I will close with this thought. I don't think it is oxymoronic to suggest that you can have a flatter Code with progressivity. I accept the premise that we need a system that treats the poor and treats the young and treats the entry-level working man and woman family differently than it treats mature assets in America. I favor a flat tax. I have said that many times. But within a flat tax you can have de facto progressivity with the type of exemption that has been talked about, Mr. Chairman, not only in your approach but in other approaches to this problem.

So I enter this caldron, enter this debate, enter this issue with some experience in tax reform and with a goal of achieving the simplicity and fairness and flatness that we have alluded to in our party, but yet can accept that challenge from Mr. Gephardt or my friend Charlie Rangel that would respect the fact that the poor, the woman on welfare, the father who is unemployed, the people working their way out of poverty should face a tax system that on a first five or six or seven rungs of the ladder does not treat their income the same way as we would treat mature assets and older and wealthier—not to draw a class division—I know it could be done. I think it is one of the most exciting challenges facing our country today in this post-cold war period.

Chairman ARCHER. Thank you for your presentation. I know that you have a lot more on your mind, and I particularly compliment you for your brevity.

I would like to ask you a few things, and I think it is good to do it here in the forum of this Committee although we could do it another time, when I hope I will be asked to come and talk to your commission.

Mr. KEMP. Absolutely, Mr. Chairman.

Chairman ARCHER. From the way you have presented your views, the goals that you have and that, I think, the overwhelming majority of the Members of this Committee have, are not different. The question is, how do we get there? I share your view that we must look long term, which is unusual for this body, and we must have an agenda for the 21st century that will push America ahead in a very competitive global marketplace, or I believe that we will see the standard of living ebb for all Americans. We must compete, look out and not just inwardly; and it seems to me that our taxes can be a major vehicle in that regard, and that is a part of growth.

I have lost patience or hope that we can change this Tax Code so that it will be growth oriented. Many efforts have occurred, including yours initially with Kemp-Roth back in 1981.

Mr. KEMP. Right.

Chairman ARCHER. Inevitably we have failed to make this current tax system one of growth, job creation, and higher real family earnings for working Americans. I think that should be perhaps the major goal in what we are about today. I think simplicity is extremely important. I think cutting down the cost of compliance, reducing it from the current minimum of $300 billion a year is important, but I also think Americans are crying out for relief in their personal lives from the IRS.

Forty million Americans will have a confrontation with the IRS this year in some form or another, 40 million Americans. And that is an unpleasant thing for any American, even though it may be relatively minor. It is also interesting to note that the taxpayers will win over 50 percent of those confrontations. So they basically——

Mr. KEMP. I am surprised.

Chairman ARCHER. They proved to be unnecessary.

It seems to me that one of our goals should be to get the IRS completely and totally out of the lives of individual Americans. I think that should be a goal, to protect freedom and the right of privacy, to get the IRS totally and completely out of the lives of individual Americans. I hope you would share that goal because the American people are crying out for it today in every townhall meeting.

So just to speak of some of the goals, I think we have common ground.

I want to ask you about a comment that was just printed in the BNA Daily Tax Report—and give you an opportunity to respond to how you are quoted in this article. Kemp said he is opposed to Archer's plan to replace the current system with a broad-based consumption tax, "I heartily don't endorse Archer's plan."

Mr. KEMP. Mr. Chairman——

Chairman ARCHER. Is that an accurate——

Mr. KEMP. I don't know—where was it said and when——

Chairman ARCHER. This is listed in the Bureau of National Affairs publication which comes out every day, and it quotes you as

having been before the National Policy Forum press conference, and apparently a reporter talked to you; I don't know what reporter, but the reporter from BNA. That is today, June 8, 1995.

Mr. KEMP. I am squirming because I don't think I have ever said I was opposed to the Archer plan. First of all, I would be dumb to say that at a press conference going into hearings——

Chairman ARCHER. I would think so.

Mr. KEMP. I am admitting it. I appreciate your bringing this up in such a public forum. I would have appreciated, as an old friend, being told about it, but I don't think I said "Archer."

I might have said a VAT tax. I personally am not for a VAT tax. I am willing to look at a bill, but I don't know what your plan is. If it is in concrete, I don't even know what it is.

I have said nice things about Dick Armey, and I have said good things about Hall-Rabushka, I have said good things about a lot of general thrusts, conceptually speaking, but as the chairman of this commission, I pledge to you as open a mind as we humanly can have.

You have pretty strong feelings, Mr. Chairman, and I don't mean to suggest that you are not totally openminded about this. I just would admit that I probably have said that I don't favor going to a VAT tax, but I am willing——

Chairman ARCHER. You say that——

Mr. KEMP. I don't think I have ever said anything that you have ever done that I would be opposed to. You can put me on the spot for the rest of the hearing——

Chairman ARCHER. I just want to be sure you were misquoted.

Mr. KEMP. I hate guys that say they were misquoted all the time. I would not say that I am opposed to the Archer plan, the Armey plan, the Nunn-Domenici plan.

Chairman ARCHER. You have told me privately on two occasions that you have an open mind on this.

Mr. KEMP. Open to everything but raising taxes.

Chairman ARCHER. I would contemplate that as long as I am Chairman of this Committee none of these plans will raise taxes, or will raise the amounts of revenue that is being——

Mr. KEMP. I have a pretty good pedigree in this regard, almost as good as yours. We came to Congress together. I would not say I am opposed to the Archer plan. I don't know what the Archer plan is, to be perfectly frank. I know you are for a sales or consumption tax, but that is as much as I know about it.

Chairman ARCHER. That is true at this point, and I will, before the end of this year, come down on a specific method; but I am of a belief that in order to have the agenda for the 21st century to create growth, to create more jobs, to compete in the world marketplace, that we must replace the income tax system with a tax on goods and services in the form of some type of broad-based consumption tax, and your quote is here that you would not replace the current tax system with a broad-based consumption tax.

Mr. KEMP. I misspoke, I will say publicly and on C–SPAN in front of my old friends. You may have misspoken along the line in your career.

Chairman ARCHER. I am sure that I have.

Mr. KEMP. Let me make the point I was trying to make, and I alluded to it in my opening statement.

I believe in taxation of people based on their ability to pay. I do not think you should tax a family that is working their way out of poverty, that must use as much of its disposable income as possible for the same burden of taxation as you would tax an investor who has mature assets. You are talking to a radical on some of these things, because I have said that I would like to eliminate the capital gains tax, particularly in the inner cities.

In the commission, I plan to be as open and fair as I can, but I do think, as Adam Smith said in the book that he wrote that launched this effort, that taxation should be predicated upon the ability of people to pay consistent with efficiency, raising revenue and not discouraging the factors of production. I am as close to that as I can probably get. But I do think the Code needs some social engineering within certain boundaries.

I agree with Mark Souder, home ownership is important to America and to the American dream. Charitable contributions, we ought to look at that. We ought to look at municipal bond sales and will you hurt the ability to finance municipal bonds and infrastructure. So I want to look at it.

If I have made statements that are beyond the pale, I ask my old friends in the Congress to allow me some maneuvering room to come up openly and honestly and allow every side to be represented. That is why I came here today. That is why I called you to ask you if you would allow me to put on the record how I feel about this commission that Dole and Gingrich have appointed me to, so that we can work toward a consensus.

Chairman ARCHER. I am pleased that this is not an accurate quote and that you have an open mind.

Mr. KEMP. It is open to everything except a VAT tax. I don't like VAT taxes. If you go in, you have to listen to people who are for a VAT tax. I don't want to raise rates, but I am going to listen to the Nunn-Domenici bill that takes the tax up to 40 percent. So it is in that context, Bill, that I think I was quoted.

I have never mentioned your name, I remove the shoes from my feet when I mention your name.

Chairman ARCHER. I won't belabor it, but I am happy to have that on the record that you enter with an open mind, because I don't know how with a flat tax, which still is income-based, even at a lower rate, you can get the IRS out of peoples' lives.

I think if that is going to be the goal, I am terribly troubled that we will not get to that goal because one of the good things that you said in this quote is that "I endorse Archer's enthusiasm for getting the IRS out of our lives and off of our property."

Mr. KEMP. Thank God. You could have started with that and made me feel better.

Have you read Dale Carnegie's, "How to——

Chairman ARCHER. The problem is, I don't know how you do that unless you put a tax on consumption and goods and services rather than an income-based tax.

Mr. KEMP. You are putting me on the spot once again.

Chairman ARCHER. I just want you not to prejudge these issues as you go into this commission.

Mr. KEMP. As I know you haven't.

Chairman ARCHER. I am willing to accept anything.

Mr. KEMP. Let me just say one thing. If the rates were low enough and the system was efficient and fair and simple enough in a profound way, not unlike what we are talking about here today, the IRS would have a lot less intrusiveness. So metaphorically I favor these things.

I am not out to repeal the 16th amendment to the Constitution. I think we have to raise revenue. There are a lot of things we have got to do. But I promise you, I am going to go into this and give you and your staff a full, fair, complete hearing, just as you have given me such a full and fair and complete hearing here today.

Chairman ARCHER. There are basically, in my view, four goals that we should seek in this process, and I am willing to accept any device or any design or any approach that will give us these four goals.

One is, I want to get the IRS completely and totally out of every individual's life in this country. I want to tear the income tax out by its roots.

Mr. KEMP. You have said that many, many times.

Chairman ARCHER. That is a goal that is shared by the overwhelming majority of the American people as we have heard in town meeting after town meeting.

Two, we should have a Tax Code that has the goal of the greatest possible incentive for savings. Savings mean capital investment, which means more productivity, which means better paying jobs for Americans. I don't think you disagree.

Mr. KEMP. I don't disagree. I would add, savings without rates of return on investing those savings is meaningless. Russia had a lot of savings, but it went nowhere because there was no place to put their money because it was taxed away on the income stream. So if you tax income too heavily and tax risk taking too heavily, you can have all the savings in the country——

Chairman ARCHER. That is why I don't want to tax income at all.

Three, I think it should be a tax system that reasonably gets at the underground economy, at people who are not paying their fair share under our current system.

Mr. KEMP. I agree.

Chairman ARCHER. Four, I think it should give us the greatest fair advantage in competing in the world marketplace by being subject to removal of the cost of government from the price of product when it leaves these shores to compete as an export overseas and being able to be charged to a product entering this country so that foreign products bear their fair share of our cost of government.

Those are the four goals, and if you can get there with your commission, whatever vehicle you come up with, I will be excited about it.

Mr. KEMP. Let me ask you just a brief question for my edification.

If you relieve the burden of the tax at the border as it gets exported overseas, does that make the cost of products to American consumers relatively higher than it does on our exported items?

Chairman ARCHER. No, because they are higher today because the cost of taxation today must be factored through, and—you know this—must be included in the price of the product. And it is included today. It would just be included in a different way that can be removed to give us a fair advantage in the world marketplace. And we will talk more about this, at length.

Mr. KEMP. If every country in the world, though, moved to the same type of tax and every country in the world tried to get an advantage at somebody else's—what kind of world trade system——

Chairman ARCHER. We are already suffering with that disadvantage with every country except Australia in the world today. That is the reality of the world marketplace today.

Mr. KEMP. You and I are a lot alike. We love to argue.

Chairman ARCHER. Let me recognize now for questions—and I apologize for the length of time that I have taken—let me recognize your friend, Mr. Rangel.

Mr. RANGEL. You haven't said anything unkind about me anywhere, have you?

Mr. KEMP. Come to think of it, there was something the other day I said about you.

Mr. RANGEL. Let me tell you something, Mr. Secretary. I was about to say, it is very difficult for me to look at this in a bipartisan way. Then along comes you, talking about fairness and equity and remembering that we all don't have the same ability to pay, and you are really shattering my thoughts that there is some preconceived idea out there by the people on the other side that it really doesn't make any difference about fairness and equity, get rid of that tax collector.

Frankly, they have done so well at finding that button that just frustrates the American people, that the people go for getting rid of the IRS and really don't understand the impact of a sales tax as its relates to percentage of consumption by low-income people.

The worst thing I can think of is getting a call from the IRS saying, could you come down and go over your tax return with us, and while you are at it, bring your lawyer or accountant. The more you start having compassion, the more you start looking for ways to take care of that.

All I am saying is that if your commission can come up with a way to wipe out all of the loopholes that we have in the tax system—we put the loopholes in there because of the high rates that we have had for high-income people, but we also put some incentives in there, as you and I have worked on, saying if it can work for them for incentives, let it work for the charitable organizations. After all, it appears as though they are going to be the safety net for the Nation.

I guess my Minority Leader, has he seen any proposal that has come from the other side that even talks about equity? Forget progressiveness, because that sounds too close to being a Socialist. But fairness and equity doesn't have to be biblical; it is just the right thing to do. It is America.

And so I never thought I would see the day to applaud someone just for using those words when you are talking about tax reform, but as long as your commission is moving in that direction, I think there is even hope for a wretched soul like me to be bipartisan.

Thank you.

Mr. KEMP. May I respond?

Mr. HOUGHTON [presiding]. Please.

Mr. KEMP. I am going to approach this on the basis that I think most of us ultimately do in our heart of hearts, which is that America is one family, one people, we have got a stake in each other's well-being, and we wouldn't tax the young who are just beginning on that ladder of opportunity that we euphemistically call "American," but we know is Asian and Latino and African and European; it is universal.

I never liked tax credits for machinery. Why should we give tax credits in the Tax Code for machinery at the expense of human capital?

So I guess in my opening comments, I might have misstated the goal with regard to a sales tax. But in effect what I would like to see this country do—just as a human being, aside from being chairman of this commission, I didn't want to be disingenuous and say that I don't approach this with some built-in feelings about what do we do about the first job that somebody gets? Should they be taxed at 20 percent, and tax me at 20 percent? I don't believe that. I think the young and the bottom rung of the ladder and people beginning their climb should definitely pay—bear less burden. And my purpose has always been in getting the rates down, was not to give a benefit to capital at the expense of labor, but ultimately to recognize that the incidence of taxation is different than the burden of taxation, and that if you overtax capital, you don't hurt the rich, you end up hurting the poor who ultimately want to improve their lot in life as well.

So that is something that I have brought to the Kemp-Roth bill, and brought to the enterprise zone bill that I sponsored with you, Charlie; and I hope that we can come out with some form of radical yet progressive reform of the Tax Code.

I appreciate your comments.

Mr. RANGEL. I hope that the problem that I am having is just one of communication here, because what you are saying is so basic American that it lends itself to bipartisan support, and I want to work toward that end.

Mr. HOUGHTON. Thank you.

Mr. Hancock.

Mr. HANCOCK. Thank you. Charlie, if the gentleman would yield, I didn't realize that there was any problem about whether it was bipartisan or not; I didn't realize that the Republican Party was un-American and the Democratic Party was—or the other way around. Maybe I have been wrong all these years.

Jack, I have known you a long time, read your articles and heard you speak several times, and it bothers me a little bit to have to take issue, but that is the name of the game. You obviously are in favor of a progressive tax of some type where the concept of ability to pay is a cornerstone. If you go back into the history of who came up with the idea of the progressive income tax, it doesn't make me too much in favor of a progressive tax.

You mentioned "mature capital," that the people that hold mature capital should pay more tax because they have accumulated that capital, so therefore they have more ability to pay. Now, what

about the owner of this mature capital who is an investor, who pledges his assets maybe to borrow money and takes the risk of losing every dime of that by loaning the money to people who need the investment capital? If you tax that mature capital to that extent, then you get rid of the entrepreneurs.

Mr. KEMP. I don't know whether you heard my testimony, but I was coming pretty close to suggesting that there ought to be a flat rate tax system with an exemption for the poor and the low income. There was the de facto progressivity; I did not testify on behalf of a progressive income tax, A. B, I favor a de facto level of progressivity, and I doubt very much whether you would even suggest that we ought to tax all people exactly the same irrespective of their ability to bear the tax burden.

There is no stronger supporter on this Earth than me in forming capital as the essence of creating jobs and growth and opportunity for people, so much so that I favor—as Jack Kemp now, not as the chairman of the commission, because I want to study all ramifications—but I think the capital gains tax is a stupid tax. It is not a tax on wealth, but a tax on creation of wealth. It is not a tax on the rich; it is a tax on the poor who want to get rich.

I don't favor estate taxes or double taxation of dividends. I favor total expense—I was there when you were in Illinois. So make sure that when you ask me a premise that you get it a little closer to the record as to what I——

Mr. HANCOCK. One of the reasons that I wanted to ask the question is because I have had people make comments in other areas, and I wanted to give you the opportunity to explain that you do not support that type of a tax.

Thank you.

Mr. KEMP. Thank you. I am glad we cleared it up.

Chairman ARCHER [presiding]. Mr. Zimmer is recognized.

Mr. ZIMMER. Thank you, Mr. Chairman. I don't have any prepared questions. I just want to tell you what a thrill it is to be here and see this exchange go on between the Chairman and Mr. Kemp, and remember that this is not taking place at some think tank or on "Firing Line" but actually before the Taxwriting Committee of the House of Representatives having testimony from a chairman of a commission who is going to have a great deal to say about what the future Tax Code of this country is going to be like.

You called yourself a radical because you want to abolish the tax on capital gains. That was considered a radical position when you first espoused it, but it is a common thread in every proposal that we are considering. Every one of these reforms that is before this Committee will treat investment and saving and job creation and growth much more kindly than the current Code, and I think any of the alternatives would be a great step in the right direction.

I am delighted and thrilled to be part of the process.

Could I ask you whether the meetings of your commission are going to be open, whether you are going to take testimony and have your considerations open to the public?

Mr. KEMP. The first meeting will be next Wednesday. Speaker Gingrich and Majority Leader Bob Dole will head it up. It will be open. All 13 commissioners will be there—14, I guess. I told the Chairman I would submit it for the record. They are men and

women of definite views. They all believe in entrepreneurial capitalism. They all believe in tax reform. They all believe in progrowth policies that are fair for the country. So it will be open.

There will not be formal hearings—there will be formal field hearings so that we can listen to men and women from all corners and backgrounds of this country who have something to say about both the problem, some solutions, and then finding the consensus that might unite the American people and the Congress and lend support to a platform for doubling the size of the American economy in the next, say, dozen years. That is my goal.

I think we talk too much about fiscal restraint, albeit that is important, but not enough people are talking about growing the size of the denominator, that is, the gross national product, and we cannot survive socially or economically or fiscally in this country with an economy that is growing at 2.5 percent per year for the next 10 years. You can't get from here to there. You can't balance the budget in an economy that goes into slow growth, and I think that issue has been lost. It needs to be recaptured and somebody has to fly that flag.

The Tax Code is a perfect place to discuss what Bill Archer talked about in terms of making the economy more competitive and getting the type of growth that can create the jobs and the new enterprises that can take this country into the 21st century.

Mr. ZIMMER. With you as chairman of the commission, the flag will be flown high, and I look forward to working with you.

Chairman ARCHER. Mr. Levin.

Mr. LEVIN. Thank you, Mr. Chairman. Welcome. It is late in the day. I think this has been the most interesting part of the day, really.

I think that, Jack, your comments are very interesting and welcome. Everybody knows of your deep interest in this, and I think it is interesting how this discussion has revealed that when you go beyond the rhetoric, there are real differences of opinion, not only between parties, but within parties.

For example, your emphasis on fairness, Jack, is quite different, I think, from the emphasis of the Chairman, who in his four goals doesn't mention that. Your emphasis on growth, I think, is rather broadly accepted between the parties and within them. I think your concern, for example, about the mortgage interest deduction is something that shows a very strong difference from the Majority Leader, who would simply abolish it; similarly, your concern about the charitable deduction. Your statement that there should be not only taxation based on ability to pay, but also the Code needs some social engineering—I take it that is consistent with your long struggle to get some empowerment zones into the Code.

I find it refreshing, and I hope that those who are here, and perhaps the media, will take note of the different emphases that we have heard today; and I think these different emphases need some honest discussion and won't be resolved by putting horns on anybody or anything, whether it is one party or another, or a government agency or another. Because I take it I heard you right, you are concerned about eliminating the deduction on home ownership, on the——

Mr. KEMP. What I said, Sandy, is that we need to look at—the interest on the mortgage, the home ownership deduction right now is sacrosanct vis-a-vis the current Code. The rates are too high, so you have to have that there to protect people who want to own that piece of the American dream. I am going to look at the possibility of what it would be like to have the rates low enough and the system simple enough so that you can give up deductions; and as far as social engineering goes, I am not a social engineer, but I do think the Tax Code should reflect social as well as economic goals for the country. And one of the highest social goals for America is a chance to own a piece of the rock.

I don't want to be accused—I was almost accused of being for the progressive income system—I am not for social engineering.

Mr. LEVIN. I don't want you to get into too much trouble.

Mr. KEMP. Thank you.

Mr. LEVIN. There is a lot of talk about the squeeze on low-income families, but you know there has also been a major squeeze on middle-income families in this country. In fact, the charts show that the tax burden of low-income families has gone down, but the tax burden on middle-income families—it is not only a tax burden, but even more so, their standard of living has just been stagnant.

Mr. KEMP. Right, right.

Mr. LEVIN. So I just hope when we look at, for example, the flat rate tax proposal, we look at its impacts on middle-income families.

You can exempt families up to $35,000 in income, but what does that mean for middle-income families?

Mr. KEMP. It is unbelievable we are sitting here and talking about a middle-income family above $36,000. I mean, I thought I was middle income when I started out in pro football and made $6,000.

The point is, Sandy, when you and I—we are roughly the same age, I am probably older than you, I am having my 60th birthday this July. I just had my ninth grandchild, and I came to Congress with Archer back in 1970. When we came in 1970—before 1970, to be sure, in the sixties, in the sixties a family of four at a median income paid probably 4 to 5 percent of their income to the Federal Government.

Today, thanks to Archer's pointing this out in the record as well as other Members who are sitting in front of me, a family of four in a median income is paying 25, 26, 27, 28 percent. No wonder they are upset about their ability to save and ability to get access to income. We overtax people. The payroll tax is too high, in my opinion. Income tax rates are too high.

Why you guys don't repeal the surtax on income—did anybody vote for it? We never voted for it. That should be repealed. They took it off boats and they put it on the whole economy.

So there is going to be a lot of debate over this, and you are right, the American dream of upward mobility is being hampered, in my opinion, by the regulatory climate to a large extent and particularly the steep progressivity of the Tax Code which punishes people for working, saving, earning, and investing in new entrepreneurial opportunities, and that is what we want to help correct. Your comments are profoundly welcome.

Thank you.

Mr. LEVIN. Thank you.

Chairman ARCHER. The gentleman's time has expired.

I have on the list one last request for inquiry from the gentleman from Minnesota, Mr. Ramstad.

Mr. RAMSTAD. Thank you, Mr. Chairman.

As an old friend, it is a pleasure to welcome you here today, Chairman Kemp, and as a fellow disciple of economic growth, I must say that nobody has been a more consistent advocate of economic growth or tax reform than you, and that is appreciated by a lot of us. Like many, I wish you were running for another job, but this seems to be an appropriate one at the present time.

Mr. KEMP. The Federal Reserve Board is not open at this time.

Mr. RAMSTAD. That is not the one I had in mind. The one I had in mind has an oval-shaped office downtown.

Mr. KEMP. The commissioner of the National Football League is not open, either.

Mr. RAMSTAD. Let me just ask you very briefly, Jack, what is the timetable for your commission and how are you going to interact with the House and the Senate? How are you going to function? Are you going to have regular meetings?

I know you said that Senator Dole and the Speaker are going to lead off. Just give us a little insight into the commission.

Mr. KEMP. Very quickly, they have charged us with coming up with a consensus approach, if possible, within 6 to 8 months, obviously prior to the primaries of 1996. I have talked to all the so-called—not so-called, I have talked to all the campaigns in the Republican Party. I would be happy to talk to anybody, including Bob Rubin, who is a fine man. He doesn't think that tax rates have anything to do with investment, which I find bizarre for a Secretary of the Treasury.

But having said that, we plan to come up with a statement/legislative agenda to show the nexus between monetary policy and tax policy by November at the latest. We will hold hearings, not formal testimony, but meet people, go to Silicon Valley, go to Houston, Tex., go around the country from Seattle to, you know——

Mr. RAMSTAD. Minneapolis?

Mr. KEMP. Minneapolis, right.

Mr. RAMSTAD. Thank you.

Mr. KEMP. And talk to people of all different backgrounds about what their problems are, to take an inventory of the problems, an inventory of the solutions, and then try to find a match between the problem and the solution, and I have made a lot of statements I know I will be hung around the neck with but, I hope to do it as objectively as I possibly can, knowing full well we live in a political environment and we have got to get something past our party, and I wouldn't be surprised if the Clinton administration is not looking surreptitiously at tax reform for 1996. If they are not, I would be quite surprised.

Mr. RAMSTAD. I certainly hope you will invite the President to submit his proposal. We tried to elicit at least something from Treasury's Assistant Secretary Samuels yesterday. They sent him to testify rather than Secretary Rubin, and I certainly hope that they will submit a proposal.

I am also glad to hear you say that you are going on the road and talking to real people and getting their input and not just those inside the beltway.

Mr. KEMP. Incidentally, there are real people on the commission, Loretta Adams, a young Hispanic woman, president of a San Diego-based market development company; Ken Blackwell, a friend of all of ours, Ohio State treasurer; Herman Cain, the chief executive officer of Godfather's Pizza; Carroll Campbell, former Governor, friend of the Chair and mine; Pete duPont, former Governor, former Congressman; Jack Faris of NFIB; Ed Feulner of Heritage; Matt Fong, State treasurer of California; Teddy Forstmann of Forstmann-Little, one of America's premier financiers and entrepreneurs; Dean Kleckner, president of American Farm Bureau; Shirley Peterson, former IRS Commissioner under Ronald Reagan; John Snow, chief executive officer of CSX Corp. and former chair of the Business Roundtable; and John Weiland of the American Home Builders, Weiland Homes in Atlanta.

So I can assure you, Jim, we will do the best we can to give some—facilitate the work that is being done by the Chairman and of course the Senate leadership.

Mr. RAMSTAD. As a Member of this Committee, I look forward to receiving your input. It would be helpful. Thank you very much, Jack.

Chairman ARCHER. For the last question, Ms. Dunn.

Ms. DUNN. Thank you, Mr. Chairman.

Jack, it is great to see you here, and it is great that people have the wisdom to bring in your level of knowledge about these tax issues that you have been speaking of for many years. I want to offer you a formal invitation to come to Seattle to hold a hearing. It would be lovely if you could do that between now and November. We may have some other thoughts on the side if that is something you could fit in.

Mr. KEMP. I would get to see my grandchildren.

Ms. DUNN. That is right. It brings me to the one question I wanted to have your thoughts on. As a border State we are interested in exports and trade in Washington State and I am on the Trade Subcommittee of this Ways and Means Committee. I haven't heard you mention border adjustability and I am wondering what your thoughts are on that topic.

Mr. KEMP. Well, that is a subject that the Chairman is quite interested in, and I will be very frank and blunt. I have yet to give as much thought to that issue as you have and as our Chairman has done. I have personally never liked a VAT tax, so I kind of shied away from the discussion of having a border adjustment on the radical theory that—maybe I don't understand it well enough, but I have yet to come to the conclusion that that was the best way to make America more competitive, by simply adjusting our tax as we export.

I have never liked messing around with exchange rates to try to get an advantage on somebody else. That is why I was so opposed to the devaluation of the Mexican peso. They thought they could improve their exports and limit their imports by devaluing the peso. All they have done is destroy their economy and send it down a cliff. So that has been my general approach.

I have got a lot to learn on the subject and I plan to listen to you and also to Chairman Archer, but I just had a bias against VAT taxes because I knew they are so easy to raise and they have just about destroyed the European economies. Every European country has a VAT tax and the general unemployment rate in Europe is probably double that of the United States, and I don't think we should Europeanize the U.S. economy. And I know you don't want to or the Chairman. So I am going to stop right there and just save myself plenty of room for listening to the debate on both sides of that issue of border adjustment.

Chairman ARCHER. Jack, thanks a lot for coming and being with us. I wish you well, and all of us will be available to provide our input to your commission because it is very, very important.

Mr. KEMP. Mr. Chairman, you have been very gracious with me, not only today but throughout your whole career. I am thrilled that you are in the chair. I look forward to approaching this subject with the type of dedication to the job that you have shown.

I applaud your efforts. I think these are the most important hearings going on in the United States of America today, I really do, and I think with your help, Mr. Chairman, we can take this country into the 21st century not only with a competitive economy but with the type of a growing, expanding opportunity society that you have devoted your career to. So I hope I haven't trespassed on the Chair's feelings by coming up with——

Chairman ARCHER. I am just glad you had the opportunity to set the record straight, because I have been misquoted before myself. Thank you.

Mr. KEMP. Thank you.

Chairman ARCHER. Senator Lugar, I apologize to the Senator for keeping him in abeyance here, but we are pleased to have you with the Committee today. You are to be officially presented to our Committee by our friend Steve Buyer, so I recognize our friend Steve Buyer for the introduction.

Mr. BUYER. Thank you, Mr. Chairman. It always extends my faith in the American people when I see you sitting in this chair.

Mr. Chairman, and to my colleagues on the Committee, I have to agree with Jack Kemp that these are very important hearings, but you know as we want to flatten the Tax Code and simplify it and reform it, it is disappointing that I don't see any of my Democrat colleagues at this hearing, I guess in testament that we are not doing social engineering with the Tax Code.

I am honored to introduce to you one of the most respected individuals to serve in the U.S. Senate. As all of us well know, Mr. Lugar is a visionary not only in foreign policy, in agriculture and small business, but his counsel is sought out by past Presidents, the current President and world leaders.

Mr. Lugar is uniquely qualified to discuss the tax reform issues presently before this Committee. He has been an innovative policymaker in every phase of his life. Mr. Lugar brings to this debate a unique perspective, that not only of a father of four and a grandfather, but a small business owner, former mayor of Indianapolis, and former member of the Indianapolis school board. You also might recall he testified about UniGov. He is also an endangered

species, Mr. Chairman, endangered in that he is an owner of a family farm that turns a profit.

So Mr. Lugar's goal, though, is to reform our Tax Code so that it will grow our economy, increase our savings rate, and reduce the intrusiveness of the Federal Government. Having followed Mr. Lugar for many years, I have learned that when Senator Lugar speaks, he has something very important to say. And with that I want to introduce to you a distinguished Senator of the United States, a colleague and friend of mine, Senator Dick Lugar.

Chairman ARCHER. Senator Lugar, welcome to our Committee. You come with credentials that are unblemished, respected by all Americans, and we are delighted to have your presentation. But if you would suspend for one moment, I would say to my colleagues who are waiting, and I hate to keep you waiting, that I am informed we have two votes. We will then have 10 minutes and three additional votes, and I think it would probably be best for you to come back after the completion of those votes so that we cannot just keep you waiting here.

Senator Lugar, you may proceed. If you have a longer printed statement, without objection, it can be inserted in the record.

STATEMENT OF HON. RICHARD G. LUGAR, A U.S. SENATOR FROM THE STATE OF INDIANA

Senator LUGAR. I thank you, Mr. Chairman. I thank my colleague from Indiana.

Mr. Chairman, I thank you for your strong leadership in the tax reform arena. Your oft-quoted comment that our current tax system be pulled out by the roots has been an inspiration as I have traveled the country advocating the elimination of the Federal income tax.

I have found during my travels in America that American families are frustrated, even angry with their economic predicament. They feel like they are running on a treadmill and the treadmill is winning. The problem is that many Americans expect that there is diminishing hope for a better future.

The economic facts justify these beliefs. From 1950 through 1973, hourly compensation, including both wages and benefits, increased an average of 3 percent a year. But since 1973, the average wage increase has been less than one-half of 1 percent. During the past two decades economic growth has been cut in half, averaging only 2.4 percent annually, and if that is not depressing enough for the average American family, limiting growth to 2.5 percent is the stated economic policy of the Federal Reserve Board.

This we must change. The American public demands it.

The cause of America's economic doldrums is twofold: The huge Federal budget deficit that robs us of capital we need to grow; and a Federal tax system that not only discourages but confiscates our savings and investment.

Our national savings rate has reached alarmingly low levels. After averaging close to 9 percent in the sixties, we recently saw our Nation's savings rate bottom out at 1.1 percent in 1992. Because of this low rate of savings, capital to fuel our economy has become increasingly scarce. As a result, our annual productivity gain has averaged just 1.1 percent from 1974 to 1994. The Concord

Coalition estimates that had our productivity held even at its pre-1974 annual rate of 2.9 percent, the median family income in America would now be $50,000 a year instead of the current level of $35,000 a year.

Americans celebrate that both Houses of Congress have now passed budget resolutions that will bring us back to balance in 7 years, but we face the most difficult task of actually implementing the budget guide in our spending measures. We must be resolute in the endeavor and not fall victim to business as usual in Washington, but as a part of the effort to balance the budget, I support providing the American public with tax relief.

I strongly believe it is time, however, to stop working around the edges of the Tax Code. We must transform it completely.

The Federal income tax system is inherently flawed. By taxing savings and investment at least twice, it has become the biggest impediment to economic growth in the country. It represents the worst form of big government intrusion into the lives of all Americans.

Each year it costs Americans more than 5 billion hours of time to comply with it. That is equal to the total worker output of my State of Indiana. It is unfair, it is riddled with loopholes, it has been changed 31 times in the past 41 years. It doesn't work. By its own admission, the Internal Revenue Service fails to collect from nearly 10 million taxpayers with an estimated $127 billion in uncollected taxes annually.

Anything this bad, this broken, this ineffective should be ended decisively, and that is what I propose. I want to scrap the income tax completely and replace it with a national sales tax.

Mr. Chairman, you have outlined the criteria for evaluating an effective tax system. It must be simple, the least intrusive, fair, border adjustable, and friendly to savings and investment. I have added it also must be transparent.

I have studied all the recent tax proposals with these six factors in mind. Many are better than the current tax system, but if we are going to overhaul our current tax system we should choose the one that meets these criteria, and I have concluded that the national sales tax is the best alternative.

The first factor in choosing an effective tax system is its simplicity. Under a national sales tax, the burden of complying with the Income Tax Code would be lifted. There would be no records to keep or audits to fear. The money a person makes is his or her own. You don't have to report it, you don't have to hide it, you may decide if you want to save it, invest it or give it to your children. It is only when you buy something you pay a tax.

Although I applaud the efforts of the flat tax advocates to simplify tax forms, nothing could be simpler than no forms at all.

The national sales tax is the least intrusive of the tax proposals. The IRS would be substantially dismantled under my proposal. The IRS would no longer look over the shoulders of every American. There would be no audits. Americans would not waste time and effort worrying about recordkeeping, deductions or exemptions that are a part of the current Tax Code.

Although the flat tax proposal taxes consumption, they do so by giving the income tax a facelift and leaving the IRS largely intact.

As you have stated, Mr. Chairman, if the roots remain, the tree will grow back.

The national sales tax is the fairest. Everyone pays the tax, including wealthy individuals, criminals, illegal aliens, and those who avoid taxation. Wealthy Americans who consume more would pay higher taxes under the national sales tax. Individuals who save and invest their money will pay less. Gone are the loopholes and deductions.

The national sales tax would also tax the underground economy. When criminals and illegal aliens consume the proceeds of their activities, they will pay a tax. Foreign tourists will pay the tax. Tax systems that rely on income reporting will never collect any of this revenue.

Of course, the fairness test must also consider those with limited means to pay tax. An integral part of my plan is protection for Americans who need it—senior citizens, the unemployed, Americans with low-paying jobs. One strategy for addressing this problem would exempt a threshold level of goods and services consumed by each American from the Federal sales tax. Each citizen who has a Social Security number would receive this exemption. For example, if the exemption level was $5,000, a family of four would have its first $20,000 in spending exempt from the sales tax. That figure would be approximately 33 percent above the 1994 poverty threshold for a family of four.

Another strategy would be exempting of such items as housing or medicine. This is a method the majority of States have chosen and one advocated by you, Mr. Chairman. Americans understand and are comfortable with this practice.

In the end, it will be up to this Committee and the Finance Committee in the Senate to decide the most desirable path.

The national sales tax is the most transparent of the tax reform proposals. A Federal tax that is evident to everyone would bolster efforts in Congress to achieve prudence in Federal spending.

There should be no hidden corporate taxes that are passed on to consumers or withholding mechanisms that mask the amount we pay. Every year the public and Congress should openly debate the tax rate necessary for the Federal Government to meet its obligations. If average Americans are paying that rate every day, they will make certain that Congress spends public funds wisely.

American exports would also benefit from the national sales tax. In January, the United States registered one of the largest trade deficits in our Nation's history. We must adopt a tax system that encourages exports. Most of our trading partners have tax systems that are border adjustable. They are able to strip out their tax when exporting their goods.

In comparison, the income tax and, for that matter, the flat tax are not border adjustable. American goods that are sent overseas are taxed twice, once by the income tax and once when reaching their destination.

In comparison, the national sales tax would not be levied on exports. It would level the playingfield with our trading partners. Best of all, foreign imports would be taxed when they are consumed in the United States.

Mr. Chairman, the last and most imperative reason for replacing the income tax with a national sales tax is it would liberate the economy by encouraging savings. For the first time in the modern era the next generation of Americans may be economically worse off than the previous one. Despite a robust economic growth over the past several years, the average income of families has fallen. They feel trapped in a box without hope of escaping.

The bottom line is that as a nation, we do not save enough. Savings are vital because they are the source of all investment and productivity gains. Savings supply the capital for buying a new machine, developing a product or service, employing an extra worker. According to a recent poll, 72 percent of Americans——

Chairman ARCHER. Senator Lugar, I have only got 1½ minutes to go vote. They don't hold votes open anymore. Should you wish to come back at the end of all these votes, which might be as much as 45 minutes from now, we would be happy to welcome you back, but unfortunately at this time I am going to have to ask you to put the rest of your statement into the record, and I apologize for that.

Senator LUGAR. I will be pleased to do so, Mr. Chairman. I will attempt to return at that point. Thank you very much.

[The prepared statement follows:]

Testimony of Senator Richard G. Lugar
House Ways and Means Committee
Hearings on Tax Reform
June 8, 1995

Mister Chairman, I thank you for your strong leadership in the tax reform arena. Your oft quoted comment that our current tax system should be "pulled out by the roots" has been an inspiration as I have traveled the country advocating the elimination of the federal income tax.

What I have found during my travels is that American families are frustrated, and even angry, with their economic predicament. They feel like they are running on a treadmill and that the treadmill is winning.

The problem is that many Americans suspect that there is diminishing hope for a better future. The economic facts justify these beliefs. From 1950 through 1973, hourly compensation --including both wages and benefits-- increased an average of 3.0 percent per year. Since 1973, the average wage increase has been less than one half of one percent.[1] During the past two decades, economic growth has been cut in half, averaging only 2.4 percent annually. And if this isn't depressing enough for the average American family, limiting growth to 2.5 percent is the stated economic policy of the Federal Reserve Board.

This we must change. The American public is demanding it.

The cause of America's economic doldrums is twofold: the huge federal budget deficit that robs us of the capital we need to grow, and a federal tax system that not only discourages, but confiscates our savings and investment.

Our net national savings rate has reached alarmingly low levels. After averaging close to 9.0 percent in the 1960's, we recently saw our nation's savings rate bottom out at 1.1 percent in 1992.[2] Because of this low rate of savings, capital to fuel our economy has become increasingly scarce. As a result, productivity has averaged just 1.1 percent from 1974 to 1994. The Concord Coalition estimates that had our productivity held its pre-1974 annual rate of 2.9 percent, the median family income would now be $50,000 a year instead of the current level of $35,000 a year.

Americans celebrate that both houses of Congress have now passed budget resolutions that will bring us to balance in seven years. We now face the more difficult task of actually implementing this budget guide in our spending measures. We must be resolute in this endeavor and not fall victim to business as usual in Washington.

As part of the effort to balance the budget, I support providing the American public with tax relief. But I strongly believe it is time to stop working around the edges of the tax code. We must transform it completely.

The federal income tax system is inherently flawed. By taxing savings and investment at least twice, it has become the biggest impediment to economic growth in the country . It represents the worst form of big government intrusion into the lives of all Americans. Each year it costs Americans more than 5 billion hours of time to comply with it. That is equal to the total worker output of my state of Indiana. It is unfair. It is riddled with loopholes. It has been changed 31 times in the past 41 years. And finally, it doesn't work. By its own admission, the Internal Revenue Service fails to collect from nearly 10 million taxpayers, with an estimated $127 billion in uncollected taxes annually.[3]

Anything this bad, this broken and this ineffective should be ended decisively, and that is what I propose. I want to scrap the income tax completely and replace it with a national sales tax.

Mr. Chairman, you have outlined the criteria for evaluating an effective tax system. It must be: (1) simple, (2) the least intrusive, (3) fair, (4) border adjustable, and (5) friendly to savings and investment. I have added that it also must be transparent. I have studied all the recent tax proposals with these six factors in mind. Many are better than the current tax system.

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[1] U.S. Department of Commerce "Competing to Win in a Global Economy." (September 1994).

[2] Rudolph Penner, "Reducing the Tax Burden on Saving" KPGM Peat Marwick (December 1994).

[3] Internal Revenue Service, Pub No. 1415, Income Tax Compliance Research: Net Tax Gap and Remittance Gap Estimates 2 (1990).

But if we are going to overhaul our tax system, we should choose the one that meets these criteria. I have concluded that a national sales tax is the best alternative.

The first factor in choosing an effective tax system is its simplicity. Under a national sales tax, the burden of complying with the income tax code would be lifted. There would be no records to keep or audits to fear. The money a person makes is his or her own. You don't have to report it. You don't have to hide it. You may decide if you want to save it, invest it, or give it to your children. It is only when you buy something that you pay a tax. Although I applaud the efforts of flat tax advocates to simplify tax forms, nothing could be more simple than no forms at all.

The national sales tax is the least intrusive of the tax proposals. The IRS would be substantially dismantled under my proposal. The IRS would no longer look over the shoulders of every American. There will be no audits. Americans would not waste time and effort worrying about record keeping, deductions, or exemptions that are part of the current tax code. Although the flat tax proposals tax consumption, they do so by giving the income tax a facelift and leaving the IRS largely intact. You have stated, Mr. Chairman, "If the roots remain, the tree will grow back."

The national sales tax is the fairest. Everyone pays the tax including wealthy individuals, criminals, illegal aliens, and others who currently avoid taxation. Wealthy Americans who consume more would pay higher taxes under the national sales tax. Individuals who save and invest their money will pay less. Gone are the loopholes and deductions.

The national sales tax would also tax the underground economy. When criminals and illegal aliens consume the proceeds of their activities, they will pay a tax. Foreign tourists will pay the tax. Tax systems that rely on income reporting will never collect any of this revenue.

Of course, the fairness test must likewise consider those with limited means to pay taxes. An integral part of my plan is protection for Americans who need it--senior citizens, the unemployed, and Americans with low paying jobs.

One strategy for addressing this problem would exempt a threshold level of goods and services consumed by each American from the federal sales tax. Each citizen who has a Social Security number will receive this exemption. For example, if the exemption level were $5000, a family of four would have its first $20,000 of spending exempt from the sales tax. This figure is approximately 33 percent above the 1994 poverty threshold for a family of four.

Another strategy might be the exempting of items such as housing or medicine. This is the method the majority of states have chosen and the one advocated by this Committee's Chairman. Americans understand and are comfortable with this practice. In the end, it will be up to this Committee and the Finance Committee in the Senate to decide the most desirable path.

The national sales tax is the most transparent of the tax reform proposals. A federal tax that is evident to everyone would bolster efforts in Congress to achieve prudence in federal spending. There should be no hidden corporate taxes that are passed on to consumers or withholding mechanisms that mask the amount we pay in taxes. Every year the public and Congress should openly debate the tax rate necessary for the federal government to meet its obligations. If average Americans are paying that rate every day, they will make certain that Congress spends public funds wisely.

American exports would also benefit from the enactment of a national sales tax. In January, the United States registered one of the largest trade deficits in our nation's history. We must adopt a tax system that encourages exports. Most of our trading partners have tax systems that are border adjustable. They are able to strip out their tax when exporting their goods. In comparison, the income tax, and for that matter the flat tax, are not border adjustable. American goods that are sent overseas are taxed twice--once by the income tax and once when reaching their destination. In comparison, the national sales tax would not be levied on exports. It would level the playing field with our trading partners. And best of all, foreign imports would be taxed when they are consumed in the United States.

Mr. Chairman, the last and most imperative reason for replacing the income tax with a national sales tax is that it would liberate our economy by encouraging savings For the first time in the modern era, the next generation of Americans may be economically worse off than the previous one Despite robust economic growth over the past several years, the average income of families has fallen. They feel trapped in a box with diminishing hope of escaping

The bottom line is that as a nation, we do not save enough. Savings are vital because they are the source of all investment and productivity gains--savings supply the capital for buying a new machine, developing a new product or service, or employing an extra worker.

According to a recent poll, seventy-two percent of Americans realize that they are not saving enough for the future.[4] Our net national savings rate in the 1990's has been 1.8 percent of Gross Domestic Product compared with a rate of 8.1 percent in the 1960's, 7.2 percent in the 1970's, and 3.7 percent in the 1980's.[5]

The Japanese save at a rate nine times greater than Americans and the Germans save five times as much as we do.[6] Today, many believe that Americans inherently consume beyond their means and cannot save enough for the future. Few realize that before World War II, before the income tax system reached its present form, Americans saved a larger portion of their earnings than the Japanese.

A national sales tax would reverse this trend by directly taxing consumption and leaving savings and investment untaxed. Economists agree that a broad-based consumption tax would increase our savings rate substantially. Economist Laurence Kotlikoff of Boston University estimates that our savings rate would more than triple in the first year. The implementation of a national sales tax is expected to create one million new jobs[7] over a ten year period and a three percent rise in wages over that same period of time.[8] Economist Dale Jorgenson of Harvard University has concluded that had a consumption tax like the national sales tax been put into place in 1986 instead of the current system, the United States would have experienced one trillion dollars in additional economic growth![9] Mr. Chairman, our citizens and our economy cannot afford to wait any longer.

As I have outlined here today, I believe the national sales tax is the best tax system to replace the income tax. It is simple. It protects privacy. It is fair and transparent. And it promotes economically beneficial behavior. For these reasons, I encourage its enactment.

Mr. Chairman, we live in an exciting time when the world is opening its arms to free enterprise. The Uruguay round of GATT significantly lowered the barriers to trade. Congress will soon open the telecommunications industry to competition, better enabling individuals and companies to interconnect across the globe. Goods and information are able to flow freely between countries with few obstructions. One of the last remaining barriers between countries is their tax systems. We must face the fact that America is competing with other countries whose tax systems are more friendly to investment than is our income tax.

If we enact a tax system that encourages investment and savings, billions of dollars of investment will flow into our country. During a recent poll taken by Princeton Economics International, executives of the top twenty Japanese companies stated unanimously that they would bring manufacturing to the United States if our country enacted a broad based retail consumption tax. It makes sense. America has the most stable political system, the best infrastructure, a highly educated workforce and the largest consumer market in the world. Our economic growth and prosperity would be unsurpassed.

There will be complex transitional issues to address. But in the end, our country will be stronger and more prosperous. That has to be our focus. Our vision must be for an America in which the American family enjoys better job prospects and more real income. Our paychecks will be bigger, our savings will be greater, and our hopes will abound. Let's give Americans this chance. Thank you.

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[4] Source. Competitiveness Policy Council/Congressional Economic Leadership Institute Poll, Feb. 1995.

[5] U.S. Department of Commerce "Competing to Win in a Global Economy." (September 1994).

[6] OECD Historical Statistics 1960-1990.

[7] John Qualls, "The Impact of a National Sales Tax on the United States Economy." Washington University (1991).

[8] Laurence Kotlikoff, "Savings and Consumption Taxation: The Federal Retail Sales Tax Example." Hoover Institution Conference Paper (May 1995).

[9] Dale Jorgenson, "The Economic Impact of Fundamental Tax Reform." Hoover Institution Conference Paper (May 1995).

Chairman ARCHER. All right, thank you.

[Recess.]

Mr. CHRISTENSEN [presiding]. Call the Committee back to order.

If Congressman Schaefer and Congressman Tauzin would begin their testimony, we are indeed honored to have you here testifying before this Committee, and look forward to your comments.

STATEMENT OF HON. W.J. (BILLY) TAUZIN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF LOUISIANA

Mr. TAUZIN. Mr. Chairman, thank you.

Both Dan and I are pleased to participate in what I think are historic hearings on the central question of whether it is time, and we think it is, to scrap the whole system by which we tax income and investment in America and to replace it with the revenue neutral national sales tax, an alternative tax to the current system.

We should ask ourselves, I guess, first of all, what is wrong with the current system, and if you were to ask that question, I suppose at a townhall meeting, you would hear a chorus of complaints, but the chorus of complaints by citizens about the current system is also backed up dramatically by the facts, the facts are that we have got an income tax system that is out of control. In 1914, it was 14 pages long. Today, it is over 2,000 pages of law, 10,000 pages of regulations, and hundreds of thousands of pages of rulings and interpretations.

Today, our income tax laws have become so complex that over 70 percent of the tax returns filed by professional tax preparers are for citizens making less than $50,000 a year. Even the so-called experts have problems with the system.

In 1992, Money magazine gave 48 professional tax preparers a financial profile of one family and asked them to prepare an income tax return. The computed tax liabilities ranged from $16,219 all the way up to $69,000. Who was right? Money magazine made the case, the system is out of control.

We spend 5.4 billion hours merely to complete tax forms. In fact, Professor Walter Williams of George Mason University stated that the country spends more time complying with the Income Tax Code than it does manufacturing every automobile, van, and truck built in the United States in 1994, it is a wasted effort. And every time we touch this animal it gets more complex. Remember tax simplification in the eighties.

The 1986 law alone made over 2,500 changes in over 4,000 places in the Code. It resulted in 48 new forms. This was tax simplification. Every time we touch it, it gets worse. Americans are increasingly less compliant with the Tax Code. The IRS now has more than 10 million taxpayers who didn't file last year, over $200 billion in misstated payments.

We know the underground economy, the place where Americans try to avoid this awful system, is now about $500 billion strong, and that $125 billion is not collected to the Treasury from that underground economy. That is $125 billion that the other taxpayers of America are paying when they work through on April 15 the tax forms.

Mr. Schaefer and I think it is time, and we hope to file a bill by this summer that will replace the entire income tax system in America with a system instead of a simple retail sales tax.

What is the beauty of it? The beauty of it is that when we make that change, number one, Americans themselves will decide how much tax they want to pay by deciding how much they want to consume. That tax system can easily make room for the necessities of life at no or very low rates and tax the other things we purchase at the customary rate.

In short, citizens will decide whether to make income and save it and invest it or to pay taxes by consuming it. Citizens will make their own choice.

More importantly, figures indicate that if we stop taxing investment and income in our society, we encourage income and investment in our society. We encourage the work ethic, we encourage people to do in fact what most of us in this Congress are desperately trying to do, to put this country back to work.

A 2.5-percent increase in the savings accounts of America will yield us a 10-percent growth in GNP. Dramatic job increases, dramatic growth in the economy, dramatic changes in the way Americans in fact invest at home. You know the other good reasons, many of them cited already.

I want to add two quick things, I know my time has expired already. First, please look at several things we have also filed in addition to the bill we are going to file on an alternative tax system. One is a bill I have filed for many, many years.

If you are not ready to change the tax system, at least take the taxes off ordinary savings accounts in America, at least start rewarding citizens, children in America with a savings ethic that says in effect if you save in a passbook account, like we used to save, you won't pay taxes on it. We have got a bill called Save America. It is a plan to do just that.

Second, I would hope you would look, and maybe the Committee can do a study on a bill we have filed called the American dividend trust fund account, which is a system of rewarding Americans in a dividend trust fund much the way Alaska does it for its citizens on the simple theory that if Congress does its job and balances the budget, that the taxes collected on corporate America, a percentage of them, would be saved in a dividend trust fund that would be rebated to Americans for having supported a government that keeps its accounts in balance.

That idea has been around for some years now, and it ought to get looked at as we look at alternative tax systems as well, savings account exemptions for taxation, a whole new system, indeed, all these concepts are worthy of this historic examination by the Ways and Means Committee.

Thank you, Mr. Chairman.

[The prepared statement follows:]

TESTIMONY OF HON. W.J. "BILLY" TAUZIN
A REPRESENTATIVE IN CONGRESS FROM THE STATE OF LOUISIANA

When I first came to Congress in 1980, I was not a fan of the income tax but, like many others, felt that it was a "necessary evil" in our lives. It wasn't long before I realized that many of my constituents who contacted me with problems were complaining about the same agency, the IRS, and the same law, the Internal Revenue Code. Constituents ask me, "Shouldn't our tax system be designed to raise the money that we need with the least amount of government interference into our lives?"

I believe the answer is yes. We must replace the present income tax with a revenue-neutral retail sales tax of between 16% to 18%. This is the only viable alternative that raises tax revenues, protects the economy and is least intrusive into our lives.

Look at our present income tax system. It has grown from 14 pages in 1914 to over 2000 pages of law, 10,000 pages of regulations and hundreds of thousands of pages of rulings and interpretations in 1995. Does anyone really understand it? Routinely tax preparers and income tax experts from the Treasury Department have testified before Congress and admitted that even they do not fully understand the Internal Revenue Code.

Does this complexity adversely affect only the wealthy? No. Our income tax laws have become so complex that over 70% of the tax returns filed by professional tax preparers are for citizens making less than $50,000 per year. Even the so-called experts have problems with our present income tax. In 1992, *Money* magazine gave 48 professional tax preparers a financial profile of one family and asked them to prepare an income tax return. The computed tax liabilities ranged from $16,219 to over $69,000.

And what about the incredible waste of productive time? According to a study commissioned by the IRS in 1985, it was determined that Americans spent 5.4 billion hours merely completing income tax forms. James Payne, of Lytton Research and Analysis, has calculated that the compliance burden of the federal income tax increased by at least 33% since 1985, which means, by some estimates, that Americans now spend a mind-boggling 8.6 billion hours each year completing income tax forms. None of this time is for productive enterprises that actually add to the social, economic or moral well-being of a society. Payne calculates the economic cost of the income tax to the American economy to be in excess of $600 billion

dollars per year-- in addition to the $600 billion per year we pay in taxes.

To put this in perspective and to illustrate the cost of the income tax to our country, Professor Walter Williams of George Mason University has stated that this country spends more total man-hours trying to comply with the income tax code than it does manufacturing every automobile, van and truck built in the United States in 1994.

And who do you think really pays for the tax compliance costs and taxes? Do businesses pay these costs? Again the answer is no. Businesses simply add them into the price of the products they sell. As a result, consumers pay between 10% to 15% more for retail goods and services.

Over the past 16 years, there have been thousands of changes to the income tax code. The Tax Reform Act of 1986 alone made nearly 2,500 changes to the income tax code and resulted in 48 new forms. These changes have made a horrible system even worse.

Some of these changes have actually eliminated jobs and devastated entire industries. Remember the luxury tax that virtually destroyed the yacht building business in the United States? I agree with the sentiments of Shirley Peterson, former Commissioner of the Internal Revenue under President Bush. Mrs. Peterson said, "My view is that we cannot 'fix' it with more tinkering at the margin. I believe that the only solution is to repeal the Internal Revenue Code and start over."

The two leading alternatives to the federal income tax are the national retail sales tax and the flat income tax. Both alternatives have similarities. Both proposals will not tax investment earnings or capital gains. Both proposals do not double tax the earnings of business. However, there are some fundamental differences between the flat income tax and the retail sales tax, and it is because of these differences that I support the replacement of the income tax with a revenue-neutral national retail sales tax.

Under the retail sales tax, we will pay our federal taxes when we make retail purchases just like most of us pay state sales taxes. As retailers make sales, they collect the national retail sales tax from their customers. The states then collect these taxes and sends a check directly to the U.S. Treasury. Sound simple? It is. The retail sales tax dramatically reduces the paperwork and time required by our antiquated system of taxation. There will only be around 10 million retailers filing federal tax returns each year.

But here's the real beauty of my plan: you "pay to play." The retail sales tax will give you the freedom to determine the amount of federal taxes you pay. For instance, if I decide to save part of my earnings and defer consumption to a later time then I will not pay taxes until I spend the savings. Even then I will be able to control the amount of tax that I pay. If I am saving to purchase a car then the amount of the car's purchase price will dictate the tax that I pay. I am suddenly in charge and no longer have to spend money in a way dictated by Washington to receive any tax breaks.

The problem with the flat income tax is simply this -- it is still an income tax! Under Congressman Armey's proposal, all of us will still file income tax returns. In fact, the Armey flat income tax requires that each wage earner in this country file a tax return each month and then a 13th return on April 15. If you own or operate in business this gets even more complicated.

Not only must the self-employed and business owners prepare 13 tax returns for their personal taxes, but they must also prepare 13 tax returns for their business. And these business tax returns won't be done on a postcard. Under the flat income tax, a business or self-employed person must still compute their "net" income. Sound familiar? It should because one of the most difficult things for the self-employed and the business owner is to determine "net" income. Imagine having to confront thirteen April 15's each year.

In 1992, Americans filed 113,604,503 individual income tax returns (including 15,495,419 nonfarm sole proprietor returns), 1,484,752 partnership returns and 3,869,023 corporation returns for a total of 118,958,278 tax returns. My staff estimates that enactment of the flat income tax will require a minimum of 1.5 billion tax returns. The flat income tax will create prosperity for the paper mills in my state but a lot of forests will have to be harvested to complete the additional paperwork.

Our current IRS system can't withstand the additional burdens imposed by a flat income tax. Although currently processing less than 10% of the number of potential flat income tax returns, IRS employees err on one of every ten income tax returns they enter into the IRS computers; the IRS now has more than 10 million taxpayers who didn't file last year; the IRS has more than $200 billion in misstated payments and

refunds; and, most troubling, the National Research Council predicts a major breakdown of the system could occur in the present income tax system before the year 2000.

Contrast this avalanche of flat income tax returns with the number of returns required by the national retail sales tax. The only tax returns required would be from providers of retail goods and services. This is estimated to be only 10 million. Everyone else will be free of any requirement to file tax returns. April 15 will be just another day, and we can finally dismantle and eliminate the IRS.

The flat income tax, on the other hand, requires retention of the IRS with all of its oppressive powers. In fact, the IRS may have to be given even more power. Professional tax preparers warn that under a flat income tax, the IRS may have to be enlarged to cope with the number of taxpayers who will not voluntarily remit their taxes each month. These same tax preparers fear that the already draconian methods presently used by the IRS will only intensify if people are forced to pay the flat income tax each month.

All of us understand that when we tax something we get less of it. The national retail sales tax does not tax income and therefore does not penalize you for working. The more you work the more you get to keep. What effect will this change have on our economy?

Professor Laurence Kotlikoff of Boston University studied the economic effects of a revenue neutral replacement of the federal income tax with a retail sales tax of between 16% to 18%. Kotlikoff concluded that this change would dramatically improve the economy and raise income and output by almost $500 billion a year or about $5,000 per family.

Martin Armstrong, chairman of Princeton Economic Institute, currently advises overseas investment funds with assets in excess of $3 trillion. Mr. Armstrong points out that the last time this country was a haven for investment capital was in 1940 when interest rates on government bonds dropped to 1%. He believes that the replacement of the federal income tax with a retail sales tax will attract, in real terms, even more investment capital than in 1940. Mr. Armstrong also predicts that many multinational companies will

locate their main offices in the United States. The result will be an unprecedented economic boom that will dramatically increase the economic prosperity of every American.

Will the flat income tax create the same economic boom? Like any income tax, the flat income tax means the more you work... the more taxes you pay. Like the present income tax, the flat income tax does not reward people for working. Yes, the flat income tax will not tax your investment earnings or capital gains. This will certainly help our ridiculously-low national savings rate. However, the flat income tax's impact on the economy will be less than the impact of the retail sales tax. People will still have to pay a flat income tax on the gross amount of their earnings and only be rewarded the next year if they invest part of what they have left. A flat tax is better than our present system, and I would support it over the status quo, but, in my opinion, a national retail sales tax is a much fairer way to go.

As I do talk radio shows across the country on this subject, many of the callers ask me how are we going to protect lower income people? Won't the sales tax be regressive? Economists tell me that, in the course of their lives, people generally spend all the money they make, so the retail sales tax is really not regressive. However, lower income people can be initially harmed by the switch from the present income tax system to the retail sales tax. There are a number of ways being discussed to create a safety net for them.

One method is by having a different rate of tax on different types of goods and services. Another method is to exempt certain of life's necessities. A third method is to consider giving rebates of the amount of the sales tax that lower income families pay. These methods are being studied now and the results will be available soon. One thing is certain: we will not implement the retail sales tax without providing for the disadvantaged people in our society.

There is another area where the retail sales tax will help create more jobs. Studies by the Department of Commerce's Bureau of Economic Analysis show that for every $1 billion of exports, 19,100 of jobs are created and most of these are higher-paying jobs. The retail sales tax will eliminate the bias against U.S. products in international trade. GATT allows countries to rebate consumption taxes at the border but not

income taxes. This amounts to as much as a 20% penalty when U.S. products are exported or when our products compete against imports.

A national retail sales tax would only be levied on retail sales in the U.S., not on exports. U.S. products will thus become more competitive in international trade. Imported goods into the United States will be forced to pay the same amount of federal tax as their domestic competitors.

One essential part of a fair tax system is that everyone shares the burden of paying for the cost of government. Unfortunately, the area of our economy that is growing most rapidly is the underground economy. Since the late 1970's, the underground economy has grown to an estimated $500 billion per year and the amount of income taxes lost is in excess of $125 billion per year and growing. The flat income tax doesn't really attack this growing problem. The national retail sales tax does.

Finally, despite all of the compelling economic reasons that favor replacement of the present income tax with a retail sales tax, there is an additional reason... FREEDOM. In 1954, the IRS could assess a total of 13 different tax-related penalties. In 1995, the number has increased to 150. Increasingly, the IRS must rely on coercion and threats to even collect 83% of the federal income taxes they calculate are due.

Baron de Montesquieu, whose writings were cited by our nation's Founders more than any other, and who inspired the very structure of our Constitution, emphasized the struggle between liberty and taxes. Direct taxes (like the income tax) would lead to slavery, but "a duty on merchandise (a retail sales tax) is more natural to liberty because it has not so direct a relation to the person."

An agency like the IRS, a tax on income, a presumption of guilt against the taxpayer, and the resulting tax tyranny are not consistent with the ideas on which this nation was formed. In *For Good And Evil*, Charles Adams' important work on the impact of taxes on civilization, Mr. Adams points out that the astute Greeks observed that tyranny (oppressive government) was the consequence of the wrong kind of taxation; and conversely liberty was the consequence of the right kind of taxation. And what was the right kind? Sales and customs taxes, said the Greeks. The wrong kinds of taxes that produced bad government were direct taxes like income and production taxes. The Greeks came to these conclusions, not from

reason, but from the examples of history. Our income taxes have proven that the Greeks were right. Much of our liberty has been lost to make our income taxes work, exactly as the Greeks predicted.

It is for these reasons that I support the replacement of the federal income tax with a national retail sales tax. It is time to make the federal government our servant again, instead of our master.

Mr. CHRISTENSEN. Thank you, Congressman, and thank you for your consistent conservative leadership in these areas.

Congressman Schaefer, we would be pleased to hear your testimony.

STATEMENT OF HON. DAN SCHAEFER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF COLORADO

Mr. SCHAEFER. Well, I thank you, Mr. Chairman, and I will add a little bit to what my good friend Mr. Tauzin has had to say. I very well remember, I know he does, the 1986 tax bill. If you really go back into the history, it started as a flat tax, and as time went on more and more things became deductible and pretty soon it was no longer fair or equal or simple, and we had a real mess on our hands when it passed.

I did not vote for it at the time, and it stands out as one of my best no votes, I believe, because it certainly has proven not to work. So, therefore, what we have been doing in Congress over a period of years has been looking for quick fixes, some way to fix this, some way to fix that, and all we ultimately do, as Billy said, is add to the Tax Code.

As a matter of fact, just since the tax reform of 1986 Congress has amended, repealed or added to more than 4,000 sections of the Income Tax Code, hoping that if we can change this section, eliminate that deduction, revise this rate, some way, somehow we are going to come up with a perfect Tax Code.

Now, I think it is obvious that the current system is beyond repair, and it should be repealed completely. My written testimony goes into great detail about the faults of the income tax.

I would ask the Chairman that it be allowed to be printed as part of the record.

Chairman ARCHER [presiding]. Without objection, your entire statement will be printed in the record.

Mr. SCHAEFER. Thank you, Mr. Chairman.

Now, for several years I as well as others, including Mr. Tauzin, have advocated replacing this flawed income tax with a national sales tax. This would be a tax on the retail level on goods and services between, say, 16 and 17 percent. This is not a VAT, this is not a VAT tax. A VAT tax, as Mr. Kemp indicated, is what is dismantling a lot of the economic system in Europe. The sales tax is simply a tax on the final finished product that a consumer purchases in one form or another.

The national sales tax could be primarily collected by the State governments, which already have the mechanisms in place. To overcome the supposed regressivity of the sales tax, I propose giving a rebate to cover a base level of tax-free consumption.

Some have suggested exempting food, medical services, and so forth, and I am not sure we are going to get to that point because then we get into a situation where if some wealthy person is throwing big parties, should that food not be taxed. We don't really think so.

There are other ways to go about that to treat that income level, say, between the $15,000 and $20,000 different than those who make more than that. So I would just say that if you want to talk about simplicity, you really have it here. A sales tax is very easy

to comply with. An individual knows every time they purchase something exactly what they are paying on their taxes. The mechanisms are already set into place in 45 different States, which would be very simple to figure out exactly what it is that that person is going to be paying.

Now, the other thing is that this sales tax is going to help us get at the underground economy. At this point in time we have millions and millions of dollars out there that are not being taxed and revenue is not coming into the Federal Government simply because it is either laundered money, it is drug money or it is from all cash operations.

These people still, however, buy clothes, they buy cars and they buy other types of products that they would ultimately be paying taxes on. The IRS, I think, on a conservative estimate, says that we are losing about $130 billion a year on the underground economy, and I think that that probably is very conservative, it is probably even higher than that.

So I would just say—I know my time is up, Mr. Chairman—I know you are very familiar with this whole approach, and as Bill says, we are in the process of drafting legislation that we hope will be ready for this summer or early into the fall.

We know this is not an easy thing to do, to dismantle something as huge as this. Billy said something about in 1914 the tax form was like 10 pages long, 14, the first tax form was 1 page. I have a copy of it, 1-page form, that first tax form that ever came out. I dare say I don't even want to look—my accountant does all my taxes now—I don't know how much it is now.

I thank the Chair and the rest of the Committee for listening to us today and hopefully we will be back to you sometime in the near future.

[The prepared statement follows:]

Statement of Representative Dan Schaefer

Before the

House Ways and Means Committee

On

Replacing the Federal Income Tax

June 8, 1995

Thank you Mr. Chairman and members of the committee for holding this hearing and inviting me to speak on replacing the federal income tax system with a national sales tax.

With this week's hearings, we in Congress are embarking on a tried-and-true Washington ritual: reforming the income tax. In fact, rarely is Congress not talking about reforming the income tax code. Washington has been on a decades-long quixotic search to "fix" the income tax; each time hoping that if it changes this section, eliminates that deduction, or raises this rate that somehow we will produce The Perfect Income Tax Code.

Since 1954, Congress has passed substantial amendments to the federal tax code an average of every 1.3 years. Since passing the Tax Reform Act of 1986, Congress has amended, repealed, or added to over 4,000 sections of the income tax code.

Taxpayers are now telling Congress: Give it up! The income tax code is beyond repair, and should be repealed completely.

But what should we replace the income tax with? Let us imagine, just for a moment, that April 15th were just another spring day -- not the dreaded Tax Day. What if our tax system required no Internal Revenue Service (IRS), had no loopholes for the rich, weakened special interests' hold on the U.S. Congress, increased Americans' paltry personal savings rate, and encouraged economic investment? And suppose the federal government could still collect at least as much tax revenue as it does today?

This is not some kind of fantastic Utopia I am describing. It could be reality if America eliminated the personal and corporate income tax system and replaced it with a national retail sales tax.

To understand the need for a national sales tax it is important to understand why the income tax code must be replaced completely. Everyone dislikes paying taxes, but the income tax makes financing government expenditures excruciatingly painful.

When the income tax was originally proposed, its backers assured the nation that it would never exceed a few percentage points. In fact, the income tax imposed after the passage of the Sixteenth Amendment had a maximum rate of seven percent, could be filled out with just a two-page form and fewer than one percent of Americans actually had to file an income tax return. This seductive, little tax was promoted as not only fair, but also as the elixir for all that ailed the country. Consider the 1913 House committee report on the legislation establishing the income tax:

> "We recommend the passage of...[the income tax]...in the confident belief that as soon as this tax and its administrative machinery become fairly understood by the people...[it] will meet with as much general satisfaction as any tax law...All good citizens, it is therefore believed, will willingly and cheerfully support and sustain this, the fairest and cheapest of all taxes."

Few predictions have been as disastrously wrong as these euphoric hopes expressed by the authors of the income tax. During the past 80 years, the income tax has become a behemoth which former President Jimmy Carter accurately described as "a disgrace to the human race."

With its myriad deductions, rules, regulations, liens, forms, withholding instructions and compliance costs, the income tax is understood by only a small coterie of tax lawyers and accountants, and is despised by almost all other Americans. And average citizens have many reasons to hate the income tax. It is expensive to administer and comply with; it is complex; it is constantly changing; it encourages rent-seeking corporations to search out special exemptions; it has resulted in a shocking loss of personal liberty; and it discourages the savings, investment and productivity needed for economic growth.

Cost and Compliance

If the income tax were evaluated as a product, we would first look at its costs. During Fiscal Year 1995 alone, Congress spent $7.6 billion on the administrative costs of the IRS. Even here in Washington that is a lot of money. However, that $7.6 billion price tag is a drop in the bucket compared to the true, hidden costs of the income tax.

In the book, Costly Returns: The Burdens of the U.S. Tax System, Dr. John L. Payne, director of Lytton Research and Analysis, identified six separate costs associated with the tax system: compliance, enforcement, disincentives, evasion, avoidance and government costs. These costs include the money and time most businesses and individuals spend to comply with the income tax, the effort and energy many other companies put into evading the income tax, the concomitant resources the government spends to catch, prosecute and incarcerate these evaders, plus much, much more. Dr. Payne found that, when all these hidden factors are all added up, the income tax "cost" $618.1 billion in 1990 alone. This makes the income tax the most expensive government program of all -- larger than Social Security, Medicare, or defense. Yet, unlike most government programs, the costs of which show up on the government's ledgers, the cost of the income tax is paid for almost entirely by the private sector.

Complexity

Much of the public's disgust with the income tax is caused by its complexity. Years of congressional tinkering and IRS rulemaking have created a monstrous set of laws and regulations that intimately affect the finances of every American family and business. The income tax code's complexity has made calculating one's taxes both time consuming and frustrating. In fact, congressional testimony has revealed that it takes businesses and individuals over 5.4 billion hours annually to comply with the income tax. That is equivalent to hiring 2.7 million people working full-time on tax compliance!

Unfortunately, the tax code is both large and growing. Since 1954, the number of sections in the income tax code has increased by 578 percent, from 103 sections to over 690. During that same time, there was a 369 percent increase in just the number of words in the code. Today, there are over 800,000 words in the income tax code. To clarify this voluminous code there are currently on the books more than 45 million words of income tax regulations!

Who can understand all this? Certainly not the average family or small business. Most can barely comprehend only a few of the IRS's 480 tax forms. Only

the most specialized super-lawyers and accountants can even pretend to understand the entire code. This legion of tax lawyers, accountants and purveyors of tax-avoidance schemes now constitute an entire industry of professionals who wade through the income tax code to help their clients figure how much taxes they owe, and often how to avoid paying those taxes. Estimates of persons working full-time to comply with the tax code reach as high as 500,000.

Uncertainty

Federalist Paper Number 62 observed two centuries ago:

> "It will be of little avail to the people, that the laws are made by men of their own choice, if the laws be so voluminous that they cannot be read, or so incoherent that they cannot be understood; if they be repealed or revised before they are promulgated, or undergo such incessant change that no man, who knows what the law is today, can guess what it will be tomorrow."

These words could easily serve as the epitaph of the income tax. As was predicted so many years ago, a law that changes with the wind will only earn the public's hatred.

Just look at the mutability of the income tax. As I mentioned earlier, since 1954 Congress has passed substantial amendments to the federal tax code every 1.3 years. Since the mammoth income tax reforms of 1986, 4,000 provisions of 40 acts have either added, amended or repealed sections or subsections of the income tax code. The GATT implementation legislation alone contained 91 changes.

What are the results of all this tax uncertainty? For one, there is a real economic cost associated with these changes. Uncertainty requires businesses to spend time, money and effort on economically unproductive activities such as tax research, tax planning, tax compliance and tax litigation. In today's tax environment, one of the few reliable forecasts a business can make is that tax law will change before any new investment comes to fruition. Additionally, businesses have to defer decisions as Congress makes up its mind about raising rates and adding deductions. The Tax Foundation has estimated that the 1993 Clinton tax package alone cost the U.S. economy over $20 billion because of uncertainty -- that is $20 billion worth of potential research, development and job training.

Not only does the constantly changing tax code create economic losses, but, as we were warned in The Federalist Papers, uncertainty carries a civic cost. Citizens become cynical and suspicious when they see tax law changed with little concern for rational economic policy. Indeed, as former IRS commissioner Shirley Peterson declared, "today, changes in the tax law are driven by political considerations and revenue constraints and wise tax policy has nothing to do with it." Is it any wonder that citizens are suspicious of the tax code?

Rent-Seeking

There are few tools more valuable to the rent-seeking corporation than the income tax. Over the past 80 years, Congress has granted special deductions and transitions rules to an array of politically-favored industries and organizations. In the process, Congress has radically skewed rational business decision-making, directing resources to politically powerful but inefficient industries, handicapping those businesses which lack access and influence in the halls of Congress and, in the process, shrinking the income tax base.

Gary S. Becker, 1992 Nobel Laureate in economics, correctly observed, "In modern economies, profits are often determined more by government subsidies, taxes and regulations than by traditional management or entrepreneurial skills." Long before Dr. Becker identified the pernicious impact of rent-seeking taxation, James Madison observed in Federalist Paper Number 10:

"The apportionment of taxes on various descriptions of property is an act which seems to require the most exact impartiality; yet there is, perhaps, no legislative act in which greater opportunity and temptation are given to a predominant party to trample on the rules of justice. Every shilling with which they overburden the inferior number, is a shilling saved to their own pockets."

All can agree that Congress has not acted with "the most exact impartiality" when bestowing the benefits of the income tax code. Once Congress abandoned the principle of a single rate applicable to all, it headed down the road to rampant rent-seeking.

The solution? While we can never eliminate the desire of industries to seek special tax breaks, we can establish a powerful bulwark against rent-seeking taxation: uniformity. Unfortunately, the current code's only uniformity is the uniformity with which citizens despise it.

Civil Liberties

The income tax has also ushered in a revolting assault on our civil liberties. Thomas Jefferson would spin in his grave if he knew that every American is required to report to the federal government not only how much he or she earns, but also a variety of other personal financial information. Today, banks, savings and loans and employers are required to report some 81 specific types of personal financial transactions. This has given the federal government an enormous amount of sensitive data about the economic activities and private lives of every citizen.

This information is not always used lawfully. A 1994 U.S. Senate hearing found widespread unauthorized snooping in taxpayer records by IRS employees. IRS bureaucrats are not the only ones who have misused IRS files and the income tax. Former New York Times investigative reporter David Burnham, in his book A Law Unto Itself: Power, Politics and the IRS, found that "Almost every [presidential] administration since the end of World War I has one way or the other used the selective enforcement of tax laws and the information contained in tax records for improper political purposes."

Savings, Investment and Productivity

The income tax penalizes those things we need most for long-term economic growth: savings, investment and productivity. Currently, investments are taxed three times: once when the money is earned as income, again when the investment earns dividends and finally when the investment is sold for a capital gain. Consumption, however, is taxed only once: when the income is earned. This encourages citizens to engage in excessive spending. Why save if you will be taxed thrice for doing so? With the income tax code's perverse incentives, is it any wonder the U.S. has one of the lowest savings rates (2.5 percent) in the industrialized world? Our poor savings rate has deprived companies of the capital needed to invest in new technologies and job-training, crippling our ability to compete overseas. This capital crunch has damaged U.S. companies' ability to expand, preventing them from creating more good, high-paying jobs.

Additionally, the income tax's high marginal tax rate discourages new production and economic growth. Today, the highest marginal income tax rate at the federal level is 42 percent. Marginal tax rates are normally sold as a way to make the rich "pay their fair share," but even middle-class families are hurt by today's high marginal tax rates. Most middle-income earners pay a 28 percent federal income tax, a 15 percent payroll tax and a five percent state/local tax. This means that the government takes 48 cents of every dollar middle-income workers earn. Economist Robert Genetski has shown in his study Taking the Voo Doo Out of Economics that high marginal tax rates are inversely related to productivity growth. Productivity and wages tend to rise when marginal rates are low, but productivity falls or grows more slowly when marginal income tax rates are high. The income tax code's high marginal tax rates, coupled with the disencentives to savings and investment, is an unnecessary, government-imposed hurdle to economic growth.

The income tax is expensive; it is complex; it changes without warning; it has spawned numerous lobbyists who massage the code to benefit the politically powerful; it has invaded our privacy; and, it discourage the savings, investment and productivity needed for renewed economic growth. Despite the good intentions of the fathers of the income tax code, we now know that the income tax is not the "fairest and cheapest of all taxes." We in Congress need to recognize that the income tax has failed. It is now time look at a totally different way of financing government spending -- before it is too late.

Luckily, Washington, and this committee in particular, is considering radical tax restructuring. What I mean by restructuring is a complete and total overhaul. America has had tax "reform" for decades. What the country needs is not well-meaning yet ineffectual reform, but a complete and total rethinking of tax policy.

One of the most popular tax restructuring proposals is House Majority Leader Dick Armey's "flat tax" proposal. To "flatten" the code by eliminating its numerous deductions and distortions would create a much better tax system. But a "flat" income tax is still an income tax. Under even the simplest flat tax, "income" must be defined, personal financial information disclosed to the IRS and income taxes collected. This will require much of the same rules, regulations, liens, forms, withholding instructions and compliance costs that exist under the current system.

Flattening the income tax code would help simplify the system and lessen some of the deterrents to savings and investment. However, if history is any guide, a flat tax would stay flat for all of one Congress. I am sure you all remember the debate on the 1986 Tax Reform Act, the mother of all tax reforms. That process began with a discussion of flattening the tax code. The final legislation, to its credit, created a tax code with fewer deductions and only two personal income tax rates, 15 and 28 percent. Since then numerous bills have revised, reformed and thrown out much of the 1986 tax bill, so that today the tax code has five rates: 15.0, 28.0, 31.0, 36.0 and 39.6 percent -- not to mention many new deductions and loopholes.

Clearly, the impulse to "fix" the income tax code would not abate once a flat tax is passed. Inevitably, exemptions and "corrections" would find their way back into the law. America would soon find itself saddled with a loophole-ridden and expensive income tax code once again. In fact, Senator Arlen Specter, who has made the flat tax a part of his presidential campaign, has already incorporated several deductions into his supposedly "flat tax" proposal. Congress' constant urge to fix the income tax code is one of the many reasons why real reform can only come with replacing the income tax structure with a simpler, more just and economically efficient system.

I propose that we replace the current system with a national retail sales tax. This would be a tax (somewhere between 16 and 19 percent) on all goods and services sold at the retail level. As part of the transition to a national sales tax, I propose abolishing the corporate and personal income tax, the gift and estate tax and the excise tax. The IRS would be retained to dispose of pending tax evasion matters, but it would also be abolished.

To finance the spending of the federal government, a national sales tax on all goods and services would be imposed. Since the states have extensive experience with sales taxes, they would be charged with administering the national sales tax. Appropriate compensation would be given to the states and to retailers to ensure that the national sales tax does not become an unfunded mandate.

The national sales tax would be imposed on all goods and services purchased for consumption. Goods purchased for resale and for the production of other taxable goods or services would be excluded. A de minimus exemption would be allowed for small transactions between individuals, such as yard sales. The national sales tax would also be imposed on all imports into the U.S., in accordance with GATT.

To combat "regressivity," a rebate would be given to taxpayers and their dependents to cover a base level of tax-free consumption. This rebate could be set to

provide tax-free consumption up to the poverty level or could be set at the zero tax rate of the current income tax. Some have suggested exempting food and/or medical services to address regressivity. However, I believe that the sales tax rate should be as uniform as possible and should have the fewest number of exemptions. Thus, I believe a rebate structure is a better way to handle regressivity.

This rebate could be distributed to citizens in one of two manners. One option would be to give all citizens monthly or quarterly checks to pay for the covered level of tax-free consumption. Another option would be to give all citizens a "smart card." This card, similar to a credit card, would be used by citizens when they purchase a good. Every time a purchase is made the taxes would be deducted from the citizen's account of tax-free consumption.

Let me be clear about what I am advocating. First, I believe we must wholly replace the income tax with a national sales tax -- not just add it on top of the existing tax structure. Second, I do not support a so-called Value Added Tax (VAT), as is used by many European countries. A VAT would simply represent another hidden level of taxation to be abused by the government. I believe a national sales tax would only work if it completely replaced the existing income tax system and if it remains a visible and simple tax.

The national sales tax would dramatically change not only tax policy, but also the way citizens live their lives. Instead of a hidden withholding income before pay day, Americans would receive all the money they earn. Instead of filing confusing forms and complying with mystifying regulations, Americans would simply pay a set tax every time they buy a good or service. Instead of a government-determined level of taxation based on income, Americans would determine how much taxes they pay based on how much they choose to consume. Gone would be the IRS bureaucracy and its assaults on the rights of taxpayers. In its stead would be a straightforward and simple tax, administered primarily at the state level. To get a feel for the advantages of a national sales tax, just ask any of the citizens of the 45 states with a sales tax: Is it easier to comply with the federal income tax or the state sales tax?

Also, a national sales tax, unlike a flat tax, would help get at the underground economy. The U.S. Treasury Department estimates that it is unable to collect over $125 billion in income taxes every year. A national sales tax would help recoup this loss, ending evasion and lessening the tax burden on hard-working, law-abiding citizens. While even under a national sales tax there would still be some evasion, a point-of-sale retail tax will be much more effective at tapping the underground economy than today's despised, loophole-ridden income tax.

In addition, under a national sales tax, American exports would skyrocket. Without taxes built into the cost of American goods, they would be much more competitive on the world market. Our companies would no longer be forced to move American jobs abroad in order to compete globally. Further, foreign companies, which often avoid paying U.S. income taxes altogether, would have their imports subjected to the same sales tax as everyone else.

Some have claimed that a national sales tax would be more "regressive" than the current income tax code. They are right, to a certain extent. The poor consume a greater percentage of their income on basic necessities and would, thus, pay a higher proportion of taxes than some of the wealthy. This problem, however, could be addressed by giving citizens rebates to cover a base level of tax-free consumption, as I described above.

In a larger and more important sense, it is the current income tax which is regressive. It cripples the economic growth needed to give the poor the opportunity to move into the middle class. In that sense, the income tax is the most regressive tax because its triple taxation of investment and high marginal rates prevent the economic growth necessary for a true opportunity society.

Moreover, the poor already pay a large "consumption" tax because they pay the corporate taxes that are currently hidden in the price of every good and service they purchase. To understand the logic of the national sales tax, it is first important

to realize that businesses do not pay taxes. I don't mean this in sense that companies find enough loopholes to avoid paying taxes. I mean taxes are simply a cost of doing business that is reflected in the final price of the product or service offered by the company. The consumer of that product or service, pay these hidden taxes. Only consumers have no one else to whom they can pass the tax. Unfortunately, the regressive aspects on the current system are hidden. Low-income families actually pay a disproportionate share of businesses' income taxes and costs of compliance. While the poor may not pay taxes on April 15th, they do every time they buy food or clothing.

Adopting a national sales tax would end this corporate tax shell-game. And, because it would eliminate the disincentives to savings and investment and the current high marginal taxes rates, the sales tax would spur robust economic growth. Dr. Lawrence Kotlikoff's study of the national sales tax predicted that a national sales tax would more than double the nation's savings rate, from 2.5 percent to 7.6 percent. This would increase U.S. citizens' standard of living between seven and 14 percent. Thus, by changing the incentives in the tax system, Congress would usher in a period of enormous economic growth and opportunity.

Many used to claim that replacing the income tax with a national sales tax was just an economist's pipe dream, but the stars are aligning in favor of the sales tax. I have joined with Representative Billy Tauzin to draft a national sales tax bill, and we are organizing congressional support for this proposal. Senator Dick Lugar has made the national sales tax a major plank of his presidential campaign. Additionally, this week's hearings before the Ways and Means Committee demonstrate the widespread desire to examine alternatives to the current tax system. I believe these hearings are the vital, first steps on the long road to a complete restructuring of the tax code.

I and taxpayers across the country believe that as we once again head down tax reform lane that Congress should not sell the country short by tinkering with the our current disastrous income tax. Instead, we should end the era of tax "reform" by completely eliminating the income tax and replacing it with a national retail sales tax.

Chairman ARCHER. My thanks to both of you for, number one, coming and having to wait, and then having to come back, and I apologize for that, but the Committee is very grateful for your testimony and for the work that you have done on this.

I wish there were more Members here to both listen to you and to inquire because we need to have this exchange as colloquy going back and forth and probing advantages and disadvantages of these various options before we can finally, I think, reach a resolution.

I, for one, have not completely decided what form of consumption tax I believe would be the best, but I do worry that those who wish to continue some form of the income tax, albeit restructured, perhaps with a reduced rate, whether you call it flat or semiflat or whatever else, is simply déjà vu.

Mr. SCHAEFER. It is still a tax on income.

Chairman ARCHER. But we have been there before, as you pointed out, and we know what happens. We know what human nature does to that kind of a system.

Mr. TAUZIN. Mr. Chairman, if you will, there is another—we don't talk about it in these terms but we need to think about it in these terms—there is another good reason to move away from income taxes. In the book "For Good and Evil," Charles Adams presents a very important work on the impact of taxes on civilization in general. He points out that the astute Greeks observed the tyranny of oppressive government was a consequence of the wrong kind of taxation; that conversely liberty was a consequence of the right kind of taxation, and what was right, and what was wrong?

Well, the Greeks had it figured out. The Greeks said that sales and custom taxes were the correct form, that provide people as much liberty as possible. You decide how much taxes you are going to pay by deciding how much you consume instead of the government saying you are guilty, you owe us money unless you can prove you are innocent, as we have the rule under the current income tax system.

The Greeks came to that conclusion, Mr. Chairman, not from reason but from examples in history, and our income tax system has proven the Greeks were right. It is a tyrannical system as opposed to one that respects and in fact enlarges the freedoms of our people.

Chairman ARCHER. I particularly appreciate your comments on that. I think maybe it was Mr. Adams who started his testimony before this Committee this week by saying that 1 page of history is worth 200 pages of logic, or maybe more than 200 pages of logic, and I thought that was a superb statement because Santayana is right when he says that if we don't learn the lessons of history, then we must relive them.

And I wonder a little bit, too, as we enter this process, how much value we place on liberty and freedom and privacy, because that is something that hadn't been discussed too much until you two people came before the Committee this afternoon. What value do you place on liberty and what value do you place on privacy, and if in fact we have this great opportunity, perhaps a once-in-a-lifetime opportunity to get the IRS completely and totally out of the lives of every individual in America, what is the value of that? I, for one, would attach a very high value to that.

Mr. TAUZIN. And you would be right, sir.

Mr. SCHAEFER. Priceless.

Chairman ARCHER. Let me ask you, if I may, do you have any specificity to how you would overcome the argument of regressivity?

Mr. TAUZIN. Well, obviously, Mr. Chairman, there are a number of ways you can overcome it. One is a complete, outright exemption, as Mr. Schaefer has talked about, of certain basic essentials that you do not tax a certain level of consumption that is essential in people's lives.

The other is to tax it at a lower rate so that everyone is contributing to their government and to the benefits of the government but at a lower rate on the things that are essential—food, clothing, shelter—and then a different rate on the things that you choose to consume that aren't necessarily essential in your lives.

There are a number of ways of treating that, and one of the things that I hope the Committee does is literally examine the various structures that will yield the same revenue neutral amount of money and yet have that element of progressivity in it.

Chairman ARCHER. But you do not at this time have a preferred method that you would like to propose to the Committee?

Mr. SCHAEFER. Well, Mr. Chairman, we do not have at this point, we are still fine tuning it, and of course, as you know, with a subject matter such as this, it would be fine tuned over a long period of time, even after it would come to this Committee. But in answer to your question, you know, the national sales tax is not regressive, it is proportional really, and that simply means that those with the most income will consume the most and therefore pay the most in taxes. And as Bill said, with those in the low-income levels, a rebate system can be—there is a lot of things we can do to fit that in. So I would have to argue just the opposite. It is not a regressive-type tax.

Mr. TAUZIN. There is another thing that you can't miss, Mr. Chairman, and that is when you do encourage income production and investment in your economy again, you create, according to the estimates we have seen, 1.6 million new jobs with this change. It literally creates economic benefits for all of us in our society, many of whom can't find a good job today. And so in the end, if it is a tax that lifts more people off the bottom and gives them a chance to succeed, encourages income and rewards savings, then it is a system that we ought to move toward as rapidly as we can.

I want to give you one example of what is absolutely outrageously outlandish in our current Code. My two sons are in college today. They both have part-time jobs. They both earned slightly under the amount, I think it is $3,000, so where taxes come into play in their lives, income taxes, but one of them took their father's advice and saved part of his income. The interest he earned on his savings account was taxable even though his total income was still under the cap.

We, as a government, are telling my son, We are going to penalize you if you do what your father suggested you do, be frugal and save some money and help our economy, your own economy. That is an awful message. But we do it not just for our children, we do it for every working family in America. If you save money, we will

tax it when you earn it, and we will tax it again when it earns revenues for you at the bank. What an awful message.

At a time when this country is trying to say to people, Get off of welfare, go to work, be productive, at a time when we are worried about interest rates being too high, not being able to afford a home, shouldn't we say we are going to reward you for producing income, reward you for saving money that is going to yield lower interest rate money available to us to build homes, reward you for investing in jobs instead of penalizing you?

It is about time, Mr. Chairman.

Chairman ARCHER. I don't think you would find any argument with the three of us who are here today because Mr. Ensign pursued that line of questioning to a witness earlier, and I have exhausted my questioning.

Mr. Ensign, would you like to comment or question?

Mr. ENSIGN. Yes, I would, simply because I didn't get a chance to question Mr. Gibbons earlier in the day, and he brought up something when we are dealing with, this regressivity question, and it seems to me that that is where the simplicity goes out of the consumption taxes. First of all, an example that was given one of the other days in Europe when they started talking about taxing different items in the economy. Maybe we don't want to tax medicine. Well, how was Head and Shoulders taxed—and this was a real debate, was Head and Shoulders taxed as a medicinal shampoo or was it taxed as a cosmetic and therefore it should be taxed.

These are legitimate—I mean, all of the different health products that we sell in the health food stores now, are those foods or vitamins or are those medicinal products? Depending on the marketing today, they want them as medicinal products. If we change the Tax Code, they may change the way that they want to label them.

So that seems to me where some of the complexity gets in the way, but also he mentioned trying to correct some of the problems because he favors obviously a progressive tax system. He mentioned that you would give, because he doesn't want to see those types of problems, some sort of tax credit for poor people, but he also wanted to see wealthier people pay something instead of having their taxes cut, so he would do like a reverse tax credit or a negative tax credit.

Well, isn't a negative tax credit an income tax? So how do you satisfy somebody like Mr. Gibbons without getting the complexities in the Tax Code with a consumption tax?

Mr. SCHAEFER. Well, let me go first, Bill, but it seems to me, and I keep going back to this, my history in this 1986 tax bill, Mr. Archer very well knows, I keep going back to that. Once you open the door and you allow this exemption on medicines or whatever, pretty soon you have got everything in the world in there that there is an exemption on.

I would much prefer to see it come down to the point where it is according to the income level of the individual, that they would have a rebate that would cover whatever they had to pay and their cost of medicine or whatever else it would be, and therefore then the other people would still be charged and would not be open for a rebate on these things. I think that this is probably the simplest

way to do it because I remember the history of this, all three of us do, and it was a mess.

Mr. TAUZIN. That is a valid concern. We were wrestling with that as we approached drafting.

Let me make a point, however, that is lost very often in the current system. Economist John Quiles in 1991 reported to this Committee this fact, that the current cost of compliance with the current income tax system, the hidden taxes involved in that cost of compliance, is currently adding 10 to 15 percent to the cost of every retail item in our economy, including Head and Shoulders, and other medicines and foodstuffs that are purchased by the poor and the elderly in our society, a 10 to 15 percent hidden tax of wasted resources, unnecessary cost of compliance.

So if we start with the notion that we are going to replace that messy system with a simple one that has some national retail tax element in it, you can start with the notion that you have got a 10 to 15 percent base already there.

Second, either the rebate technique or, as I suggested, two levels, two rate techniques can accomplish the kinds of concern—can overcome the concerns of regressivity that you and I and others are very concerned about without necessarily getting us into the complexities of tax simplification of the eighties like we saw.

Mr. SCHAEFER. The income tax we have now is truly regressive.

Mr. ENSIGN. The other problem that I see with some of the proposals that are out there dealing with regressivity or progressivity, first of all, is, how do we get to where it is neither regressive or progressive? That seems to be the fair system, is if we get, where fairness is that it is neither regressive nor progressive, and striking a balance there seems to be a very difficult task to achieve.

Mr. SCHAEFER. Well, my way of thinking is that on an NST it probably is as much middle ground as you can possibly get between the regressive and the progressive type of thing because this is all a choice that people make, and just think if you are out making $100 a week, you get a paycheck for $100, you don't get a paycheck for $75 or $76 or whatever, and therefore you have that.

Mr. ENSIGN. Just one last quick comment, and that is, the only thing that scares me about this is that it is so easy to raise this tax, any kind of consumption tax because it is almost a hidden tax. One of the ways they talked about was making it hidden in the price of the good and if it is hidden in the price of the good, and some people say even our State sales taxes are hidden taxes simply because nobody really pays attention to that tax that they are paying. They pay attention to the tax that is taken out of their paycheck but they don't pay attention to the tax that they pay at the grocery store, so in effect it is much easier to raise this type of a tax in the future, the rates on this, than it is the income tax.

Mr. SCHAEFER. Well, I would certainly agree with the gentleman if it would be concerning a VAT, but not when you are considering an NST. They are two different things. The VAT is truly hidden, as Billy said, in our current system, there is some 12, 15 percent in there that is hidden, but that 16 or 17 percent that is tacked on to the final suit that you buy, you know exactly what that is, and that is set by Congress. And here we are, we change the Tax

Codes all the time, and we are changing the brackets and we are doing all this.

Sure, with an act of Congress you can change it from 17 to 18 percent, but you think you are going to hear some squawking and squealing? You bet you will. So therefore I think as long as the revenues are coming in——

The final thing, Mr. Chairman, I would just say is that Bill and I are going to create a national sales tax caucus, and the purpose of it is for all those individuals who wish to know more about it and become involved and disseminate the information, I think this will be a good step.

Chairman ARCHER. We welcome your input, and we really do have to move along. We still have a number of additional witnesses today. I really do thank you for the work you have done and for your presentation today. We are going to be moving along with this and having more hearings and more deliberations in this Congress, and we will really be looking for whatever counsel and suggestions that you can give us.

Thank you very much.

Mr. TAUZIN. Thank you, Mr. Chairman.

We didn't get a chance to say this when we got here, Mr. Archer. I want to personally thank you. You stepped out in an extraordinarily courageous way to begin this debate, and if we arrive at that awfully wonderful point and America does in fact come up with an alternative system, it is simple, it works, April 15 can just be another day in our lives instead of the awful day it is. America will have you to thank, sir.

Thank you very much.

Chairman ARCHER. Thank you. I hope we can get there.

Our next witnesses are Professor Hall and Alan Reynolds.

Gentlemen, thank you for being so patient today. I apologize for the length of time that you have had to wait in order to be able to come and make your presentation, and I am very grateful to you and I look forward to what you have to tell the Committee. Welcome. And, Dr. Hall, will you proceed.

STATEMENT OF ROBERT E. HALL, PH.D., SENIOR FELLOW AND PROFESSOR OF ECONOMICS, HOOVER INSTITUTION, STANFORD UNIVERSITY

Mr. HALL. Thank you, Mr. Chairman. I am honored to have this opportunity to discuss the plan to replace the income tax with a flat consumption tax. No one is more conscious of the hour than I am, so I will be very brief. My prepared testimony is about 25 pages, and I invite anyone who wants to learn more to read that.

Chairman ARCHER. Without objection, your entire testimony will be printed in the record.

Mr. HALL. Thank you, Mr. Chairman.

This Committee has heard a number of meritorious plans for replacing the income tax with a consumption tax. Those include a national sales tax, a VAT or an income tax with unlimited deduction for saving, and I want to be clear that I am a supporter of any of those consumption tax plans.

By far the most important national priority, I believe, should be to switch to a consumption tax. It is almost to the detailed level which of those we choose.

My testimony will hit the high points as to why the Hall-Rabushka flat tax plan is the best way to move to consumption taxation, but again, I stress that all of these are good plans, and if this Committee were to decide to push ahead with any one of them, I would welcome the opportunity to come back and say exactly how an economist would see that VAT, a sales tax, a value-added tax, or a flat tax could be set up in a most economically successful way.

First of all, simplicity. I think it is well known now and I don't go through what I used to do of showing off tax forms because I think these tax forms have been published everywhere, and Congressman Armey, in particular, has been spreading them far and wide, but we do have just two postcard tax forms. And the virtue of simplicity is something I have learned more and more I think is part of the appeal of both the flat tax and other consumption taxes, but it is terribly important, the fact that a good tax is also a simple tax is a lesson that I think we should push very, very hard.

A second thing that I would stress is that either the value added principle or the sales tax principle is a very good one for setting up consumption taxes, it is really—something like a value-added tax or a sales tax is the right way to go about taxing consumption. First of all, it is obvious that it taxes consumption. That is particularly true of the sales tax, but it is also true of the value-added tax.

The Hall-Rabushka flat tax is a value-added tax. It is just a rearrangement of a value-added tax to provide some other benefits, but at its core it is a value-added tax, and again a value-added tax and a sales tax are very, very close relatives as a matter of economics; they are both consumption taxes.

A third point is that the flat tax is progressive and fair. One of the most important challenges that faced us in 1981 in designing the flat tax was exactly this question: How do we make it progressive and fair? And the answer is an exemption.

The reason that we are not strictly a value-added tax is that we figured out a way to slightly rearrange it in order to make it progressive and fair, and that is by providing an allowance. Our allowance is $25,500 for a family of four. Of course, other allowances are possible, and Congressman Armey has proposed a larger family allowance, and that is fine. That is something that certainly should be discussed further.

A fourth point and one that I have recently been doing more research on has to do with transition problems.

I didn't used to worry about transition because it never occurred to me that the flat tax would be taken seriously in Washington, but now that it is, I have been looking at transition issues seriously.

One transition issue that has gotten too little attention is that a sales or value-added tax would create a burst of inflation in the U.S. economy. This is not an idle possibility. When Britain adopted a VAT tax in 1979, their economy went into a tailspin associated with the burst of inflation that accompanied it. There would be no inflation with Hall-Rabushka.

A second related point is that the border adjustment which might go with a value-added tax would bring a sharp appreciation of the dollar, and I would see that as a giveaway to speculators who guessed right about the reform.

I have run out of time, but I think I have hit the high points as far as why, among all the good consumption taxes, this is, I believe, the best consumption tax.

Let me just—one of the topics that I wanted to cover is the topic of border adjustments. That is one I have thought through carefully recently. Border adjustments are not the cosmic issue that I think earlier witnesses suggested. I see that as an option that we have, and we should think seriously about doing it one way or the other. The thing I would stress is that if we adopt a VAT tax with border adjustments or a sales tax with border adjustments, with the rebate of the exports, there would be an immediate appreciation of the dollar that would offset it.

There is no improvement in competitiveness associated with a border adjustment and there is no dumping through the Tax Code. It is a neutral issue, and we ought to decide it on other grounds.

Now my time is up.

Chairman ARCHER. Thank you for living within the time constraints. I know 5 minutes is not long compared to the complexity of these subjects.

[The prepared statement follows:]

THE FLAT TAX

Testimony of Robert E. Hall
Senior Fellow, Hoover Institution, Stanford University
Professor of Economics, Stanford University
before the
House Committee on Ways and Means
June 8, 1995

Tax forms really can fit on postcards. A cleanly designed tax system takes only a few elementary calculations, in contrast to the hopeless complexity of today's income taxes. My Hoover colleague, Alvin Rabushka, and I have developed a complete plan for a whole new tax system. Our system puts a low tax rate on a comprehensive definition of income. Because its base is so broad, the tax rate is an astonishingly low 19 percent but raises the same revenue as does the current tax system. The tax on families is fair and progressive—the poor pay no tax at all, and the fraction of income that a family pays rises with income. The system is simple and easy to understand. And the tax operates on the consumption-tax principle—families are taxed on what they take out of the economy, not what they put into it.

Our system rests on a basic administrative principle: income should be taxed exactly once, as close as possible to its source. Today's tax system violates this principle in all kinds of ways. Some kinds of income—like fringe benefits—are never taxed at all. Other kinds, like dividends and capital gains, are taxed twice. And interest income, which is supposed to be taxed once, escapes taxation completely in all too many cases, where clever taxpayers arrange to receive interest beyond the reach of the IRS.

Under our plan, all income is taxed at the same rate. Equality of tax rates is a basic concept of the flat tax. Its logic is much more profound than just the simplicity of calculation with a single tax rate. Whenever different forms of income are taxed at different rates or different taxpayers face different rates, the public figures out how to take advantage of the differential.

PROGRESSIVITY, EFFICIENCY, AND SIMPLICITY

Limiting the burden of taxes on the poor is a central principle of tax reform. Some ideas for tax simplification and reform flout this principle—neither a federal sales tax nor a value-added tax is progressive. Instead, all citizens, rich and poor alike, pay essentially the same fraction of their spending in taxes. We reject sales and value-added taxes for this reason. The current federal tax system avoids taxing the poor, and we think it should stay that way.

Exempting the poor from taxes does not require graduated tax rates rising to high levels for upper-income families. A flat rate, applied to all income above a generous personal allowance, provides progressivity without creating important differences in tax rates. Graduated taxes automatically create differences in tax rates among taxpayers, with all the attendant opportunities for tax-avoidance tricks. Because it is high-income taxpayers who have the biggest incentive and the best opportunity to use special tricks to exploit tax-rate differentials, applying the same tax rate to these taxpayers for all of their income in all years is the most important goal of flat-rate taxation.

Our proposal is based squarely on the principle of consumption taxation. Saving is untaxed. We solve the problem that has perplexed the designers of the current tax system, which now contains an incredible hodgepodge of savings and investment incentives. As a general matter, the current system puts substantial taxes on the earnings from savings. On that account, the economy is biased toward too little saving and too much consumption. But Congress has inserted a number of special provisions to spur saving. Most importantly, saving for retirement is excused from current taxation. Workers are not taxed on the amount their employers contribute to pension funds, and the employers can deduct those contributions. The self-employed can take advantage of the same opportunity with Keogh, IRA, and SEP plans. The overall effect of the existing incentives is spotty—there are excessive incentives for some saving-investment channels and inadequate incentives for others. In our system, there is a single, coherent provision for taxing the return to saving. All income is taxed but the earnings from saved income are not taxed further.

We believe that the simplicity of our system is a central feature. Complex tax forms and tax laws do more harm that just the deforestation of America. Complicated taxes require expensive advisers for taxpayers and equally expensive reviews and audits by the government. A complex tax invites the taxpayer to search for a special feature to exploit to the disadvantage of the rest of us. And complex taxes diminish confidence in government, inviting a breakdown in cooperation with the tax system and the spread of outright evasion.

AN INTEGRATED FLAT TAX

Our flat tax applies to both businesses and individuals. Although our system has two separate tax forms—one for business income and the other for wages and salaries—it is an integrated system. When we speak of its virtues, like its equal taxation of all types of income, we mean the system, not one of its two parts. As we will explain, the business tax is not just a replacement for the existing corporate income tax. It covers all businesses, not just corporations. And it covers interest income, which is currently taxed under the personal income tax.

In our system, all income is classified as either business income or wages (including salaries, and retirement benefits). The system is airtight. Taxes on both types of income are equal. The wage tax has features to make the overall system progressive. Both taxes have postcard forms. The low tax rate of 19 percent is enough to match the revenue of the federal tax system as it existed in 1993, the last full year of data available as we write.

Here is the logic of our system, stripped to basics: We want to tax consumption. The public does one of two things with its income—spend it or invest it. We can measure consumption as income minus investment. A really simple tax would just have each firm pay tax on the total amount of income generated by the firm less that firm's investment in plant and equipment. The value-added tax works just that way. But a value-added tax is unfair because it is not progressive. That's why we break the tax into two pieces. The firm pays tax on all of the income generated at the firm except the income paid to its workers. The workers themselves pay tax on what they earn. And the tax they pay is progressive.

To measure the total amount of income generated at a business, the best approach is to take the total receipts of the firm over the year and subtract the payments the firm has made that are not part of the income generated. This approach guarantees a comprehensive tax base. The successful value-added taxes in Europe work just this way. The base for the business tax is the following:

Total revenue from sales of goods and services

less

purchases of inputs from other firms

less

wages, salaries, and pensions paid to workers

less

purchases of plant and equipment

The other piece is the wage tax. Each family pays 19 percent of its wages, salary, and pension income over a family allowance. The allowance makes the system progressive. The base for the compensation tax is total wages, salaries, and retirement benefits less the total amount of family allowances.

In 1993 the revenue from the corporate income tax, with a tax rate of 34 percent, was $118 billion. The revenue from our business tax at a rate of only 19 percent would have been $362 billion, just over three times as much, even though the tax rate is not much over half the current corporate rate. There are three main reasons that the flat business tax yields much more revenue than does the existing corporate tax. First, slightly more than half of business income is from non-corporate businesses—professional partnerships, proprietorships, and the like. Second, our business tax does not permit the deduction of interest paid by businesses, whereas the corporate income tax does permit that deduction. Third, the business tax puts a tax on fringe benefits, which escape any taxation in the current system.

The substantial revenue the government would derive from the flat business tax is the key to the fairness of our tax system. Because most business income goes to the rich, putting an airtight tax of 19 percent on that income permits a lowering of taxes and tax rates on working people.

The other side of the coin, of course, is that our wage tax would have yielded less revenue than does the current personal income tax—$265 billion in 1993 as against $510 billion. We are not proposing a massive shift in taxes from wages to capital income. Our wage tax applies just to wages, salaries, and private pensions, whereas today's personal income tax includes unincorporated business income, dividends, interest, rent, and many other kinds of income that we tax as part of business income. The switch to the more reliable principle of taxing business income at the source, rather than hoping to catch the income at the destination, is the main reason that the business tax yields so much more revenue than does the corporate tax.

The Individual Wage Tax

The individual wage tax has a single purpose—to tax the large fraction of total income that employers pay as cash to their workers. It is not a tax system by itself, but is one of the two major parts of the complete system. The base of the tax is defined narrowly and precisely as actual payments of wages, salaries, and pensions.

The tax form for our wage tax is self-explanatory. To make the tax system progressive, only earnings over a personal or family allowance are taxed. The allowance is $25,500 for a family of four in 1995, but would rise along with the cost of living in later years. All the taxpayer has to do is report total wages, salaries, and pensions at the top, compute the family allowance based on marital status and number of dependents, subtract the allowance, multiply by 19 percent to compute the tax, take account of withholding, and pay the difference or apply for a refund. For about 80 percent of the population, filling out this postcard once a year would be the only effort needed to satisfy the Internal Revenue Service. What a change from the many pages of schedules the typical frustrated taxpayer fills out today!

Form 1 — **Individual Wage Tax** — **1995**

Your first name and initial (if joint return, also give spouse's name and initial) | Last name | Your social security number

Present home address (number and street including apartment number or rural route) | Spouse's social security no.

City, town, or post office, state, and ZIP code | Your occupation> | Spouse's occupation>

1	Wages and salary	1	
2	Pension and retirement benefits	2	
3	Total compensation (line 1 plus line 2)	3	
4	Personal allowance		
	(a) ☐ $16,500 for married filing jointly	4(a)	
	(b) ☐ $9,500 for single	4(b)	
	(c) ☐ $14,000 for single head of household	4(c)	
5	Number of dependents, not including spouse	5	
6	Personal allowances for dependents (line 5 multiplied by $4,500)	6	
7	Total personal allowances (line 4 plus line 6)	7	
8	Taxable compensation (line 3 less line 7, if positive; otherwise zero)	8	
9	Tax (19% of line 8)	9	
10	Tax withheld by employer	10	
11	Tax due (line 9 less line 10, if positive)	11	
12	Refund due (line 10 less line 9, if positive)	12	

For the 80 percent of taxpayers who don't run businesses, the individual wage tax would be the only tax to worry about. Many features of current taxes would disappear. We will discuss these disappearances in detail later. They include charitable deductions, mortgage interest deductions, capital gains taxes, dividend taxes, and interest taxes. Anyone who is self-employed or pays expenses directly in connection with making a living will need to file the business tax in order to get the proper deduction for expenses. Fortunately, the business tax form is even simpler than the wage tax form.

Again, we stress that the wage tax is not a complete income tax on individuals. It taxes only wages, salaries, and pensions. The companion business tax picks up all other components of income. Together they form an airtight tax system.

The Business Tax

It's not the purpose of the business tax to tax businesses. Fundamentally, people pay taxes, not businesses. The idea of the business tax is to collect the tax that the owners of a business owe on the income produced by the business. Collecting business income tax at the source of the income avoids one of the biggest causes of leakage in the tax system today: Interest can pass through many layers where it is invariably deducted when it is paid out, but not so frequently reported as income.

Airtight taxation of individual business income at the source is possible because we already know the tax rate of all of the owners of the business—it is the common flat rate paid by all taxpayers. If the tax system has graduated rates, taxation at the source becomes a problem. If each owner is to be taxed at that owner's rate, the business would have to find out the tax rate applicable to each owner, and apply that rate to the income produced in the business for that owner. But this is only the beginning of the problem. The IRS would have to audit a business and its owners together in order to see that the owners were reporting the correct tax rates to the business. Further, suppose one of the owners made a mistake, and later was discovered to be in a higher tax bracket. Then the business would have to refile its tax form to collect the right tax. Obviously this wouldn't work. Business taxes have to be collected at the destination, from the owners, if graduated rates are to be applied. Source taxation is only practical when a single rate is applied to all owners. Because source taxation is so much more reliable and inexpensive, there is a powerful practical argument for using a single flat rate for all business income.

The business tax is a giant, comprehensive withholding tax on all types of income other than wages, salaries, and pensions. It is carefully designed to tax every bit of income outside of wages, but to tax it only once. The business tax does not have deductions for interest payments, dividends, or any other type of payment to the owners of the business. As a result, all income that people receive from business activity has already been taxed. Because the tax has already been paid, the tax system does not need to worry about what happens to interest, dividends, or capital gains after these types of income leave the firm. The resulting simplification and improvement in the tax system is enormous. Today, the IRS receives over a billion Form 1099s to keep track of interest and dividends. It takes an overwhelming effort to match these forms to the 1040s filed by the recipients. The only reason for a Form 1099 is to track income as it makes its way from the business where it originates to the ultimate recipient. Not a single Form 1099 would be needed under a flat tax with taxation of business income at the source.

The way that we have chosen to set up the business tax is not at all arbitrary—on the contrary, it is dictated by the principles we set forth at the beginning of this testimony. The tax would be assessed on all the income originating in a business, but not on any income that originates in other businesses, nor would it tax the wages, salaries, and pensions paid to employees. All of a business's income derives from the sale of its products and services. On the top line of the business tax form (our Form 2) goes the gross sales of the business—its proceeds from the sale of all of its products. But some of the proceeds come from the resale of inputs and parts the firm purchased; the tax has already been paid on these items because the seller also has to pay the business tax. So the firm can deduct the cost of all the goods, materials, and services it purchases for the purpose of making the product it sells. In addition, it can deduct its wages, salaries, and pensions, for the taxes on these will be paid by the workers receiving them, under our wage tax. Finally, the business can deduct all its outlays for plant, equipment, and land. A little later we will explain why this investment incentive is just the right one.

Form 2	Business Tax		1996
Business Name			Employer Identification Number
Street Address			County
City, State, and ZIP Code			Principal Product
1	Gross revenue from sales	1	
2	Allowable costs		
	(a) Purchases of goods, services, and materials	2(a)	
	(b) Wages, salaries, and pensions	2(b)	
	(c) Purchases of capital equipment, structures, and land	2(c)	
3	Total allowable costs (sum of lines 2(a), 2(b), 2(c))	3	
4	Taxable income (line 1 less line 3)	4	
5	Tax (19% of line 4)	5	
6	Carry-forward from 1994	6	
7	Interest on carry-forward (6% of line 6)	7	
8	Carry-forward into 1995 (line 6 plus line 7)	8	
9	Tax due (line 5 less line 6, if positive)	9	
10	Carry-forward to 1996 (line 6 less line 5, if positive)	10	

Everything left from this calculation is the income originating in the firm, and is taxed at the flat rate of 19 percent. In most businesses, a lot is left, so the prospective revenue from the business tax is the $362 billion we computed earlier. Many deductions allowed to businesses under current laws are eliminated in our plan, including interest payments and fringe benefits. But our exclusion of these deductions is not an arbitrary move to increase the tax base. In all cases, the elimination of deductions, when combined with the other features of our system, moves toward the goal of taxing all income once at a common, low rate and to achieve a broad consumption tax.

Eliminating the deduction for interest paid by businesses is a central part of our general plan to tax business income at the source. It makes sense because we propose not to tax interest received by individuals. The tax that the government now hopes (sometimes in vain) that individuals will pay will assuredly be paid by the business itself.

We sweep away the whole complicated apparatus of depreciation deductions, but we replace it with something more favorable for capital formation, an immediate 100 percent first-year tax write-off of all investment spending. Sometimes this approach is called expensing of investment; it is standard in the value-added approach to consumption taxation. In other words, we don't deny depreciation deductions, we enhance them. More on this shortly.

Fringe benefits are outside the current tax system entirely, which makes no sense. The cost of fringes is deductible by businesses, but workers are not taxed on the value of the fringes. Consequently, fringes have a big advantage over cash wages. As taxation has become heavier and heavier, fringes have become more and more important in the total package offered by employers to workers—fringes were only 1.2 percent of total compensation in 1929 when income taxes were unimportant, but reached almost 18 percent in 1993. The explosion of fringes is strictly an artifact of taxation, and fringes are an economically inefficient way to pay workers. Were the tax system neutral, with equal taxes on fringes and cash, workers would rather take their income in cash and make their own decisions about health and life insurance, parking, exercise facilities, and all the other things they now get from their employers without much choice. Further, failing to tax fringes means taxes on other types of income are all the higher. Bringing all types of income under the tax system is essential for low rates.

Under our system, each business would file a simple form. Even the largest business—the General Motors Corporation in 1993, with $138 billion in sales—would fill out our simple postcard form. Every line on the form is a well-defined number obtained directly from the business's accounting records. Line 1, gross revenue from sales, is the actual number of dollars received from the sales of all the products and services sold by the business, plus the proceeds from the sale of plant, equipment, and land. Line 2a is the actual amount paid for all the inputs bought from other businesses necessary for the operation of the business (that is, not passed on to its workers or owners). The firm could report essentially any purchase provided the purchase was actually needed for the business's operations and was not part of the compensation of workers or owners. Line 2b is the actual cash put in the hands of workers and former workers. All the dollars deducted on this line will have to be reported by the workers on their Form 1 wage tax returns. Line 2c reports purchases of new and used capital equipment, buildings, and land. Note that the firm won't have to agonize over whether a screwdriver is a capital investment or a current input—both are deductible, and the IRS won't care which line it will appear on. The taxable income computed on line 4 bears little resemblance to anyone's notion of profit. The business tax is not a profit tax. When a company is having an outstanding year in sales and profits but is building new factories to handle rapid growth, it may well have a low or even negative taxable income. That's fine—later, when expansion slows but sales are at a high level, the income generated will be taxed at 19 percent.

Because the business tax treats investment in plant, equipment, and land as an expense, companies in the start-up period will have negative taxable income. But the government will not write a check for the negative tax on the negative income. Whenever the government has a policy of writing checks, clever people abuse the opportunity. Instead, the negative tax would be carried forward to future years, when the business should have positive taxable income. There is no limit to the number of years of carry-forward. Moreover, balances carried forward will earn the market rate of interest (6 percent in 1995). Lines 6 through 10 show the mechanics of the carry-forward process.

INVESTMENT INCENTIVES

The high rates of the current tax system significantly impede capital formation. On this point almost all experts agrees. The government's solution to the problem has been to pile one special investment or saving incentive on top of another, creating a complex and unworkable maze of regulations and tax forms. Existing incentives are appallingly uneven. Capital projects taking full advantage of depreciation deductions and the deductibility of interest paid to organizations exempt from income tax may actually receive subsidies from the government, rather than being taxed. But equity-financed projects are taxed heavily. Investment incentives severely distort the flow of capital into projects eligible for debt finance.

Our idea is to start over by throwing away all of the present incentives and replacing them with a simple, uniform principle—the total amount of investment will be treated as an expense in the year it is made. The entire incentive for capital formation is on the investment side, instead of the badly fitting split in the current tax system between investment incentives and saving incentives. The first virtue of this reform is simplicity. Businesses and government need not quarrel, as they do now, over what is an investment and what is a current expense. The distinction doesn't matter for the tax. Complicated depreciation calculations, carrying over from one year to the next, driving the small business owner to distraction, will vanish from the tax form. The even more complicated provisions for recapturing depreciation when a piece of equipment or a building is sold will vanish as well, to everyone's relief.

Expensing of investment has a much deeper rationale than simplicity. Every act of investment in the economy ultimately traces back to an act of saving. A tax on income with an exemption for saving is in effect a tax on consumption, for consumption is the difference between income and saving. Consumption is what people take out of the economy; income is what people contribute. A consumption tax is the exact embodiment of the principle that people should be taxed on what they take out, not what they put in. The flat tax, with expensing of investment, is precisely a consumption tax.

Expensing investment eliminates the double taxation of saving; this is another way to express the most economically significant feature of expensing. Under an income tax, people pay tax once when they earn and save and again when the savings earn a return. With expensing, the first tax is abolished. Saving is, in effect, deducted in computing the tax. Later, the return to the saving is taxed through the business tax. Although economists have dreamt up a number of other ways to eliminate double taxation of saving (involving complicated record keeping and reporting by individuals), the technique exploited in our flat tax is by far the most straightforward.

In our system, any investment, in effect, would have the same economic advantage that a 401K, IRA, or Keogh account has in the current tax system. And we achieve this desirable goal by reducing the amount of record keeping and reporting. Today, taxpayers have to deduct their Keogh-IRA contributions on their Form 1040s and then they have to report the distributions from the funds as income when they retire. Moreover, proponents of the "cash-flow" consumption tax would extend these requirements to all forms of saving. Our system would accomplish the same goal without any forms or record keeping.

CAPITAL GAINS

Capital gains on rental property, plant, and equipment would be taxed under the business tax. The purchase price would be deducted at the time of purchase, and the sale price would be taxed at the time of the sale. Every owner of rental real estate would be required to fill out the simple business tax return, Form 2.

Capital gains would be taxed exclusively at the business level and not at the personal level. In other words, our system would eliminate the double taxation of capital gains inherent in the current tax system. To see how this works, consider the case of the common stock of a corporation. The market value of the stock is the capitalization of its future earnings. Because the owners of the stock will receive their earnings after the corporation has paid the business tax, the market capitalizes after-tax earnings. A capital gain occurs when the market perceives that prospective after-tax earnings have risen. When the higher earnings materialize in the future, they will be correspondingly taxed. In a tax system like the current one, with both an income tax and a capital gains tax, there is double taxation. To achieve the goal of taxing all income exactly once, the best answer is to place an airtight tax on the income at the source. With taxation at the source, it is inappropriate and inefficient to tax capital gains as they occur at the destination.

Another way to see that capital gains should not be taxed separately under the flat tax is to look at the national income accounts. Gross domestic product, the most comprehensive measure of the nation's command over resources, does not include capital gains. The base of the flat tax is GDP minus investment, that is, consumption. To include capital gains in the flat-tax base would depart from the principle that it is a tax on consumption.

Capital gains on owner-occupied houses are not taxed under our proposal. Very few capital gains on houses are actually taxed under the current system—gains can be rolled over, there is an exclusion for older home sellers, and gains are never taxed at death. Exclusion of capital gains on houses makes sense because state and local governments put substantial property taxes on houses in relation to their values. Adding a capital gains tax on top of property taxes is double taxation in the same way that adding a capital gains tax on top of an income tax is double taxation of business income.

IMPORTS, EXPORTS, AND MULTINATIONAL BUSINESS

With NAFTA and the growth of trade throughout the world, U.S. companies are doing more and more business in other countries, and foreign companies are increasingly active here. Should the U.S. government try to tax business operations in other countries owned by Americans? And should it tax foreign operations in the United States? These are increasingly controversial questions. Under the current tax system, foreign operations of U.S. companies are taxed in principle, but the taxpayer receives a credit against U.S. taxes for taxes paid to the country where the business operates. Because the current tax system is based on a confused combination of taxing some income at the origin and some at the destination, taxation of foreign operations is messy.

Under the consistent application of taxing all business income at the source, the flat tax embodies a clean solution to the problems of multinational operations. The flat tax applies only to the domestic operations of all businesses, whether of domestic, foreign, or mixed ownership. Only the revenue from the sales of products within the United States plus the value of products as they are exported would be reported on line 1 of the business tax Form 2. Only the costs of labor, materials, and other inputs purchased in the United States or imported to the United States would be allowable on line 2 as deductions for the business tax. Physical presence in the United States is the simple rule that determines whether a purchase or sale is included in taxable revenue or allowable cost.

To see how the business tax would apply to foreign trade, consider first an importer selling its wares within the United States. Its costs would include the actual amount it paid for its imports, valued as they entered the country—this would generally be the actual amount paid for them in the country of their origin. Its revenue would be the actual receipts from sales in the United States. Second, consider an exporter selling goods produced here to foreigners. Its costs would be all of the inputs and compensation paid in the United States, and its revenue would be the amount received from sales to foreigners, provided that the firm did not add to the product after it departed the country. Third, consider a firm that sends parts to Mexico for assembly and brings back the final product for sale in the United States. The value of the parts as they leave here would count as part of the revenue

of the firm, and the value of the assembled product when it was returned would be an expense. The firm would not deduct the actual costs of its Mexican assembly plant.

Under the principle of only taxing domestic activities, the U.S. tax system would mesh neatly with the tax systems of our major trading partners. If every nation used the flat tax, all income throughout the world would be taxed once and only once. Because the basic principle of the flat tax is already in use in the many nations with value-added taxes, a U.S. flat tax would harmonize nicely with those foreign tax systems.

Application of the wage tax, Form 1, in the world economy would follow the same principle. All earnings from work in the United States would be taxed, irrespective of the worker's citizenship, but the tax would not apply to the foreign earnings of Americans.

Choices about the international location of businesses and employment are influenced by differences in tax rates. The United States, with a low tax rate of 19 percent, would be much the most attractive location among major industrial nations from the point of view of taxation. Although the flat tax would not tax the overseas earnings of American workers and businesses, there is no reason to fear an exodus of economic activity. On the contrary, the favorable tax climate in the United States would draw in new business from everywhere in the world.

THE TRANSITION

In this testimony, we lay out a good, practical tax system. We have not made concessions to the political pressures that may well force the nation to accept an improved tax system that falls short of the ideal we have in mind. One area where the political process is likely to complicate our simple proposal is the transition from the current tax to the flat tax. The transition issues that are likely to draw the most attention are depreciation and interest deductions. In both cases, taxpayers who made plans and commitments before the tax reform will cry loudly for special provisions to continue the deductions.

Congress will face a choice between denying taxpayers the deductions they expected before tax reform or granting the deductions and raising the tax rate to make up for the lost revenue. Fortunately, this is a temporary problem. Once existing capital is fully depreciated and existing borrowing paid off, any special transitions provisions can be taken off the books.

Depreciation Deductions

Existing law lets businesses deduct the cost of an investment on a declining schedule over many years. From the point of view of the business, multiyear depreciation deductions are not as attractive as the first-year write-off prescribed in the flat tax. No business will complain about the flat tax as far as future investment is concerned. But businesses may well protest the unexpected elimination of the unused depreciation they thought they would be able to take on the plant and equipment they installed before the tax reform. Without special transition provisions, these deductions would simply be lost.

How much is at stake? In 1992, total depreciation deductions under the personal and corporate income taxes came to $597 billion. At the 34 percent rate for most corporations (which is close to the rate paid by the individuals who are likely to take deductions as proprietors or partners), those deductions were worth $192 billion. At the 19 percent flat rate, the deductions would be worth only $108 billion.

If Congress chose to honor all unused depreciation from investment predating tax reform, it would take about $597 billion out of the tax base for 1995. In order to raise the same amount of revenue as our original 19 percent rate would, the tax rate would have to rise to about 20.1 percent.

Honoring past depreciation would mollify business interests, especially in industries with large amounts of unused depreciation for past investment but little prospect of large first-year write-offs for future investment. In addition, it would buttress the government's credibility in tax matters by carrying through on a past promise to give a tax incentive for investment. On the other had, the move would require a higher tax rate and a less efficient economy in the future.

If Congress did opt to honor past depreciation, it should recognize that the higher tax rate needed to make up for the lost revenue is temporary. Within five years, the bulk of the existing capital would be depreciated and the tax rate should be brought back to 19 percent. From the outset, the tax rate should be committed to drop to 19 percent as soon as the transition depreciation is paid off.

Interest Deductions

Loss of interest deductions and elimination of interest taxation are two of the most conspicuous features of our tax reform plan. Shortly we will discuss the important economic changes that would take place once interest is put on an after-tax basis. During the transition, there will be winners and losers from the change, and Congress is sure to hear from the losers. Congress may well decide to adopt a temporary transitional measure to help them. Such a measure need not compromise the principles of the flat tax or lessen its contribution to improved efficiency.

Our tax reform calls for the parallel removal of interest deduction and interest taxation. If a transitional measure allows the continuation of deductions for interest on outstanding debt, it should also require the continuation of taxation of that interest as income of the lender. If all deductions are completely matched with taxation on the other side, then a transition provision to protect existing interest deductions would have no effect on revenue. In that respect, interest deductions are easier to handle in the transition than are depreciation deductions.

If Congress decides that a transitional measure to protect interest deductions is needed, we suggest the following. Any borrower may choose to treat interest payments as a tax deduction. If the borrower so chooses, the lender must treat the interest as taxable income. But the borrower's deduction should be only 90 percent of the actual interest payment, while the lender's taxable income should include 100 percent of the interest receipts.

Under this transitional plan, borrowers would be protected for almost all of their existing deductions. Someone whose personal finances would become untenable if the mortgage-interest deduction were suddenly eliminated can surely get through with 90 percent of the earlier deduction. But the plan builds in an incentive for the renegotiation of the interest payments along the lines we discussed earlier. Suppose a family is paying $10,000 in annual mortgage interest. They could stick with this payment and deduct $9,000 of it per year. Their net cost, after subtracting the value of their deduction with the 19 percent tax rate, would be $8,290. The net income to the bank, after subtracting the 19 percent tax it pays on the whole $10,000, would be $8,100. Alternatively, the family could accept a deal proposed by the bank: The interest payment would be lowered to $8,200 by rewriting the mortgage. The family would agree to forego their right to deduct the interest, and the bank would no longer have to pay tax on the interest. Now the couple's cost will be $8,200 (instead of $8,290 without the deal) and the bank's income will be $8,200 (instead of $8,100 without the deal). The family will come out $90 ahead and the bank will come out $100 ahead. The deal will be beneficial to both.

One of the nice features of this plan is that it does not have to make any distinctions between old borrowing, existing at the time of the tax reform, and new borrowing, arranged after the reform. Lenders would always require that new borrowers opt out of their deductions and thus would offer a correspondingly lower interest rate. Otherwise, the lender would be saddled with a tax bill larger than the tax deduction received by the borrower.

As far as revenue is concerned, this plan would actually add a bit to federal revenue in comparison to the pure flat tax. Whenever a borrower exercised the right to deduct interest, the government would collect more revenue from the lender than it would lose from the borrower. As more and more deals were rewritten to eliminate deductions and lower interest, the excess revenue would disappear, and we would be left with the pure flat tax.

THE FLAT TAX AND THE ECONOMY

Tax reform along the lines of our simple tax will influence the American economy profoundly: Improved incentives for work, entrepreneurial activity and capital formation will substantially raise national output and the standard of living. Everyone would favor such an economic renaissance. But what about some of the other effects of tax reform? Is it a giveaway to the rich? Will it destroy the housing market by ending mortgage deductions? Can charitable institutions survive without tax deductions for gifts? Can the flat tax end the federal deficit?

Stimulus to Growth

The flat tax at a low, uniform rate of 19 percent will improve the performance of the U.S. economy. Improved incentive to work through increased take-home wages will stimulate work effort and raise total output. Rational investment incentives will raise the overall level of investment and channel it into the most productive areas. And sharply lower taxation of entrepreneurial effort will enhance this most critical input to the economy.

Work Effort

About two thirds of taxpayers today enjoy the low income tax rate of 15 percent enacted in 1986. Under the flat tax, over half of these taxpayers would face zero tax rates because their total family earnings would fall short of the exemption amount ($25,500 for a family of four). The others in this group would face a slight increase in their tax rate on the margin, from 15 percent to 19 percent. The remaining third of taxpayers in 1991 were taxed at rates of 28 and 31 percent, much higher than the flat rate of 19 percent. And the addition of the 39.6 percent bracket in 1993 worsened incentives further. Heavily taxed people earn a disproportionate share of income: In 1991, 58 percent of all earnings were taxed at rates of 28 percent or higher. The net effect of the flat tax with marginal rates of zero and 19 percent would be a dramatic improvement of incentives for almost everyone who is economically active.

One point we need to get straight at the very start is that a family's marginal tax rate determines its incentives for all types of economic activity. There is much confusion on this point. For example, some authors have written that married women face a special disincentive because the marginal tax on the first dollar of her earnings is the same as the marginal tax on the last dollar of her husband's earnings. It is true that incentives to work for a woman with a well-paid husband are seriously eroded by high tax rates. But so are her husband's incentives. What matters for both of their decisions is how much of any extra dollar of earnings they will keep after taxes. Under the U.S. income tax, with joint filing, the fraction either of them takes home after taxes is always the same, no matter how their earnings are split between them.

For the switch from the current tax law to our proposed flat tax, a reasonable projection, in the light of the research on labor supply, is an increase of about 4 percent in total hours of work in the U.S. economy. The increase of 4 percent would be about 1.5 hours per week on the average, but would take the form of second jobs for some workers, more weeks of work per year for others, as well as more hours per week for those working part time. The total annual output of goods and services in the U.S. economy would rise by about 3 percent, or almost $200 billion. That is nearly $750 per person, an astonishing sum. Of course, it might take some time for the full influence of improved incentives to have their effect. But the bottom line is unambiguous: tax reform would have an important favorable effect on total work effort.

Capital Formation

Economists are far from agreement on the impact of tax reform on investment. As we have stressed earlier, the existing system puts heavy tax rates on business income, even though the net revenue from the system is small. These rates seriously erode investment incentives. Erratic investment provisions in the current law and lax enforcement of taxes on business income at the personal level, however, combine to limit the adverse impact. The current tax system subsidizes investment through tax-favored entities such as pension funds, while it taxes

capital formation heavily if it takes the form of new businesses. The result has been to sustain capital formation at reasonably high levels but to channel the investment into inefficient uses.

The most important structural bias of the existing system is the double taxation of business income earned in corporations and paid out to shareholders. Double taxation dramatically reduces the incentive to create new businesses in risky lines where debt financing is not available. On the other side, the existing system places no current tax on investments that can be financed by debt and where the debt is held by pension funds or other nontaxed entities. The result is a huge twist in incentives, away from entrepreneurial activities and toward safe, debt-financed activities.

The flat tax would eliminate the harmful twist in the current tax system. The flat tax has a single, uniform incentive for investment of all types—businesses would treat all purchases of capital equipment and buildings as expenses. As we noted earlier, allowing immediate write-off of investment is the ideal investment incentive. A tax system that taxes all income evenly and allows expensing of investment is a tax on consumption. Two leading public finance economists, Alan Auerbach and Laurence Kotlikoff, estimated that the use of a flat-rate consumption tax in place of an income tax would raise the ratio of capital stock to GDP from 5.0 to 6.2. Other economists are less optimistic that the correction of the double taxation of saving would provide the resources for this large an increase in investment. But all would agree that there would be some favorable effect on capital formation.

In terms of added GDP, the increase in the capital stock projected by Auerbach and Kotlikoff would translate into 6 percent more goods and services. Not all of this extra growth would occur within the seven-year span we are looking at. But, even allowing for only partial attainment in seven years and for a possible overstatement in their work, it seems reasonable to predict a 2 to 4 percent increase in GDP on account of added capital formation within seven years.

Entrepreneurial Incentives and Effort

U.S. economic growth has slowed in the past decade, and surely one of the reasons is the confiscatory taxation of successful endeavors and the tax subsidy for safe, nonentrepreneurial undertakings. There aren't any scholarly studies with quantitative conclusions on the overall benefits from a fundamental shift, but they could be large.

Today's tax system punishes entrepreneurs. Part of the trouble comes from the interest deduction. The people in the driver's seat in the capital market, where money is loaned and borrowed, are those who lend out money on behalf of institutions and those individuals who have figured out how to avoid paying income tax on their interest. These people don't like insecure loans to new businesses based on great new ideas. They do like lending secured to readily marketable assets by mortgages or similar arrangements. It's easy to borrow from a pension fund to build an apartment building, buy a boxcar, put up a shopping center, or anything else where the fund can foreclose and sell the asset in case the borrower defaults. Funds won't lend money to entrepreneurs with new ideas, because they are unable to evaluate what they could sell off in case of a default.

Entrepreneurs can and do raise money the hard way, by giving equity interests to investors. An active venture-capital market operates for exactly this purpose. But the cost to the entrepreneur is high—the ownership given to the financial backers deprives the entrepreneur of the full gain in case things work out well.

So far we have just described the harsh reality of trying to get other people to put money into a risky, innovative business. Even with the best tax system, or no taxes at all, entrepreneurs would not be able to borrow with ordinary bonds or loans and thus capture the entire future profits of a new business. Equity participation by investors is a fact of life. But it is the perverse tax system that greatly worsens the incentives for entrepreneurs. The combination of corporate and personal taxation of equity investments actually is close to confiscation. The owners of a successful new business are taxed first when the profits flow in, at 34 percent, and again when the returns make their way to the entrepreneur and the other owners. All of them are likely to be in the 40 percent bracket for the personal income tax—the combined effective tax rate is close to 60 percent. The entrepreneur first gives a large piece of the action to the inactive owners who put up the capital, and then surrenders well over half of the remainder to the government.

The prospective entrepreneur will likely be attracted to the easier life of the investor who uses borrowed money. How much easier it is to put up a shopping center, borrow from a pension fund or insurance company, and deduct everything paid to the inactive investor.

Today's absurd system taxes entrepreneurial success at 60 percent while it actually subsidizes some leveraged investments. Our simple tax would put the same low rate on both activities. A huge redirection of national effort would follow. And the redirection could only be good for national income. There is nothing wrong with shopping centers, apartment buildings, airplanes, boxcars, medical equipment, and cattle, but tax advantages have made us invest far too much in them, and their contribution to income is correspondingly low. Real growth will come when effort and capital flow back into innovation and the development of new businesses, the areas where confiscatory taxation has discouraged investment. The contribution to income from new resources will be correspondingly high.

Total Potential Growth from Improved Incentives

We project a 3 percent increase in output from increased total work in the U.S. economy, and an additional increment to total output of 3 percent from added capital formation and dramatically improved entrepreneurial incentives. The sum of 6 percent is our best estimate of the improvement in real incomes after the economy has had seven years to assimilate the changed economic conditions brought about by the simple flat tax. Both the amount and the timing are conservative.

Even this limited claim for economic improvement represents enormous progress. By 2002, it would mean each American will have an income about $1900 higher, in 1995 dollars, as a consequence of tax reform.

INCOME DISTRIBUTION AND FAIRNESS

The flat tax would not make everyone better off straightaway. Today, heavy taxation of successful salary earners and entrepreneurs yields quite a bit of revenue, pushing these people out of their most productive undertakings and diverting their attention to tax avoidance. Until a response to improved incentives takes place, it is an obvious mathematical law that lower taxes on some people will have to be made up by higher taxes on others. If tax reform were a zero-sum process, giving relief to some by raising taxes on others, it would be politically unlikely to occur. Revitalization of the economy, with more income to divide between the big earners and the rest, is the point of tax reform. Our flat tax, however, is designed to be fair from the start. It will insulate the poor from all taxation. It will dramatically limit the taxation of wages and salaries, especially among those who are most successful and productive. It will pay for these tax reductions by imposing on business income a sensible tax at a low rate, thus raising the amount of federal revenue collected from businesses.

The current personal and corporate taxes tax wages heavily and business income lightly. The flat tax would reverse this inequity and benefit the great majority of Americans, whose income comes almost entirely in the form of wages. In comparison to the current personal income tax on wages, the flat tax would impose a lower burden on both low earners and high earners. We can't tell if there are any income groups who would pay significantly higher taxes, including the wage taxes they would pay directly and the business taxes they would pay indirectly. This group could not include the poor, who receive almost no business income.

If we are right that improved incentives will actually raise real incomes by 6 percent after seven years, then it won't take too long for the taxpayers who lose at the outset to come out ahead. The worst immediate impact of the flat tax is to reduce after-tax incomes of people who have been aggressive and successful in keeping business income out of the hands of the IRS. The tax rates on their business incomes will rise to 19 percent. But these people are particularly likely to be able to take advantage of the growth of the economy stimulated by improved taxation.

Interest Rates

The flat tax would pull down interest rates immediately. Today's high interest rates are sustained partly by the income-tax deduction for interest paid and the tax on interest earned. The tax benefit ameliorates much of the pain of high interest, and the IRS takes part of the income from interest. Borrowers tolerate high interest rates and lenders require them. The simple tax would permit no deduction for interest paid and put no tax on interest received. Interest payments throughout the economy will be flows of after-tax income, thanks to taxation of business income at the source.

With the simple tax, borrowers will no longer be so tolerant of interest payments, and lenders will no longer be concerned about taxes. The meeting of minds in the credit market, where borrowing equals lending, will inevitably occur at a lower interest rate. Potentially, the fall could be spectacular. Much borrowing comes from corporations and wealthy individuals, who face marginal tax rates of 34 and 40 percent. On the other hand, the wealthy, almost by definition, are the big lenders in the economy. If every lender and every borrower were in the 40 percent bracket, simple logic shows that a tax reform eliminating deduction and taxation of interest would cut interest rates by four tenths—for example, from 10 to 6 percent. But the leakage problem in the United States is so great that the actual drop in interest would be far short of this huge potential. So much lending comes through the devices by which the well-to-do get their interest income under low tax rates that a drop of four tenths would be impossible. Lenders taxed at low rates would be worse off if taxation were eliminated but interest rates fell by that much. The meeting of the minds in an economy with lenders enjoying low marginal rates before reform would have to come at an interest rate well above six tenths of the pre-reform level. But the decline would be at least a fifth—say from 10 percent to 8 percent. Reform would bring a noticeable drop in interest rates.

The decline in interest rates brought about just by putting interest on an after-tax basis would not by itself change the economy very much. To Ford Motors, contemplating borrowing to finance a modern plant, the attraction of lower rates would be offset by the cost of lost interest deductions. But the flat tax will do much more than put interest on an after-tax basis. Tax rates on corporations will be slashed—to a uniform 19 percent from the double taxation of a 34 percent corporate rate on top of a personal rate of up to 40 percent. And investment incentives will be improved through first-year write-off. All told, borrowing for investment purposes will become a better deal. An investment boom is likely to occur. As the boom develops, borrowing will rise and will tend to push up interest rates. In principle, interest rates could rise to their prereform levels, but only if the boom is vigorous. We can't be sure what will happen to interest rates after tax reform, but we can be sure that high-interest, low-investment stagnation will not occur. Either interest will fall or investment will take off.

As a safe working hypothesis, we will assume that interest rates fall in the year after tax reform by about a fifth, say from 10 to 8 percent. We assume a quiescent underlying economy, not perturbed by sudden shifts in monetary policy, government spending, or oil prices. Now, take a look at borrowing decisions made before and after reform. Suppose a pre-reform entrepreneur is considering an investment yielding $1 million a year in revenue and involving $800,000 in interest costs at 10 percent interest. Today the entrepreneur pays a 40 percent tax on the net income of $200,000, giving an after-tax flow of $120,000. After reform, the entrepreneur will earn the same $1 million, and pay $640,000 interest on the same principal at 8 percent. There will be a 19 percent tax on the earnings ($190,000), without deducting interest. After-tax income is $1,000,000 - $640,000 - $190,000 = $170,000, well above the $120,000 before reform. Reform is to the entrepreneur's advantage and to the advantage of capital formation. Gains from the lower tax rate more than make up for losses from denial of the interest deduction.

How can it be that both the entrepreneur and the government come out ahead from the tax reform? They don't—there is one element missing from this accounting. Before the reform, the government collected some tax

on the interest paid by the entrepreneur—potentially as much as 40 percent of the $800,000, but, as our stories about leakage make clear, the government is actually lucky to get a small fraction of that potential.

To summarize, the flat tax automatically lowers interest rates. Without an interest deduction, borrowers require lower costs. Without an interest tax, lenders are satisfied with lower payments. The simple flat tax will have an important effect on interest rates. Lower interest rates will also stimulate the housing market, a matter of great concern to almost everybody.

Housing

Everyone who hears about the flat tax, with no deductions for interest, worries about its effect on the housing market. Won't the elimination of the deduction depress the prices of existing houses and impoverish the homeowner who can only afford a house because of its interest deductions? In all but the long run, house prices are set by the demand for houses, because the supply can only change slowly. If tax reform increases the cost of carrying a house of given value, then demand will fall and house prices will fall correspondingly.

If tax reform had no effects on interest rates, its adverse effect on carrying costs and house values would be a foregone conclusion. Inevitably, the prospective purchaser faced with the loss of the interest deduction would have to settle for a cheaper house. Collectively, the reluctance of purchasers would bring house prices down so that the buyers could afford the houses on the market. But, as we stressed earlier, our tax reform will immediately lower interest rates. And lower rates bring higher house prices, a point dramatically impressed on homeowners in reverse in the early 1980s when big increases in interest severely dampened the housing market. The total effect of reform will depend on the relative strengths of the contending forces—the value of the lost interest deduction against the value of lower interest. There are good reasons to think interest rates would fall by about 2 percentage points—say from 10 to 8 percent for mortgages.

We won't argue that tax reform will stimulate the housing market. But we do feel that the potential effects on house prices are small—small enough to be lost in the ups and downs of a volatile market. Basically, reform has two effects—to reduce interest rates and related costs of funds (and so to stimulate housing and other asset markets) and to deny interest deductions (and so to depress housing). To a reasonable approximation, these influences will cancel each other out.

If tax reform sets off a rip-roaring investment boom, interest rates might rise in the years following the immediate drop at the time of the reform. During this period, when corporations will be competing strongly with home buyers for available funds, house prices would lag behind an otherwise brisk economy. The same thing happened in the great investment boom of the late 1960s. But to get the strong economy and new jobs that go with an investment boom, minor disappointments in housing values would seem a reasonable price. In the long run, higher incomes will bring a stronger housing market.

What about the construction industry? Will a slump in new housing accompany a tax reform that banishes interest deductions, as the industry fears? The fate of the industry depends intimately on the price of existing housing. Were tax reform to depress housing by raising carrying costs, the public's interest in new houses would fall in parallel with its diminished enthusiasm for existing houses. Because tax reform will not dramatically alter carrying costs in one direction or another, it will not enrich or impoverish the construction industry.

So far, we have looked at the way prospective buyers might calculate what value of house they can afford. These calculations are the proximate determinants of house prices. But they have no bearing on the situation of an existing homeowner who has no intention of selling or buying. To the homeowner, loss of the tax deduction would be pure grief.

Our transition proposal takes care of the problem of existing mortgages without compromising the principles of the flat tax or diminishing its revenue. Homeowners would have the right to continue deducting 90 percent of their mortgage interest. Recall that the bank would then be required to pay tax on the interest it received, even though interest on new mortgages would be untaxed. Homeowners could expect to receive attractive propositions from their banks to rewrite their mortgages at an interest rate about three percentage points lower, but without tax deductibility. Even if banks and homeowners could not get together to lower rates, the homeowner could still deduct 90 percent of what he deducted before.

CHARITABLE CONTRIBUTIONS

Deduction of contributions to worthy causes would be a thing of the past under our tax reform. Will the nation stop supporting its churches, hospitals, museums, and opera companies when the tax deduction disappears? We think not. But we should also be clear that incentives matter—the current tax system with high marginal rates and tax deductions provides inappropriately high incentives for some contributions. The immediate effect of tax reform may be a small decline in giving. Later, as the economy surges forward under the impetus of improved incentives for productive activity, giving will recover and likely exceed its current levels.

Tax reform will be a tremendous boon to the economic elite from the start. After all, those with high salaries will benefit directly and immediately from the reduction in the tax rate from 40 percent to 19 percent. Those with lightly taxed business income stand to benefit more indirectly. Their economic activities are severely distorted by the devices and activities they have adopted to avoid taxes. Freed from these distortions, they may well become better off even though they are paying more taxes. For both groups, removal of tax deductions from their favorite cultural activities is a reasonable price to pay. With substantially higher after-tax incomes among their customers as well as donors, the universities and other institutions will make up part or perhaps all of the ground they will lose when tax deductions disappear. □

Chairman ARCHER. Mr. Reynolds, you may proceed.

STATEMENT OF ALAN REYNOLDS, DIRECTOR, ECONOMIC RESEARCH, HUDSON INSTITUTE

Mr. REYNOLDS. Thanks.

A tax system that is friendly to economic progress must, number one, impose the lowest possible marginal tax rates on both capital and human capital, and two, be as neutral as possible between savings and consumption. That applies to both of the major proposals we have heard here today. The Nunn-Domenici proposal has high marginal tax rates, so I score it on one of the two criteria not so well.

No economist who is remotely familiar with research or tax policy really denies that either of these flat taxes on a consumption base would improve long-term economic growth. What the usual claim is, they say there is a tradeoff between efficiency and equity and between growth and fairness. It is as though the tax system should hold the economy back in order to make sure that nobody speeds ahead of anybody else. As the Australians like to put it, mow down the tall poppies; don't sow more seed.

The trouble with this idea of sort of playing Robin Hood with the Tax Code is, there is no evidence that it has ever worked. There was an OECD study in 1985 that concluded, "the evidence for almost all countries suggests that the tax overall has relatively minor effects on income distribution." They found zero effect in the United States. Yet any time any proposed tax change is made that would be conducive to savings, any change—capital gains, lower rates, anything—they are routinely dismissed out of hand by income statistics that are quite primitive.

These tax distribution tables that we use are highly misleading, an exercise in partial equilibrium accounting or bookkeeping. At best, even if they could be purged of errors about how do you handle the corporate tax and that sort of thing, they would only show the immediate, most visible impact of tax changes on annual income and ignore completely the longer run impact on lifetime income.

Punitive tax rates on the return from saving must result in capital becoming more scarce relative to labor. When anything becomes more scarce, capital included, it also becomes more valuable. So before tax returns to capital it must rise by at least enough to compensate for the tax.

For example, if lendable funds become more scarce, those who have already accumulated financial assets can command higher interest rates. If fewer apartments are built because of high taxes on rental income, then the landlords can charge higher rents on the remaining apartments. If fewer young people invest time and tuition on advanced degrees, then those who already have those professional credentials can charge higher fees or command higher managerial salaries.

In short, the tax burden on human capital has shifted to labor and, particularly, unskilled labor. When the ratio of capital to labor falls, so also do productivity and real wages.

This was very well explained by CEA member Joe Stiglitz as early as 1978 in his critique of the estate tax, and as also expanded

in his 1988 textbook. I don't quote him simply because he is a Democrat. Some of my best friends are Democrats, including Bob Hall here.

This is Stiglitz' quote, part of it:

> General equilibrium effects have important distributional consequences. A tax on interest may reduce the supply of savings and this, in turn, may reduce the productivity of workers and their wages. A tax on capital may reduce the supply of capital, thereby increasing the return on capital. The degree of inequality may be increased by such a tax. If, as a result of the income tax, skilled workers supply less labor and investment is discouraged, unskilled labor's productivity and hence their wage will decline.

In short, what Stiglitz is saying here is that what passes for soak the rich taxes on capital or on skills, in the static distribution tables and in media articles are really soak the poor taxes in disguise. We have to consider what happens in the long run to the wages of less skilled workers if tax policy makes savings and skills more scarce. There is nothing particularly fair about an economy that is stagflation prone, deeply dependent on the mercy of foreign savers, and is offering inferior job opportunities.

A flat tax, by contrast, will increase the economy's stock of capital and of human capital, will encourage investment in both, and that reduces the relative income shares of those already endowed with those assets. We are spreading and expanding the wealth at the same time while greatly increasing real tax receipts.

Thank you very much.

Chairman ARCHER. Thank you. That is a lot of excellent information. I wish that I could digest all of it at once.

Mr. REYNOLDS. I do have a prepared testimony which I hope you will look at.

Chairman ARCHER. If your prepared testimony is available, it will be inserted in the record without objection.

[The prepared statement follows:]

TESTIMONY OF ALAN REYNOLDS
HUDSON INSTITUTE

Modern developments in economic theory, such as "optimal tax" and "new growth" theories, stress the importance of incentives to economic progress, emphasizing that (1) marginal tax rates must be kept as low as possible on both capital and human capital, and that (2) tax policy should be as neutral as possible between consumption and savings. Unlike the current tax regime, or some proposed alternatives, the Hall-Rabushka "flat tax" meets both criteria.[1]

Empirical research in the nineties has confirmed what economic logic has long suspected. There is no longer any room for reasonable doubt that, as Mendoza and Tesar put it, "a well conceived tax reform can improve the economy's savings, investment, and growth rates and result in sizable welfare gains."[2] That study cited eight others to demonstrate that point. Another survey by Engen and Skinner referred to a dozen more papers supporting their own finding (based on 107 countries over 15 years) that "a ten percentage point tax increase is predicted to reduce output growth by 3.2 percentage points per annum."[3] World Bank economists Easterly and Rebelo looked at evidence going back to 1870 and recent comparisons between 28 countries, finding "a negative association between [economic] growth and . . . the marginal income tax rate."[4] They also found that "about two thirds of the countries in our sample generated less revenue than would be collected by implementing a linear [flat rate] tax with a rate that coincides with the lowest statutory rate."

I have cited numerous other studies in previous testimony before this committee (January 17, 1995) on the importance of marginal tax rates to labor force participation, intensity of work effort, and investment in human capital (education and training).[5] Work and education incentives are strongly affected by high marginal tax rates resulting from the loss of transfer payments if incomes rise, as well as from the tax code *per se*.[6] Researchers at the IMF, for example, estimate that "an increase of 1 percentage point in either consumption or labor income taxes may induce a reduction in the hours of work between ½ and 1 ½ percentage points."[7]

Skepticism on this power of tax policy to improve the quantity and quality of labor and capital is now largely confined to a few agencies advising Congress and the Executive branch, such as the Congressional Budget Office, Congressional Research Service, Council of Economic Advisers and U.S. Treasury. Economists at these agencies cannot deny that lower marginal tax rates are quite likely to improve capital formation and work incentives. Instead, they typically engage in a highly selective review of obsolescent studies (e.g., neglecting most or all of the recent work just mentioned) in order to insinuate that any beneficial effects from lower marginal tax rates on labor and savings are highly uncertain and not worth the trouble of estimating.[8] The inference that Congress should not act in the absence of a total "consensus" among economists amounts to saying that Congress should never do anything (because there will always be a few stubborn or ill-informed economists).

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[1] The Nunn-Domenici "USA Tax" imposes extremely high *marginal* tax rates at quite modest income levels, on both labor income and returns on savings, though amounts saved would be exempt.

[2] Enrique G. Mendoza & Linda L. Tesar, "Supply Side Economics in a Global Economy," National Bureau of Economic Research [NBER] Working Paper No. 5986, April 1995.

[3] Eric M. Engen & Jonathon Skinner, "Fiscal Policy and Economic Growth," NBER Working Paper No. 4223, December 1992.

[4] William Easterly and Sergio Rebelo, "Fiscal Policy and Economic Growth: An Empirical Investigation," paper presented to a World Bank conference, Washington D.C., February 8-9, 1993.

[5] Another even newer example of this large body of evidence is Nada Eissa, "Taxation and Labor Supply of Married Women: The Tax Reform Act of 1986 as a Natural Experiment," NBER Working Paper No. 5023, February 1995.

[6] Marginal tax rates of 49-75% for most recipients of the Earned Income Tax Credit are a serious disincentive to work, but would be alleviated by the enlarged personal exemption under a flat tax. See Edgar Browning, "Effects of the Earned Income Tax Credit on Income and Welfare," *National Tax Journal*, March 1995, and John Karl Scholz, "The Earned Income Tax Credit" *National Tax Journal*, March 1994.

[7] E. Mendoza, A. Razin & L. Tesar, "An International Comparison of Tax Systems in Industrial Countries," *Staff Studies for the World Economic Outlook*, IMF, December 1993, p. 101.

[8] In a paper presented to the National Tax Association, Arlington VA, May 22, 1995, Jane Gravelle of the Congressional Research Service says a 1987 paper by Mroz "suggests that errors in statistical techniques *may* be responsible for large responses [of female labor supply to tax rates] found in many previous studies." As Triest points out, "it is important to recall that Mroz's results apply only to [hours worked by] working women," *not* to whether or not marginal rates affect the decision to work. Robert K. Triest, "The Efficiency Cost of Increased Progressivity," in Joel Slemrod, ed., *Tax Progressivity and Income Inequality*, Cambridge University Press, 1994, p. 142.

This sort of appeal to ignorance is often buttressed by faulty theoretical speculations. It is often said, for example, that people may decide to work less, rather than more, in response to lower taxes, because they could have just as much after-tax income as before with less work. However, that argument confuses a revenue-neutral reduction in *marginal* tax rates with a revenue-losing "tax cut" that is unrelated to productive behavior. If average tax burdens remain the same while marginal rates decline, any "tax cut" applies only to *increases* in income (e.g., from saving or improving skills). If a majority of people worked less and/or saved less, the economy would produce less real income per person, leaving no possibility for a so-called "income effect" for the economy as a whole.[9]

Partial Equilibrium Revenue Estimates

> The information and advice that policy makers receive often ignores valuable lessons that academic research, and indeed very basic economic reasoning, can provide. . . . There is little rationale for discarding partial information in favor of ignorance.[10]

The misinformation that Congress often has to cope with is most mischievous in the case of partial equilibrium analyses of the effect of tax changes on revenue and income distribution. In the process of drafting 1986 Tax Reform Act, for example, faulty estimates of revenue and tax incidence led to the notion that lower marginal tax rates on labor income must be offset by higher tax rates on the returns to capital -- pension contribution, profits and capital gains. Yet revenue growth turned out to be unexpectedly rapid where tax rates were reduced (the individual income tax) and surprisingly disappointing where tax rates were increased (corporate profits and capital gains). In this case and many others in the eighties (e.g., passive loss provisions, alternative minimum taxes for corporations), estimated revenues from highly inefficient "tax increases" were greatly exaggerated, if not invisible, due to inadequate consideration of behavioral responses.[11] After two seemingly large increases in marginal tax rates on upper-income individuals, enacted in 1990 and 1993, revenues from the individual income tax fell from 8.6% of GDP in 1989 to 8.2% in 1994.

> To avoid accounting for behavioral savings and labor supply responses when making policy forecasts . . . cannot be justified based on existing studies.[12]

In the process of estimating revenues (and also of estimating the *distributional* effects of tax changes), it is *always* assumed that tax policy has no effect at all on real GDP, labor supply, savings, interest rates, stock prices, capital flows, exchange rates, or any other "macroeconomic" variables. Although revenue estimators have begun to include a few *micro*economic behavioral responses (such as capital gains realizations), no microeconomic efficiency gain or loss is ever permitted to have any effects on the overall economy, or even on the extent of tax avoidance. For such reasons, revenue estimates *always* exaggerate gains from higher tax rates, and *always* exaggerate losses from lower tax rates. The reasons for these systematic errors go far beyond the question of whether the estimates are static or dynamic. Although revenue estimating procedures remain unduly secretive (the mysterious "black box" technique), they do not appear to ask even the most obvious questions -- such as the impact of estate planning on receipts from the income tax, the impact of corporate taxes on debt-equity ratios (leverage), or the impact of capital gains taxes on asset values and national wealth.

When estimating what tax rate would be needed under a flat tax, even proponents of such a reform adopt the usual "static" procedure. That is, they start with some recent measure of *existing* labor and business income, subtract exemptions and business deductions, and then calculate what average rate on the remaining tax base would yield as much revenue as current taxes on incomes and estates. This technique wrongly assumes that the amount of income earned and reported would be no higher

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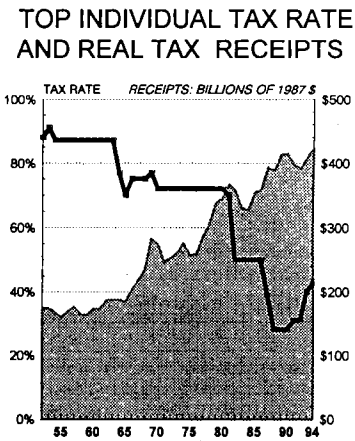
[9] Alan Reynolds, "Marginal Tax Rates" in David R. Henderson, ed., *The Fortune Encyclopedia of Economics*, Warner, 1993.

[10] Alan J. Auerbach, "Public Finance in Theory and Practice," *National Tax Journal*, December 1993.

[11] Alan J. Auerbach, "Tax Projections and the Budget: Lessons from the 1980s," NBER Working Paper No. 5009, February 1995.

[12] William C. Randolph & Diane Lim Rogers (Congressional Budget Office) "The Implications for Tax Policy of Uncertainty About Labor Supply and Savings Responses," paper presented at the National Tax Association, Arlington VA, May 22-23, 1995.

than it is now. A huge body of research on the behavioral response to taxation tells us with great certainty that the assumption of unchanged income is incorrect. A *maximum marginal tax rate of 20% or less is going to result in a very significant increase in the amount of money income that is reported* for tax purposes.[13] Part of that increase will be due to reduced tax avoidance, and from a shift into cash income and out of perks, stock options and deferred compensation schemes. Some additional increase in the tax base will be due to increased work, savings and investment.[14] There is some controversy over which effect is most important, but there is no doubt at all that the tax base of both individual and business income taxes will expand as the marginal tax rate falls.



Tax Foundation; OMB; Historical Statistics of the U.S.

Figure 1

If "static" estimates conclude that a 19-20% tax rate would be revenue neutral, the reality is that such a rate would actually result in a very substantial increase in real tax receipts over time. As Figure 1 shows, past reductions of high marginal tax rates on individual income (1965-68 and 1982-89) were followed by sustained increases in real receipts from this tax (and other taxes), while periods of higher tax rates (1952-64, 1969-70 and 1990-94) saw little or no lasting increase in real receipts.

Figure 2 shows a similar pattern for the capital gains tax, with real receipts rising whenever the marginal rate fell, and vice-versa.

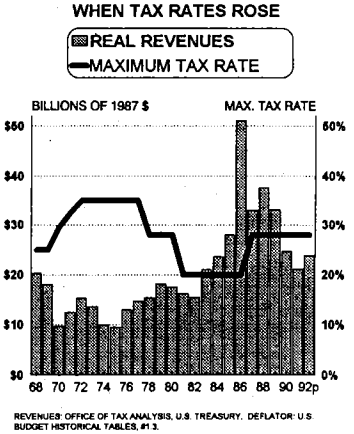


Figure 2

Increases in revenue resulting from a reduction of deadweight losses (such as not trading securities to avoid capital gains tax) or implicit taxes (such as accepting the lower return on tax-exempt bonds) are welcomed by taxpayers. The top 1% gladly paid 27.6% of all federal income tax in 1988, up from 17.9% in 1981. Nobody will gain when "the rich" now pay a shrinking share of taxes in response to the 1993 increase in tax rates. "If, for example, a taxpayer responds to reductions in the marginal tax rate on wages by increasing taxable wage income (e.g., by spending more hours in paid work, or bargaining for a higher share of cash wages in total compensation), then this response increases taxes paid and is also associated with an increase in the taxpayer's well-being."[15]

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[13] Martin Feldstein, "The Effects of Marginal Tax Rates on Taxable Income: A Panel Study of the 1986 Tax Reform Act," NBER Working Paper No. 4496, October 1993.

[14] Hall and Rabushka estimate, quite conservatively, that added work effort and capital formation would raise real GDP by 5-7% within a few years. For any given average tax rate (typically around 19% of GDP), *real* tax receipts would rise by a similar amount, even aside from reduced evasion and substitution of cash income for perks, stock options and the like. Robert Hall & Alvin Rabushka, *The Flat Tax*, Hoover, 1995, pp 86-87.

[15] Richard Kasten, Frank Sammartino & Eric Toder, "Trends in Federal Tax Progressivity, 1980-93," in Slemrod, *op. cit.*, p. 35.

A static approach to estimating a national sales tax suffers the opposite miscalculation from that affecting the flat tax. While static revenue estimates are sure to *over*estimate the tax rate required under a flat tax on labor income and business capital, the same techniques are very likely to *under*estimate the flat rate that would be required on sales. Any additional tax on sales would certainly *reduce sales* and thus shrink the tax base, requiring a substantially higher tax rate than would be assumed by calculating a percentage of today's sales, in the absence of that tax. Since exports are excluded from taxation, any increase in the ratio of exports to GDP would further shrink the base of a sales tax and require a still higher tax rate on domestic consumers. High rates of sales tax, even VAT, are also notoriously prone to smuggling and "bootlegging" (offering a lower price for cash, with no receipt). It is instructive that when Mexico increased the VAT from 10% to 15% in 1995, the tax was left at 10% near the border to avoid losing sales and revenues to the U.S.

The flat tax, by contrast, is as leakproof as can be imagined. Under current law, employers deduct the cost of benefits but employees do not pay taxes on those perks (17% of compensation). Corporations deduct the cost of interest paid, but corporate bonds and commercial paper are often held by tax-exempt institutions or foreigners, who pay no tax on the interest income. Two huge and growing loopholes are effectively closed by applying a low flat tax to gross business income, minus only the cost of wages and capital equipment. The taxation of benefits at the employer level and reduction of marginal tax rates on employee salaries would reverse the trend of negotiating for overly-generous medical benefits, making the flat tax the most cost-effective health reform proposal ever devised. Although the *individual* income tax is conceptually equivalent to a consumption tax, the flat tax on business cash flow is more comparable to a profits tax. And because perks and interest expense are not deductible, the flat business tax is far more *inclusive* than the present tax on business profits (albeit at a lower rate and with expensing for capital).

> The uniformity of [flat] marginal tax rates . . . means that income can be taxed at its source; taxing income at its source will reduce compliance costs and increase compliance rates. . . . Many of the advantages of a flat-rate tax come only from a pure flat-rate tax, not from its modified form. . . . Nick Stern, of the London School of Economics, calculated that the . . . optimal flat-rate tax was 19 percent. . . . Jerry Hausman of M.I.T. claims that by introducing a flat-rate tax, it may be possible to lower the tax rate facing almost all income groups, because the reduction in the distortions would generate such a large increase in labor supply[16]

Alternative proposals for replacing individual and corporate income taxes with a national sales tax do not include *any* direct tax on business income, as the flat tax does. As a result, the sales tax rate would have to be much higher on labor in order to totally exempt income from capital. There would also have to be extremely stern inspection of imports and exports, and of retailing (including flea markets, garage sales and sales of used cars).[17]

Distribution Tables Ignore Tax Shifting

It is unfortunate that tax policy changes that would improve incentives to add to savings or labor income are often blocked by opinions and statistics that give a highly misleading impression about who is really hurt by high tax rates that ostensibly fall on "the rich." There have been complaints, for example, that taxpayers earning more than $100,000 would receive 52% of the benefits from the recent House tax bill.[18] This is scarcely surprising since 43% of all individual income taxes are paid

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[16] Joseph E. Stiglitz, *Economics of the Public Sector*, Norton, 1988, p. 619.& 489. See also why "it may be desirable to have a flat-rate tax" on p. 502, and why a flat rate tax is politically more stable on p. 160n.

[17] "The general view among experts, a view obviously shared by most governments, is that 10 percent may well be the maximum rate feasible under a retail sales tax." Vito Tanzi, *Taxation in an Integrating World*, Brookings Institution, 1995, pp. 50-51.

[18] Steven Pearlstein, "Widening the Income Gap: Tax, Spending Cuts May Add to Inequality," *The Washington Post*, May 29, 1995. An accompanying chart shows that the 22% of families earning more than $75,000 receive 50% of pretax income, which is just another way of saying they produce 50% of national output.

by the 4% of tax returns reporting incomes above $100,000.[19] A distribution-neutral tax reduction, which returned taxes in the exact proportion paid, would undoubtedly be attacked as conferring 43% of the benefits to "the rich," and doing nothing for those who pay no taxes. Any change in the tax code designed to improve savings is bound to be most helpful to those who save. And those who save are bound to have higher incomes later in life (e.g., dividends, interest income, and capital gains) than those with similar salaries who do not save. Any proposal that hopes to increase saving without benefitting those who do most of the saving is sure to fail.

What is most misleading about the typically emotional, non-analytical popular discussions of the "fairness" issue is the failure to consider *what happens to wages of less-skilled workers if tax policy makes savings and skills more scarce than otherwise*. There is nothing particularly "fair" about a stagnant economy with inferior job opportunities.

The official "distribution tables" that play such a big role in tax policy debates are fundamentally flawed -- to the point of being essentially meaningless. This is not a question of doing a better job with constructing such tables, but of discarding them as unrepairable. The whole concept of distribution tables does not even begin to ask the right questions, so it cannot possibly lead us to the right answers. It is simply an effort to substitute bad accounting for good economics. Even the unquestioned habit of dividing "families" into, say, the highest and lowest fifths of the income distribution is quite suspect when the income floor defining the top 20% is rising because of a larger portion of families earning higher incomes (see Appendix A).

Distribution tables involve many dubious technical problems, such as arbitrarily deciding what share of the corporate tax to assign to labor or to capital (some tables used in the 1986 tax reform debates totally ignored the corporate tax), or how to "impute" the rental value of homes. Arbitrary assumptions, however, are the least of many problems making distribution tables quite useless.

A more serious problem is that annual incomes are a notoriously poor measure of longer-term living standards, or lifetime income. The group with the lowest income in any single year includes, as Fullerton and Rogers point out, "some young workers just starting their careers who will likely earn more later, some retirees who had earned more earlier, [and] some people with volatile incomes who just had a bad year . . ." They found that if you label the top 30% of the population as rich, and the bottom 30% as poor, then *13.8% of those who appear to be poor in any given year will actually be rich over their lifetimes*, while 2.6% of the annually rich are actually poor.[20] Many of today's "poor" are just young people who are trying very hard to become tomorrow's "rich." *High marginal tax rates on the returns to schooling and saving make climbing the income ladder very difficult for newcomers, greasing the rungs on the ladder of opportunity.* Looking at taxes from a lifetime perspective also shows that any consumption-based tax (e.g., the individual flat tax or a single-rate VAT) is proportional, not regressive, because lifetime income is virtually identical to lifetime consumption for most people (the difference is bequests, which make consumption a better tax base than income, because heirs can consume in excess of income by tapping wealth).

Another issue likely to be ignored by any distribution tables is how to account for the very real savings from making the tax code extremely simple. With a flat tax, taxpayers are going to save real money and valuable time -- perhaps $200 billion a year or more -- from not having to keep complicated tax records, buy tax books and software, and hire accountants and tax attorneys. How should that benefit be distributed among income classes?[21] The biggest savings go to those with the most complicated tax forms, but that includes many small businesses and small investors. The biggest losers from tax simplification are an affluent bunch -- lawyers, accountants and tax lobbyists -- but their skills could usually be adapted to more productive pursuits. *All* taxpayers benefit from reduced collection costs. The IRS staff and budget could be greatly reduced and many offices leased or sold.

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[19] The top 4% of tax returns paid 43% of federal income tax in 1993, according to Associated Press calculations But note that the percentage of *tax returns* with incomes above $100,000 is much smaller than the percentage of working people with incomes that high, because millions of people pay *no* income tax, while most joint returns with incomes above $100,000 have at least two full-time salaries per tax return.

[20] Don Fullerton & Diane Lim Rogers, *Who Bears The Lifetime Tax Burden?*, Brookings Institution, 1993, pp. 2 & 26.

[21] I am indebted to Alvin Rabushka for raising this question.

The most fundamental problem with distribution tables, however, is that the longer-run "incidence" of high marginal tax rates on savings and human capital -- who is actually hurt -- is quite different from what the general public has been lead to believe. Distribution tables are an inherently misleading exercise in "*partial equilibrium*" accounting, representing only the *immediate*, most visible impact of tax changes on annual incomes, and totally ignoring the longer-run effects on lifetime incomes.

> Changes in labor supply, savings and investment . . . would affect wage rates and interest rates, which in turn feed back to employment and savings decisions, and then in turn to wage rates and interest rates. . . . It requires a "general equilibrium" model to account for all these effects.[22]

High tax rates on the returns from saving (such as dividends, interest income and capital gains), or on stocks of accumulated capital (estates), must result in capital becoming more scarce, relative to labor. This may even happen fairly quickly, due to "capital flight" to other countries. *When anything becomes more scarce -- including capital or exceptional skill -- it also becomes more valuable.* Before-tax returns to capital rise by at least enough to compensate for the tax, leaving after-tax returns unchanged or higher in the long run (partly because net returns to capital have to be competitive with returns available on international markets).

The ways in which capital taxes raise the pre-tax return to capitalists may be thought of in terms of physical capital (if apartments become more scarce, landlords charge higher rents), or as financial capital (if lendable funds become more scarce, those who have accumulated savings can charge higher interest rates). The main point is that those who already own increasingly scarce capital do not bear the tax in the longer run. In the short run, capital taxes fall more heavily on those who are trying to acquire capital, such as young people trying to start a business or buy a house. The ultimate burden of capital taxes, however, is clearly on labor. *When the ratio of capital to labor stops growing, so do productivity and real wages*

The idea that capital taxes are likely to be shifted to labor should not be surprising to anyone familiar with general equilibrium economics. The point was stated most clearly by Joseph Stiglitz many years ago, in his classic critique of the estate tax:

> The reduction in savings and capital accumulation will, in the long run, lead to a lower capital-labor ratio; and the lower capital-labor ratio will . . . lead to an increase in the share of [national income received by] capital. Since income from capital is more unequally distributed than is labor income, the increase in the proportion of income accruing to capital may increase the total inequality of income.[23]

Stiglitz generalized this important point in his 1988 textbook, *Economics of the Public Sector*:

> General equilibrium effects have important distributional consequences . . . A tax on interest may reduce the supply of savings and . . . this in turn may reduce the productivity of workers and their wages. . . . A tax on capital may reduce the supply of capital, thereby increasing the return to capital . . . the degree of inequality may actually be increased by such a tax. . . .
>
> If as a result of the income tax, skilled workers supply less labor and investment is discouraged, unskilled laborers' productivity and, hence, their wage, will decline.
>
> The long-run incidence of a tax on savings (or capital) may be on workers.[24]

In short, what appear to be "soak the rich" taxes on capital or skills (in static, partial equilibrium distribution tables) may well turn out to be "soak the poor" taxes in disguise. This general equilibrium result applies to taxes on estates, capital gains, dividends, and high marginal rates in general.

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[22] Jane G. Gravelle, "Behavioral Feedback Effects and the Revenue Estimating Process," *op. cit.*

[23] Joseph E. Stiglitz, "Notes on Estate Taxes," *Journal of Political Economy*, April 1978

[24] Stiglitz, *Economics of the Public Sector*, op. cit., pp. 393, 493 & 430.

A similar mechanism is at work with high tax rates on *human* capital. Today's steep marginal tax rates on joint returns with incomes above $140,000 are, to a considerable extent, aimed at reducing the return on past investments made in MBA, MD, JD and PhD degrees. The trouble is that fewer people will invest so much time and tuition in higher education in the future if they believe they will face punitive tax rates later, when they finally reap the rewards at mid-life. Trostel estimates that a 1% increase in tax rates eventually leaves the economy with nearly a 1% smaller stock of human capital, with a much stronger effect if marginal tax rates are "progressive" (thus falling most heavily on returns to advanced schooling).[25] Proposed deductions for tuition do not address the main incentive, which is the after-tax *return* on schooling, not the up-front cost. The main cost of schooling is time spent not working. Moreover, a tuition deduction would be useless to less affluent students who pay their own way (through scholarships, loans and work), because they rarely have enough taxable income to benefit from a deduction.

Just as tax-induced scarcity of capital results in the tax burden falling on labor, in the form of lower wages, tax-induced scarcity of human capital is shifted to consumers. Scarce professionals charge higher fees, and scarce managerial talent can command higher salaries. Although the full impact of discouraging investment in human capital may not be felt for a generation, some occurs more quickly through reduced immigration of high skilled and talented people, and increased emigration of such people ("brain drain"). Talent may also be diverted from highly-taxed productive activity toward "underground" activities or rent-seeking (lobbying for government favors, such as import quotas).

Because high tax rates on highly skilled people tend to make skills *relatively* scarce and thus raise *before-tax* incomes for those who already possess such skills, Stiglitz has speculated that a flat tax (though a very big improvement) might not be flat enough:

> If the labor supply of the skilled is relatively elastic, and of the unskilled relatively inelastic, then a uniform [flat] marginal rate on both might increase the before tax relative wage of the skilled; to offset this, one might wish to have a lower marginal tax rate on the skilled.[26]

General equilibrium theory predicts that *as a result of the tax-induced relative scarcity of skilled people, before-tax salaries and fees in skilled occupations will be bid up.* An increased supply of people with professional and managerial skills, by contrast, "places downward pressure on the return to skills, easing, rather than exacerbating, distributional concerns."[27] Ironically, punitive tax rates on "the rich" (i.e., on savers and on human capital) go a long way toward explaining why the distribution of *before-tax* incomes has become less equal in every major "welfare state" of Europe and North America, but not in most Asian NICs, where marginal tax rates are quite low (particularly on capital).

It is not easy to earn a high income. Steeply rising marginal tax rates have a demoralizing impact on those who might otherwise make that difficult struggle, thus making capital and skills artificially scarce and valuable.

By increasing the incentive to save, and to invest time and money in education and training, a flat tax would enlarge the economy's stock of capital and human capital, thus reducing the relative income shares of those who are already endowed with such assets, while increasing real tax receipts and enlarging national wealth in the process.

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[25] Philip A. Trostel, "The Effect of Taxation on Human Capital," *Journal of Political Economy*, April 1993.

[26] Joseph E. Stiglitz, "Pareto Efficient and Optimal Taxation," in Alan Auerbach & Martin Feldstein, eds., *Handbook on Public Economics*, North Holland, 1988.

[27] Mary E. Lovely, "Economic Development in a Global Context," National Tax Association, Arlington VA, May 22-23, 1995.

Appendix A: Income Distribution Statistics Are Fatally Flawed

The 1994 *Green Book*, from the House Ways and Means Committee, shows "average family cash income by family type and income quintile" (Table H-23) for 1973, 1979, 1989 and 1992. The figures for married couples with children are less misleading than total family income, because unmarried mothers have been a rising percentage of all families, making comparisons of family income invalid over long periods of time.

The choice of years is less than ideal, because 1973 and 1979 were cyclical peaks, followed by inflationary recessions that hurt the poor quite badly. Price controls in 1973 also understated measured inflation and thus overstated real incomes. Because inequality always increases in recessions, it would be more reasonable to compare 1992 with other years just after recession, such as 1976 or 1983.

There are many problems with Congressional Budget Office adjustments to Census figures. The CBO includes things that are not real income (realized, nominal capital gains) and excludes things that are (in-kind transfer payments). As a result, "CBO shows income falling in the bottom two quintiles [from 1980 to 1993], while Census shows income rising."[28] Also, any annual snapshot of income ignores wealth and is a poor measure of actual living standards; using consumption or an average of income over several years shows far more "equality" than annual income data.

Taking these figures at face value, with all their flaws, still does not show what many people suppose.

Among married couples with children, the mean average of cash income in the top fifth rose by 16% from 1973 to 1992, which many interpret as proof that "the rich got richer." This is incorrect. Aside from the top 20% (or 1% or 5%) of the income distribution, every other "fifth" has both a floor and a ceiling (the maximum is obviously unlimited at the top). The income floor defining the top 20% is determined by income growth at lower income levels.

As Figure 3 shows, the percentage of families earning more than $50,000 a year (in constant 1992 dollars) rose sharply from 1980 to 1989, and remained fairly high in 1992. The much discussed "vanishing middle class" has been precisely matched by a rising percentage of families earning what had previously been considered a high income.

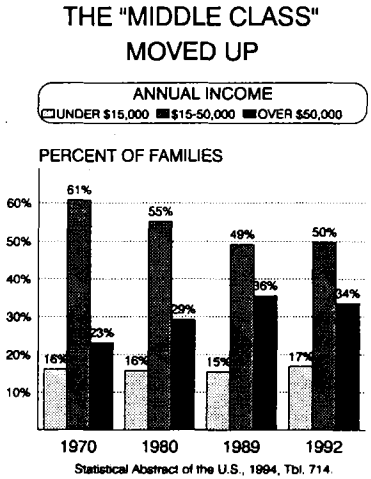


Figure 3

One result of so many more families earning relatively high incomes was to push up the minimum income needed to be counted among the "top 20%." According to the Green Book, the amount of income needed to make it into the top fifth rose from $52,937 in 1973 (measured in 1989 dollars) to $60,895 in 1992. We should scarcely be surprised that a mean average of all income above $60,895 is larger than the average of all income above $52,937. The average in 1992 was 16% larger than it was in 1973 in large part because the floor had been raised by 15%. Since the 1992 average excludes all income between $52,937 and $60,895, while the 1973 figures include those lower incomes, the average had to increase substantially. The "top fifth" turns out to be a moving target.

[28] William G. Gale, "Comments," in Joel Slemrod, ed., *Tax Progressivity and Income Inequality*, Cambridge, 1994, pp. 51-57.

Whenever real wages and salaries are rising, the incomes of those who work are bound to gain relative to those on relatively fixed "cash" incomes (as opposed to in-kind incomes, such as Medicaid and food stamps), including welfare mothers who now dominate the bottom fifth. Comparisons of average real incomes between the top fifth (where the average number of workers exceeds two), and the bottom fifth (where the average number of full-time, full-year workers is close to zero) must necessarily show widening "inequality" whenever employed people are receiving any pay increases that exceed inflation -- unless cash transfer payments are also rising in real terms.

Since there is no ceiling on the income included in the top 20% or 1%, dividing all income above the rising floor by a fixed percentage of the population will necessarily show an increase in mean income in that group whenever a rising percentage of families are earning higher real incomes, thus pushing up the minimum amount of income needed to be counted among the top group. This flaw is fatal. It means that the whole exercise of comparing real income growth by fifths is a statistical hoax.

Appendix B: Attempting To Use Tax Policy To Favor Exporters

One argument in favor of a value-added or retail sales tax (over an income tax that exempts income saved or returns from saving) is that GATT rules would allow such a tax to be rebated when goods were exported. This is supposed to favor exports and thus reduce the U.S. trade and current account deficit. In reality, the current account deficit would decline only if the sales tax proposal was more effective in promoting savings than in encouraging investment (i.e., if U.S. savers invested abroad).

Suppose it was feasible to impose, say, a 16% sales tax on all goods and services. Like any other price increase, this tax would indeed reduce demand for imports, but it would equally reduce demand for domestic products. Rebating the tax at the border (a very costly procedure) would not make U.S. exports any cheaper than they are today, because they do not bear such a tax at the present time.

Because the larger domestic market would shrink as a result of the sales tax, the incentive to invest in capacity for domestic sales would be reduced. Businesses would tend to shift production toward exports -- e.g., making more cars with right-hand drive and fewer with left-hand drive. If the U.S. was operating close to capacity, however, shifting output toward exports would require that a larger share of domestic demand be filled by imports. The U.S. might export more Hondas from Ohio, but also import more Fords and Chryslers from Canada and Mexico.

The U.S. has a chronic current account deficit because savings have been inadequate to finance investment. That investment-savings gap (about $160 billion last year) is filled by an inflow of foreign capital from private investors and/or foreign central banks, so long as they are willing to accumulate dollar-denominated securities and real property. *The impact of any tax reform proposal on the capital surplus and matching current account deficit ultimately depends on its impact on savings and investment.* The flat tax encourages investment through low tax rates on the returns, and through treating purchases of capital equipment no differently than wages (both are immediate expenses). The flat tax also encourages savings by eliminating the double taxation of dividends and triple taxation of capital gains and estates. In my judgement, the longer-run effect on savings is likely to be larger, thus reducing the need to finance investment with foreign savings.

In the short run, though, the value of U.S. stocks, bonds and nonresidential property would undoubtedly rise, reflecting the discounted present value of the reduced marginal tax on returns to capital. Such a bull market would attract considerable foreign investment for a few years, pushing the dollar up (as happened with the capital-friendly tax reform of 1981). The Fed could prudently limit the potentially deflationary impact of the rising dollar by accommodating the demand for dollars at lower interest rates (long-term rates would fall anyway, due to elimination of the "tax premium," making all bonds and mortgages equivalent to tax-exempt bonds). The medium-term effect of a flat tax will be a dramatic increase in U.S. wealth, a reduction of interest rates, and a roaring boom in business investment, tax receipts, domestic savings, and inflows of foreign savings. In the longer run, as the capital stock expands toward a new equilibrium -- increasing capacity to meet both domestic and export demand -- added domestic savings and wealth will begin to displace capital inflows, pushing the current account toward surplus.

Chairman ARCHER. There are so many things I would like to ask you because I think both of you are great resources to this Committee, and we would like to continue to work with you in the months ahead so that we can get your input to try to resolve the best alternative to accomplish the goals that all of us want to see happen.

I am a little bit curious about your comment, Dr. Hall, about border adjustability. I don't have the expertise of an economist like you. I have a business background, and I think some degree of common sense, but certainly not the degree of expertise that you have on economic issues.

If I am able to produce a product in my business and by some fell swoop reduce the price of that product by 15 to 20 percent, so that suddenly I am able to export it for 15 to 20 percent less than what I was charging in the last month, how does that increase the value of the dollar?

Mr. HALL. Well, the dollar, Mr. Chairman, is a price in this instance that is determined relative to other currency, for example, the German deutsche mark in a fluid market. In that market, the value that Germans get for the deutsche mark in exchange for dollars is determined every few minutes and is driven very much by their opportunities to purchase. If suddenly American goods are much cheaper to Germans and, correspondingly, German goods more expensive to Americans because the counterpart border adjustment says that we tax the imports at the VAT tax rate as they come in, and say it is a 20 percent tax rate, then the exchange rate can change by 20 percent instantaneously and leave us where we were before.

That is precisely what will happen. That is what happened, for example, in the British experience.

Chairman ARCHER. I am not speaking now in my hypothetical example of border adjustability of a tax. I am just speaking about the price of my product that I am able to sell now because I have been able to eliminate a certain expense in my operation; therefore I am more efficient, and therefore I am able to sell that product at a 15 to 20 percent lower price.

What I worry about in the macroeconomic description that you give to all of this is that if that is true, then we don't have to worry about countries that have cheaper labor rates that can produce a product that is cheaper, because the currency exchange rates will take care of all that and there is no problem. And I don't think the real, practical, day-to-day economic world works that way.

If, for example, it was going to be taken care of as you say, then when we went through this massive increase in the price of oil in the seventies, the exchange rates would have taken care of that and it would not have had any impact. The relative price of products between what our selling price is as we go overseas and what the price of the incoming foreign product is when our consumers have to purchase it, it seems to me, have not historically been offset. Changes in those relations have not been offset by the value of the currencies.

Let me add one other thing, and maybe this is overly simplistic, but if in fact by border adjustability removing the expense of government, which is an expense of doing business, from the price of the product when we sell it is going to increase the value of the

dollar, don't we need a more stable, more valuable dollar today? Would that not help us? All the complaints I hear from economists today is that the dollar is too soft. We have been talking about artificial means to bolster it and to improve its value.

Mr. HALL. You have raised some very interesting questions. On the last point, I would certainly not be one to say that we should try to do something artificial to the dollar. The mechanism that I described——

Chairman ARCHER. I am not suggesting we should either. But if we had border adjustability in the price of our products and the result was that the dollar improved in value, it seems to me we would be reaching for a goal that right now most economists I have talked to believe would be healthy.

Mr. HALL. Well, it would be a very artificial way to do it, because if we put in border adjustment and then appreciation of the dollar occurred, that would leave us back where we are today. It would just be an artifact of that change that the dollar is worth 20 percent more. It wouldn't really mean anything because when we try to purchase something with those dollars, they turn out to be worth what they used to be worth because we now have to pay a 20 percent import duty that we didn't used to have to pay. So the purchasing power of our dollars in the world market is exactly the same, and that is why the change occurred in the first place.

The other question you raised was, for example, when oil becomes more scarce, as it did when OPEC cut back oil production. There is no way that an exchange rate by itself can deal with the scarcity. Border adjustment doesn't create any scarcity, doesn't affect supply or demand of anything. It is something that can just be immediately accommodated by exchange rates.

On the other hand, when there is less oil being produced, that is something that makes us worse off as an oil consumer, and there is nothing that exchange rates can do. So there is no suggestion here that exchange rates completely insulate us from the world market. That would be impossible. But they do completely offset the effect of border adjustments.

Again, I want to stress I am not against border adjustments. They don't have any harmful effect. It is a neutral issue. I just want to caution anyone against the notion that somehow the U.S. position in the world economy would be different if we had border adjustments as opposed to not having border adjustments. To economists, it is a nonissue. It is not harmful, but it is a nonissue.

Chairman ARCHER. Thank you very much for your response to that.

I had a colloquy with my friend Jack Kemp earlier today, and he said that there is no way that his commission—at least he is reported to have said, and he somewhat confirmed it today—that his commission would recommend a value-added tax and you have described the flat tax that Dick Armey introduced as a VAT tax. Where does Mr. Kemp go?

Mr. REYNOLDS. Maybe I should answer that. I will probably be the research director on his commission.

A lot of this has to do with the way you describe things. Consumption is the base of all the taxes we are talking about in the sense that we are exempting savings, so by definition, that is a con-

sumption tax. That is sort of the sense in which he means, it is much like a value-added tax.

The business portion of—I would not describe the business portion of Hall-Rabushka as a VAT, although that is the portion most would call a VAT. The other part, I certainly would call a consumption-based income tax or an income minus savings tax. The returns from savings at the individual level are gone and the returns from savings at the business level are taxed. One of the biggest loophole-plugging parts of it is that business can no longer deduct interest expense, so leverage is no longer a way to escape business taxation.

I wouldn't worry much about the terminology. We will come up with a good plan and will certainly look at anything you have prepared, or any of the other congressmen who have talked about a consumption tax. Whether a tax is explicitly levied on what we buy as opposed to what we earn is a rather subtle distinction in an economist's mind because all taxes fall on individuals as workers or suppliers of capital. So where we collect it is an issue, but not a critical issue, and it shouldn't be as divisive an issue as it has become.

Chairman ARCHER. I hope that your counsel will be accepted and heard by the members of this commission, because I think that the points that you are making are extremely important.

We could go on forever on this. I am going to recognize Mr. Christensen for inquiry.

Mr. CHRISTENSEN. Thank you, Mr. Chairman. I have one quick question. Yesterday, late in the day, we heard a panel, all four pretty much agreed that a consumption tax would not go after the underground economy as we have been saying it would.

Mr. Reynolds, what is your take on that? What would they base their opinion on?

Mr. REYNOLDS. They seem to equate the underground economy with drug dealers and that is probably a pretty small piece of the puzzle. There is avoidance and evasion by even sophisticated people wearing business suits that testify before this Committee. I wouldn't know of any people like that, but for example, I increased my mortgage, increased my deferred compensation, switched from NASDAQ stocks to munis when this Congress increased the marginal tax rate to 36 percent. This is all perfectly legal tax avoidance strategy.

How do any of these proposals affect that? You are lowering my marginal rate, so I have less incentive to do that sort of thing. When the marginal rate was 28 percent, I didn't even keep records of my business lunches and things of that sort. So really you are getting at the incentive.

There is enormous evidence that tax evasion activity is highly responsive to the tax rate involved. This isn't true of illegal activities, but the sales tax is not going to fix that. You are not going to report the sale of an illegal drug any more than you are going to report the income from it. That is, I think, a poor way to sell that proposal. There will be avoidance of sales with a high sales tax and there will be avoidance of income with a high income tax, and our task is to keep the tax rates down to minimize either type of avoidance.

Does that help?

Chairman ARCHER. Not really. Will you yield to me briefly?

Mr. CHRISTENSEN. Yes.

Chairman ARCHER. It seems to me in that equation you leave out one aspect. It is true that the sale of the drug would not be subject to the tax because it is still illegal and underground, but the proceeds from the sale of the drug, when spent by the recipient of those proceeds, is going to bear a share of the cost of government. If the person who is pushing the drugs illegally gains the money from the sale and buys a Mercedes, they are going to pay a share of the cost of government; whereas today, under the current system or even under the flat tax, they will not pay. Isn't that a fair——

Mr. REYNOLDS. Yes. All of these tax reforms that lower rates, including a sales tax, will reduce avoidance and evasion. That is more important in terms of revenue, vastly more important than the issue of illegal activity.

What is wrong with your example is that most of the customers of the drug lord, if you will, are earning their income in the legal economy and paying income tax, so we are going to free the customer of the tax and get the pusher—that would be OK, but it probably doesn't yield any revenues. Somebody who is a Wall Street broker snorting coke is using aftertax income to buy the coke now. You are going to alleviate his income tax and go after the seller. I see that as a wash and as a nonissue.

Chairman ARCHER. Let's talk about an area that is not, it seems to me, a wash, although you may be able to elucidate it. All of the various members of our economic society that deal in cash are paying no income tax when they are recipients of cash, nor is there a deductibility under the current income tax system for the person who pays that money. The person who receives that cash irrespective of the activity, whether it be—I won't isolate names, but you know the various types of activities that deal in cash—when they spend that money they are going to pay part of the consumption tax if it is a tax on goods and services.

Mr. REYNOLDS. True.

Chairman ARCHER. Whereas today they pay nothing, nor is there a deduction under the current Code for those people who make the payment in cash to them.

Mr. REYNOLDS. Yes. I will give you some examples since you are being nice enough not to—home repair and home cleaning. If someone comes and cleans your house, you pay cash; you don't report Social Security either by the way. I suspect that might be a minor advantage of sales tax.

But the major advantage of both proposals, including this one, is that a lot of the reason people avoid taxes is, the rates are too high. You get the marginal rates down and that is going to be a much more copious revenue generator than the other thing.

The other issue you are raising has a lot to do with people's perception of fairness, and I can't comment on that. I didn't do that well in moral philosophy.

Chairman ARCHER. You are a very excellent witness, and I am very grateful to you. I don't want to get into an argument with you because I am trying to learn.

The GAO testified that the loss, not including illegal activities, to the cash economy, where we were not getting any income tax, was somewhere around $120 billion a year. Now, I don't think that is insignificant, and that is a cumulation of all of these activities that we were talking about. It's not the money going into tax-exempt bonds.

I would submit that one of my concerns is that if we are going to try to get at that and create the feeling of fairness on the part of all Americans, lowering the rate won't get them. If I am paying zero percent today and you come to me and say you can pay 20 percent, isn't this a wonderful deal, I am a human being, I am going to say, I don't want to pay 20 percent. That was the argument in 1986, that if we reduced the rate to 28 percent, people would say, that is so much less so I will be so delighted to pay it. But if they were paying zero, they didn't.

Mr. REYNOLDS. It worked to some extent, too. You had a revenue windfall after the 1986 bill partly as a result of that and partly as a result of people like me reporting higher cash income. That is correct, and I accept your point as far as it goes, but I think we have to weigh the fact that with the sort of sales or VAT tax rate that we will be talking about—and I am afraid the numbers will be higher, because when we look at what is going to get left out, like hospital rooms and financial services and so on, the rate will be pretty high; you have to offset against that savings—that there will undoubtedly be smuggling and selling under the counter at wholesale to evade that tax too.

Basically, people will evade taxes. In countries where they have very high sales tax, such as Brazil, that is the one that is avoided and that is where the underground economy is. Where they have high income tax, like this country, that is the one that is avoided and that is where the pressure is.

Chairman ARCHER. I yield back to the gentleman from Nebraska if he has further comments.

Mr. CHRISTENSEN. Thank you, Mr. Chairman.

Chairman ARCHER. Thank you for yielding the time.

Mr. Collins.

Mr. COLLINS. Only one or two questions.

You mentioned those who tried to maybe successfully evade reporting some income or switching their income to nontaxable areas, as you did with bonds. What percentage of the taxpayers would fit into that category? Because most working people receive a W–2 or 1099 for services rendered.

What percentage of the taxpayers would actually fit into your bracket, not your income bracket, but would have the means——

Mr. REYNOLDS. Before the rate went up, I was targeted to be in the 36 percent bracket. Because I am clever, it will probably be 31 percent. I think that with the spread of 401(k)s which is a way to defer compensation, and municipal bonds that are held by people in tax brackets as low as 28 or 31, these are significant revenue losers.

All of the itemized deductions people are complaining about losing are mostly an advantage to fat cats like me, and I will gladly give them up for a low marginal rate even if you keep my average rate as high as it is.

Mr. COLLINS. Would you make it 5 percent of the taxpayers being able to shift funds around——

Mr. REYNOLDS. I think it is bigger than that, more like 10 is a possibility. Investments, pension deferral; it is usually only low-income people who can use IRAs.

Mr. COLLINS. One question about the cash economy mentioned: If someone receives in cash, they don't hoard that cash. They probably spend that cash on a consumer good somewhere or another service, so the cash revolves again within the private sector economy, whereas if the government were successful in taxing that cash transaction, then they would take a portion of that transaction out of the private sector into the government till.

So it is which comes first, the chicken or the egg?

Mr. REYNOLDS. They will either take it out of what you spend or out of what you earn. By the time you die, it doesn't matter much because we tend to spend everything we earn and that is why income tax and consumption tax really aren't that different.

Mr. COLLINS. Thank you.

Chairman ARCHER. Thank you very much. We look forward to having further contact and input from you as the months go on. We appreciate your coming.

Mr. REYNOLDS. Thank you, Mr. Chairman.

Chairman ARCHER. Our last panel is Hon. Paul Craig Roberts, Dr. Richard Rahn, Stephen Moore, Steven Hayes and Michael Rothschild.

Mr. Rahn.

STATEMENT OF RICHARD W. RAHN, PH.D., CHAIRMAN OF THE BOARD, BUSINESS LEADERSHIP COUNCIL

Mr. RAHN. Thank you, Mr. Chairman.

Mr. Chairman and Members of the Committee, thank you for giving me the opportunity to testify today. My testimony is delivered on behalf of the Business Leadership Council for whom I am pleased to serve as chairman of the board of directors. I am also president of the Novecon companies, which create and operate businesses in the former Soviet Union and Eastern Europe.

Mr. Chairman, you have been quoted as saying you are "committed to tearing out the income tax by its roots." Your goal is not only desirable, but now a necessity as a result of advances of electronic money and the smart card. Thoughtful observers understand that the present income tax system is increasingly dysfunctional and must be replaced. The rising complexity and costs of the management of compliance with the existing tax system have made it not only unfair but increasingly uneconomic.

The present income tax system is strongly biased against productive savings and investment, which in turn has sharply reduced our rate of capital formation and, hence, the standard of living for most Americans. New technologies such as electronic money and the smart card will make the existing tax system increasingly difficult to manage and easy to escape for those who so choose. The existing system is intrusive, subject to, and all too often abused by, government officials as not compatible with a free society in which citizens should be considered innocent until proven guilty and not have to fear their own government.

My testimony can be summarized in the following four points:

The new electronic money and smart card technologies which will operate on a global basis outside the control of any government make the replacement of the existing income tax in the very near term an absolute necessity, because anyone who chooses to do so will be able to escape taxes on interest dividends and capital gains with virtually no danger of being caught.

The new technologies can solve many of the problems in providing desired social safety for the poor or elderly and in eliminating the regressivity problem with a tax reform proposal such as a national sales tax.

Any new tax system must rely on what is possible without excessive regulation or intrusion into the private lives of its nation's citizens, because an intrusive system is not only incompatible with a free society, but given the rapidity of technological progress, will always be destined to fail.

All the major new alternative tax proposals, including the Armey flat tax, Nunn-Domenici and a national sales or VAT are vastly superior to the existing tax system, but it is imperative they be designed to be fully compatible with the new technologies.

The revolution taking place in electronic money means that banks and other organizations will be able to create their own money for transactional or investment purposes and literally move these moneys around the globe at the speed of light. Definitions of income and money will be increasingly blurred, presenting an impossible task to the tax collector who tries to tax things which can be transformed instantaneously into something else and move anyplace in the world with no paper or electronic trail. Public key cryptography, which has already been developed, means electronic banknotes can be certified without the issuer knowing to whom it was issued. Smart cards used as an electronic purse can have the same anonymity as paper cash.

Government authorities cannot stop this revolution because it is a worldwide revolution, with too many people having the knowledge. Censorship and regulation will not work because progress in developing the means of evasion will always be far ahead of those who are trying to restrict it, in the same way that most totalitarian governments have largely given up trying to control flow of information because technology has made it an impossible task.

As responsible Members of the Congress you have only one choice and that is, design a new tax system which provides adequate revenue for the government without attempting to tax what cannot be involuntarily taxed. Fortunately, the task is not only doable, but if correctly done will result in much higher rates of growth and a simpler, less intrusive system.

New technologies will greatly assist the management of many government programs. For instance, smart cards are already being used in some food stamp programs to reduce fraud. Smart cards could be used to provide low-income people or everyone with a tax-free consumption allowance each month to offset the regressive features of a national sales tax.

Smart cards will also prove to be much better vehicles for the elderly to receive and spend their Social Security and Medicare

funds, given they can be uploaded or downloaded through the telephone and can be used only by the intended recipient.

In conclusion, those who believe envy to be a virtue rather than a sin will begin with their familiar whine about the distributional impact of any replacement for the current tax system. Given that the income data will be increasingly less reliable, so in turn will the distributional data. We urge the Congress to ignore the envy crowd and instead concentrate your energies on designing a tax system which raises the required amount of revenue with the least amount of economic damage, so all Americans will benefit from resulting higher rates of economic growth.

Thank you, Mr. Chairman.

[The prepared statement and attachments follow:]

TESTIMONY OF RICHARD W. RAHN
THE BUSINESS LEADERSHIP COUNCIL

Mr. Chairman and Members of the Committee, thank you for giving me this opportunity to testify today on replacing the income tax. My testimony is delivered on behalf of the Business Leadership Council, for whom I pleased to serve as Chairman of the Board of Directors. The Business Leadership Council is a new association of entrepreneurial business leaders who are committed to working to limit the size of government and to expand economic growth. Its members believe that the central purpose of all economic policy should be to promote a higher standard of living for the American public and that among the most important means of achieving this goal is the adoption of sound tax policies. In addition, I am President of the Novecon companies, which create and operate business joint ventures in the former Soviet Union and Eastern Europe. Relevant to my testimony is the fact that one of our companies is engaged in a project to market smart card technology in the former Soviet Union.

Mr. Chairman, you have been quoted as saying you are "committed to tearing out the income tax out by its roots". Your goal is not only desirable, but now a necessity as a result of the advances in electronic money and the smart card.

Thoughtful observers understand that the present income tax system is increasingly dysfunctional and must be replaced. The rising complexity and costs of the management of and compliance with the existing tax system have made it not only unfair but increasingly uneconomic. The present income tax system is strongly biased against productive saving and investment, which in turn has sharply reduced our rate of capital formation and hence the standard of living for most Americans. New technologies, such as electronic money and the smart card, will make the existing tax system increasingly difficult to manage and easy to escape for those who so choose. Finally, the existing system is intrusive, subject to, and all too often abused by, government officials, and is not compatible with a free society, in which citizens should be considered innocent until proven guilty and not have to fear their own government.

At your request, the focus of my testimony today will be on the impact of new technologies on the tax system. Rather than go into great detail on these technologies, I am appending the cover story from ***Business Week*** (June 12, 1995), and an article I wrote for the **Washington Times,** entitled *The Death of the Income Tax?* (March 6, 1995). These articles give sufficient background on the relevant technologies.

<u>Summary</u>

My testimony can be summarized in the following four points:

1. The new electronic money, or E-money, and smart card technologies, which will operate on a global basis outside the control of any government, make the replacement of the existing income tax, in the very near term, an absolute necessity because anyone who chooses to do so will be able to escape taxes on interest, dividends, and capital gains with virtually no danger of being caught .

2. The new technologies can also solve many of the problems in providing desired social safety nets for the poor or elderly and in eliminating the regressivity problem with tax reform proposals such as the national sales tax.

3. Any new tax system must rely on what is possible without excessive regulation or intrusion into the private lives of its nation's citizens, because an intrusive system is not only incompatible with a free society but, given the rapidity of technological progress, will always be destined to fail.

4. All of the major new alternative tax proposals, including the Armey flat tax, Nunn-Domenici (but at lower rates), and national sales tax or VAT, are vastly superior to the existing tax system; but it is imperative that they be designed to be fully compatible with the new technologies.

Importance of E-Money

The revolution taking place in electronic money means that banks and other organizations will be able to create their own money for transactional and/or investment purposes and literally move these moneys around the globe at the speed of light. The definition of money as a government-created legal tender will become less and less relevant. The existing distinctions between money, goods, services, and assets will increasingly disappear as they become more interchangeable.

Definitions of income and money will be increasingly blurred, presenting an impossible task to a tax collector who tries to tax things which can be transformed instantaneously into something else and moved to anyplace in the world with no paper or electronic trail. Public-key cryptography, which has already been developed, means electronic bank notes can be certified without the issuer knowing to whom it was issued. Smart cards used as an electronic purse can have the same anonymity as paper cash.

Government authorities cannot stop this revolution, because it is a worldwide revolution with too many people having the knowledge. Censorship and regulation will not work because progress in developing the means of evasion will always be far ahead of those who are trying to restrict it. In the same way that most totalitarian governments have largely given up trying to control the flow of information, because technology has made it an impossible task, governments need to realize that the old central bank monopolies on the issuance of money will also go the way of the buggy whip.

Government officials have two choices: to redesign their tax and monetary systems to reflect technological reality, or to try to create a system in which every investment and every expenditure by every person is known throughout their lives. In the new world of monetary freedom there is no halfway ground. Either the government will know everything, or the government will only know what is voluntarily revealed. An all-knowing government is doomed to fail, practically and politically, and attempts to impose a "big brother" government could impoverish the Nation and trample our liberties.

Thus, as responsible Members of Congress, you have only one choice, and that is to design a new tax system that provides adequate revenue for the government without attempting to tax what cannot be involuntarily taxed. Fortunately, the task is not only doable but, if correctly done, it will result in much higher rates of growth and a simpler, less intrusive tax system.

The new technologies will greatly assist the management of many government programs. For instance, smart cards are already being used in some food stamp programs to reduce fraud. Smart cards could be used to provide low income people (or everyone) with a tax free consumption allowance each month to offset regressive features of any national sales tax. Smart cards will also prove to be much better vehicles for the elderly to receive and spend their Social Security and Medicare funds, given that they can be uploaded and downloaded through the telephone and can be used only by the intended recipient.

An important practical consideration when designing a replacement for the existing income tax is whether the proposed tax base is realistically subject to tax in the aftermath of the electronic revolution. This is because as a general principle, what cannot be taxed efficiently should not be taxed at all. The converse, however, does not hold.

If taxpayers may easily avoid reporting particular types of income or transactions with virtually no danger of being caught because of technological innovations, then the tax on that type of income or transactions is, quite literally, voluntary and will only be paid by those conscientious citizens who abide by our tax laws out of a sense of duty and honor rather than the threat of civil or criminal penalties. Establishing a genuinely voluntary tax is not a formula for fairness and will lead to a disproportionate burden being borne by those who choose not to evade.

The tax base of the future will need to be tied to long-term relationships, real estate, tangible property or other high-profile or public assets or activities. Income flows that may be effected in secret, electronically and anywhere in the world are bad candidates for taxation in the electronic age. Taxes tied to real property or tangible personal property or the sale of goods and services to the public are much more difficult to evade. Taxes tied to the employer-employee relationship are enforceable because of the stability, length and visibility of the relationship. Taxes tied to the operation of businesses dealing with the public or with many business customers are more easily enforced because of the necessarily public and open nature of such businesses.

The electronic age with virtually instantaneous international financial transactions and with encrypted confidential smart cards substituting for money will make the taxation of capital transactions, interest and dividends increasingly problematic. In an age where most people can today transfer money and pay bills with an ordinary telephone, enforcing taxation on these types of transactions will become virtually impossible. The cost of trying to enforce them may well exceed the revenue collected and certainly will exact a price in terms of lost economic efficiency and lost privacy rights that exceeds the benefits of their continued taxation.

Those who believe envy to be a virtue rather than a sin will begin their familiar whine about the distributional impact of any replacement for the current tax system. Given that income data will become increasingly less reliable, so in turn will tax distributional data. We urge the Congress to ignore the "envy crowd", and instead concentrate your energies on designing a tax system which raises the required amount of revenue with the least amount of economic damage, so that all Americans will benefit from the resulting higher rates of economic growth.

Size of Government

Congress cannot properly determine what type of tax system we should have until it is determined what the revenue goals for the new system should be.

From the end of World War II until the late 1970s, there was a common belief that our economic and societal ills could be cured by increasing the role of government. As a result, government grew larger and larger both in absolute and relative terms, not only in the United States but in much of the rest of the world. Fair-minded people increasingly understood that the Keynesian economists were wrong, and that distinguished economists, such as Frederick von Hayek and Milton Friedman, had both a better understanding of how the economy operates and better prescriptive solutions. They taught us that beyond a certain point increasing taxes, government spending, and regulations did more to reduce the social welfare than to improve it. The increasingly widespread recognition that government could, and indeed had, become counterproductive ushered in the Reagan revolution. The result has been that government taxation and spending have not grown relatively over the past twelve years, even though regulation has continued to grow in both relative and absolute terms.

During the past twenty years, serious academic work has been done on the appropriate size of government, not only for the United States, but for the rest of the world as well. The empirical evidence that government taxing, spending, and regulation is well beyond the optimum point is now overwhelming, and all Americans are suffering as a result. Specifically, we now know that social welfare and economic growth would be maximized if government were one-quarter or less of Gross Domestic Product, as contrasted with the present more than one-third.

Knowing this, it makes no economic or political sense to design a new tax system to raise as much money on a static revenue basis as the existing system. We know that as we downsize government in relative terms, economic growth rates will increase. We know that as we reduce high marginal tax rates and the current tax bias against saving and investment, we will increase the supply of productive labor and have a higher level of

capital formation, which will lead to higher rates of economic growth. (Please see charts at back of testimony.)

Because the majority in this Congress has had the courage to develop a path to a balanced budget that slows the rate of growth of government spending, the federal government share of GDP should fall to 18% by 2003. History tells us that economic growth will increase as a result. This means that you can generate the same tax revenue at reduced tax rates. At the same time, because of higher growth, there will be fewer people in poverty, thus reducing the demands on government assistance programs, and hence government spending.

Fair-minded people understand that the reason you wish to slow the growth of government spending is not because you are mean-spirited or tools of the rich. It is because you understand that a smaller government will mean that most Americans, and particularly poor Americans, will have much greater opportunity and live much better. It is too bad that some in the media cannot distinguish between the "name" of government programs and the cost-effectiveness of these programs. Eliminating a government program with a compassionate name, but whose cost to the taxpayers is greater than the benefits to the recipients, is the compassionate and responsible thing to do. Because some of your political opponents and some in the media are irresponsible is no reason for you to stoop to their level. For America's sake, continue to have courage.

Unfortunately, the Congress has let itself get trapped by budget rules that make no sense. Again, I am referring to the requirement of "relatively static" revenue estimates for tax and spending changes. These rules make no economic sense, and they make no political sense, now that a majority in Congress favors economic growth and opportunity over static redistributionism. When the rule makes no sense, change it. (The left in the media and their academic and political allies will scream; but the American people vote on performance, not on arguments about whose tax forecast model is correct.)

The reason it is important not to be slaves of the wrong rule is that the current rule will force you to have higher tax rates. This is equally true for consumption-based income tax plans, the flat tax, and the national sales tax proposals. Because of the static revenue trap, all of the proposed plans will increase taxes on some sizable portion of the population, thus causing for them unnecessary hardship and their justifiable political opposition.

Designing a New Tax System

There are three politically viable and economically sound alternatives that could replace the existing income tax: a so called consumed income or cash flow tax (Nunn-Domenici, but at a lower rate), a national sales tax, and a flat rate income tax (Armey.) Each of these proposals would simplify the existing tax system, eliminate the tax bias against savings and investment, reduce the disincentive to work, and promote economic growth and a higher standard of living for the American public.

Each of these proposals has distinct advantages and disadvantages, which this Committee must address over the next few years as it meets the challenge of developing a replacement for the income tax. The Business Leadership Council is establishing a Tax Alternatives Working Group to work systematically through these issues, and we look forward to working with this Committee as the debate unfolds.

Even though all of the major proposals for a replacement tax are vastly superior to the existing tax system, none is perfect, and all will have problems in the transition period. These problems can largely be mitigated by reducing the maximum marginal tax rate from that which their proponents are proposing. This can be done responsibly, by further reducing the growth in spending so that eventually all levels of government are absorbing less than 25% of GDP. This would entail reducing federal spending to the neighborhood of 15-17%. In effect, virtually all businesses and individuals would be getting a "tax cut", thus mitigating their political opposition and reducing the

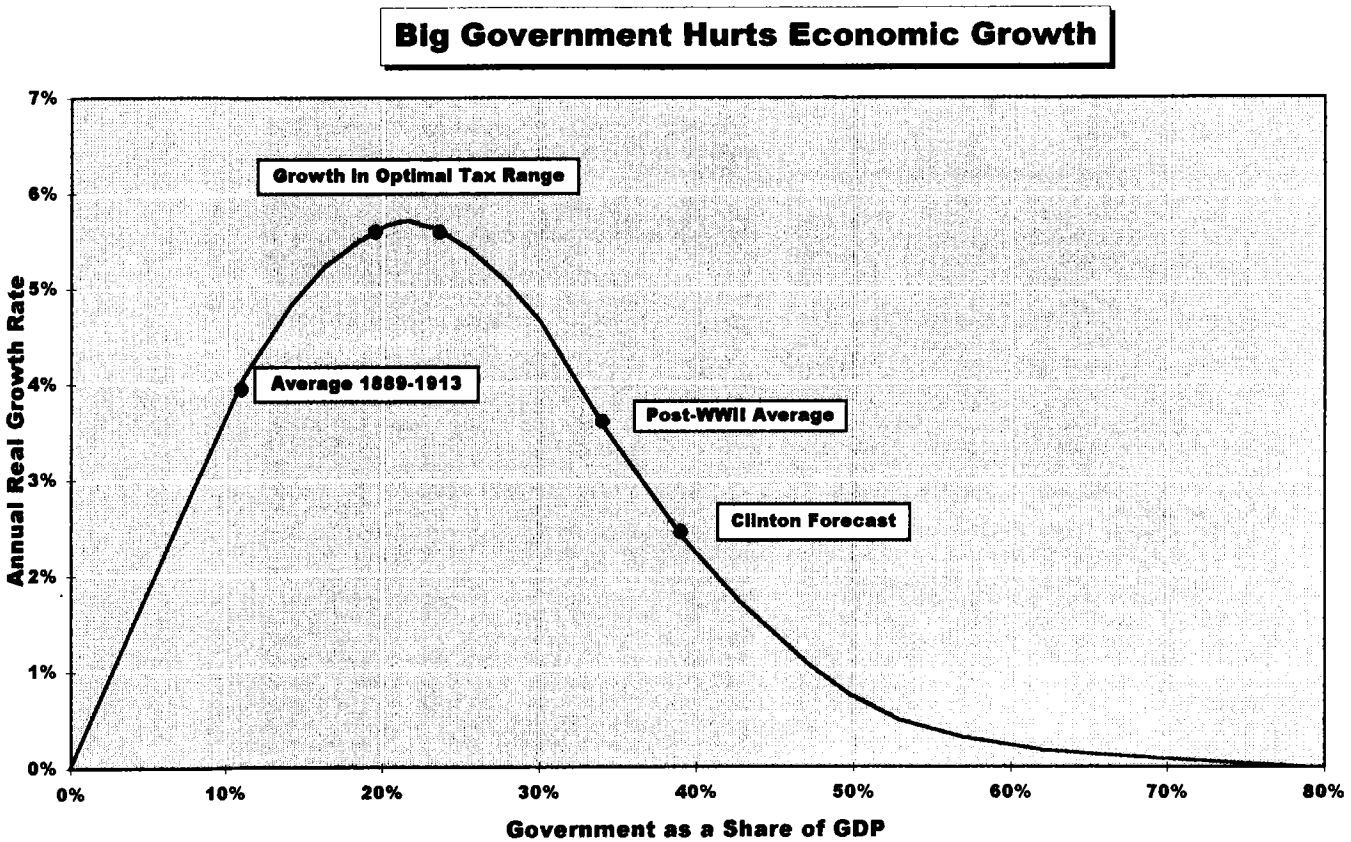
impediments to work, save, and invest. In fact, the higher economic growth engendered by the spending growth reductions and the less destructive tax system is likely to increase the absolute revenues for government to spend.

For the full benefits to occur from any of the income tax replacement plans now being discussed, they must be accompanied by drastic changes in the operations of the IRS. While it will indeed cause some revenue loss to restrict the IRS' ability to take actions without first proving willful wrongdoing, and to reduce the paperwork and documentation the IRS can require, it is a small price to pay for a free society. In addition, a national sales tax ought not to be enacted without the repeal of the 16th Amendment, because without such a repeal there is a great danger that some future Congress will inflict on us both an income tax and a national sales tax. At the same time, a flat tax ought not be enacted without the Congress' curtailing the IRS.

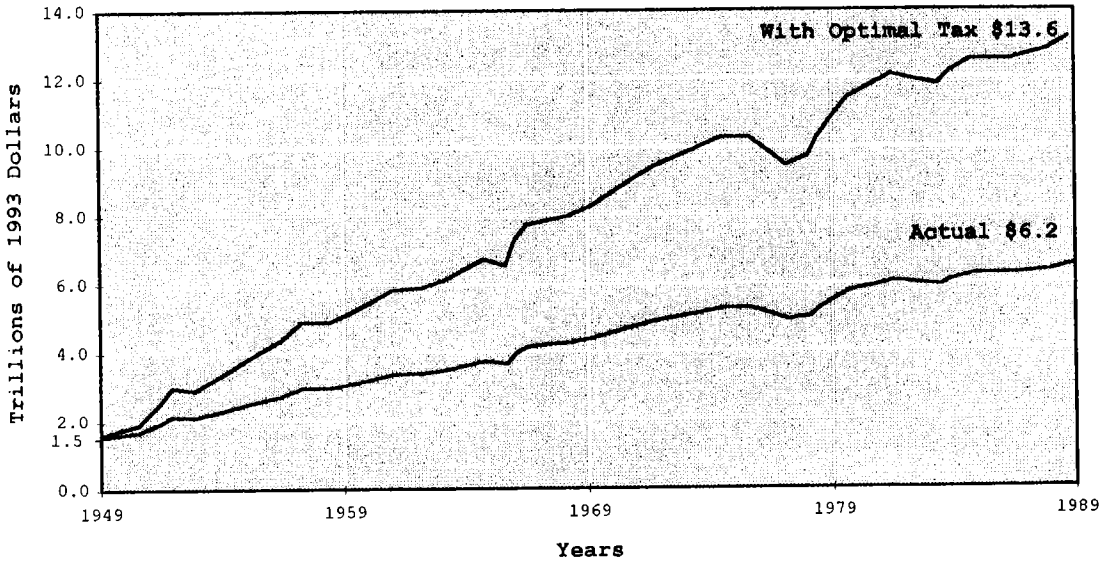
Conclusion

In conclusion, a new tax system should be designed to generate the optimal revenue, and government should be scaled back accordingly. The new tax system should be simpler and fairer. The IRS should be eliminated or sharply curtailed.

It is no longer optional whether we should scrap the current dysfunctional income tax: electronic money makes that a necessity, because interest, dividends, capital gains, and some other income will be able to be hidden. The silver lining is that E-money and smart cards can solve the regressivity problem and will force us to design an unobtrusive, pro-growth tax system which will benefit all Americans.


Big Government Hurts Economic Growth
Growth in Optimal Tax Range
Average 1889-1913
Post-WWII Average
Clinton Forecast
Annual Real Growth Rate
7%
6%
5%
4%
3%
2%
1%
0%
0%
10%
20%
30%
40%
50%
60%
70%
80%
Government as a Share of GDP

Path of Real Gross National Product



OP-ED PAGE A20 / MONDAY, MARCH 6, 1995 ★ The Washington Times

The death of the income tax?

By Richard Rahn

Death and taxes are among life's certainties. Far less common, but much more enjoyable to contemplate, is the death of a tax.

In fact, a little-known technology may be about to accomplish what generations of Americans have joked and dreamed about —and both the new Ways and Means Committee Chairman Bill Archer and his predecessor, Chairman Sam Gibbons have said they desire: the annihilation of the income tax. But now it is becoming possible, and perhaps even necessary.

Before proceeding to describe — in loving detail — its imminent demise, let's remember why the murder is justifiable. The income tax discriminates against savings and investment. Economic growth and job creation are penalized. As the tax system grows ever more complex, and changes pile on changes, the cost of compliance grows even more rapidly — unalloyed economic dead weight.

Think of the resources that would be freed, and the human happiness that would accrue, if all the tax lawyers and accountants were put to work doing something useful. Think of all the gains to taxpayers once they were freed from the burden of compliance.

The cost is more than economic. The complexity of the system also causes fear. One rarely knows what the proper tax liability is. For most large businesses and many individuals, the only thing they know for certain is that the amount they paid is wrong. And though the media reports every April — the stories of leading accounting firms and Internal Revenue Service offices each calculating a different liability from the same data — may be amusing, the reality is otherwise. Each year the IRS tries to send people to jail for not determining a liability that is, by the very nature of the system, almost impossible to calculate.

The gains to the American people, economically and psychologically, will be magnificent.

Unfortunately, also, the very Congress that claims to want to get the government off people's back is complicating things even further. Among the various tax-cut bills that have been introduced, only Rep. Dick Armey's flat tax bill will produce significant simplification. Left to themselves, it is unlikely that the legislators, buffeted as they are by the lobbyists and lawyers, will ever summon the courage to put the IRS out of its, and our, misery.

Fortunately, computer hardware and software may soon do what representatives and Senators will not. For centuries, people have paid their bills, and received their income, by cash or check. These costly methods of payment may be coming to a rather abrupt end.

Electronic transfers greatly reduce the cost of transaction and the possibility of loss. Americans are now starting to pay their bills by using credit cards, and by inexpensive "Smart Phones." These systems provide customers with a full record of income and payments: good for record-keeping, but bad for privacy. In fact, the IRS is already working on a system to gather all your financial information electronically and prepare your tax return for you. That might crimp the tax lawyers and accountants a bit, but the Big Brother police state aspects are at least as unpalatable.

There is, however, a technological alternative. An experiment now under way, called "E-cash," operating in Amsterdam by a company named DigiCash. The electronic version of the anonymous paper dollar is now with us. Individuals will be able to move their funds around the world, literally at the speed of light, from one bank to another or to a creditor, without the bank knowing to whom the money was paid, or the creditor knowing from which bank or even country the money came.

Through the use of cryptographic technology (scrambled numbers for personal codes), the ease of conducting electronic transaction would be combined with the elegant anonymity of paying in cash. The two most important features of the "E-cash" system — security and anonymity —will be ensured by using cryptographic digital signatures to establish the authenticity of the payer, while at the same time assuring his anonymity and untraceability. The virtual electronic dollar bills will, at the same time, be assigned individual electronic serial numbers, which will also be checked for authenticity. The bank will know how much to pay and what code to pay it to, but will not know the owner of the receiving code, hence the payee too remains anonymous.

Naturally, the IRS doesn't like it. But the matter may be beyond its control. In the next few months, Americans will be offered two competing versions of the future. The first is the society in which all of your transactions can be monitored by the government (and other interested parties). The second is where you as an individual choose which of your transactions will be made available to curious eyes, and which will remain anonymous.

Many in the government and other organizations will argue for a ban on anonymous systems, contending that such capabilities benefit primarily drug traffickers, money launderers, assorted terrorists and plain old tax dodgers. Libertarians, on the other hand, will warn of the dangers that accrue when government has almost total scrutiny of individuals. One doesn't have to envision what a Hitler or Stalin could have done with such a system; just try to imagine the kind of ordeal investigators could inflict on anyone trying to get Senate confirmation for government service.

The fact is that the fears of both sides are correct. But some of the legitimate fears of the government can be mollified by repealing the income tax and substituting a value-added or business-transfer tax. Anonymous systems will make it easier for criminals and evaders to do what they are already doing successfully, especially as private encryption protocols are developed.

But without an income tax, it won't matter. The gains to the American people, economically and psychologically, will be magnificent. Even the government, which relies on public trust, will gain. An on such terms, that would be a very good thing.

Richard Rahn is President of Novecon Ltd. in Washington and a fellow of the Seattle-based Discovery Institute.

THE FUTURE

In his pinstriped suit and wire-rimmed glasses, Timothy L. Jones looks every bit the traditional British banker. Sure enough, he has spent a dozen years at National Westminster Bank PLC. But ask Jones what he is doing now, and he responds with an intensity worthy of a Silicon Valley entrepreneur. Leaning across a table, he waxes eloquent about his new enterprise, Mondex, and the future of the product he's selling: a new kind of electronic money.

Mondex, which was launched by NatWest, is not alone: A raft of companies are developing their own forms of electronic money, known as E-cash. E-cash is money that moves along multiple channels largely outside the established network of banks, checks, and paper currency overseen by the Federal Reserve. These channels enable consumers and businesses to send money to each other more cheaply, conveniently, and quickly than through the banking system.

Cover Story

Some of the E-cash players are faceless, dubious outfits that exist in cyberspace and can be traced only to a post-office box—in the physical world. But there are plenty of others, ranging from techno-savvy startups with names such as DigiCash and CyberCash, to corporate icons including Microsoft, Xerox, and Visa. Citicorp is even developing what it calls the Electronic Monetary System, an entire infrastructure for using electronic money to be issued by Citi and other banks.

These companies are part of a mass experiment that could transform the way we think about money. In the process, it could change consumers' financial lives and shake the foundations of global financial systems and even governments.

Digital money is the ultimate—and inevitable—medium of exchange for an increasingly wired world. With E-cash, you'll no longer need to carry a wad of bills in your pocket or fumble for exact change. Instead, you might carry a credit-card-size piece of plastic with an embedded microchip that you will "load" up with E-money you buy with traditional currency. Or, you might store your digital coins and dollars—downloaded over phone lines from your bank or other issuer of E-money—on your PC or in an electronic "wallet," a palm-size device used to store and transmit E-money.

This digital money will let you shop online, zapping money to a merchant over the Internet, or perhaps paying for a movie on demand over an interactive-TV network. It also has the potential to replace cash and checks for everyday purchases—in stores, restaurants, or taxis that accept E-cash. Businesses could also keep a stash of E-cash on hand for buying office supplies, or use it to transact directly with each other instead of going through banks and electronic funds transfers.

THE START OF A REVOLUTION. In many ways, E-cash, which can be backed by any currency or other asset, represents the biggest revolution in currency since gold replaced cowrie shells. Its diversity and pluralism is perfectly suited to the anarchic culture of the Internet and the evolving web of networks known as the Information Superhighway. "Electronic commerce will literally change the way business is done worldwide," says James G. Cosgrove, vice-president and general manager for business multimedia services at AT&T. "We're about to see another revolution similar to the Industrial Revolution." Adds Richard K. Crone, senior manager in the financial-services group at KPMG Peat Marwick: "We're in the beginning stages of the cash-replacement cycle."

But the advent of E-cash raises all sorts of questions, most of which remain unanswered: Who should be allowed to issue E-cash, and who will regulate those issuers? How will taxes be applied in cyberspace, which transcends physical boundaries? Who will set the standards? How do you ensure that payments made over the Net will be secure? How will consumers be protected?

EARLY MONEY

Seashells, odd rough-hewn coins—the first money was flexible, highly distinctive, and exchanged in multifarious ways. Objects were gradually replaced by standardized commodities such as gold and silver, and these in turn by paper money. Yet even early currency was at first issued by private banks, local governments, and others—usually backed by gold and silver. Diversity abounded.

OF MONEY

E-cash could transform the world's financial life

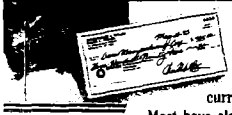
How will regulators police money laundering and counterfeiting on private networks?

While regulators wrestle with these questions, technology is remaking the monetary system. That's what Microsoft CEO William H. Gates III had in mind when he bid for personal-finance software maker Intuit Inc. He saw programs such as Intuit's as the gateway that would draw millions of consumers onto his online network where they could pay bills, get financial advice, or shop, perhaps paying him for access. But the Justice Dept. worried about Microsoft's reach, and he abandoned the deal on May 20.

Tough break, but it will hardly slow Gates down. Microsoft is working with Visa on a system for securing credit-card transactions over the Net. But that's just one piece of a much bigger problem Microsoft is trying to solve. Gates has dozens of programmers busy devising a sweeping system, Microsoft Network, to help people do business safely in cyberspace—or more specifically, in Microsoft's own network and interactive-TV systems—using a range of payment options. Microsoft won't reveal much about its E-cash plans, but, says Nathan P. Myhrvold, Microsoft's top advanced-technology expert, "we're very interested in the area."

They should be. The stakes are enormous. Seamus McMahon, a vice-president at Booz, Allen & Hamilton, sees as

BANK MONEY



The current money system is largely monolithic. Nearly all major countries have a single system of national currencies and bank checks. Most have elaborate infrastructures built around commercial banks and a central governing body such as the Federal Reserve Board. That entity is usually the only facility allowed to issue money. Perhaps because of their monopoly structures, money systems tend to resist change and innovation. Traders can move millions of dollars around the globe at the touch of a button. But the small check-based transactions of consumers can take days to clear. And chartered airplanes physically transport billions of checks around the country every workday.

E-CASH

E-cash may be technologically light-years ahead of early money. But in many ways, it is closer to seashells than greenbacks. E-cash is digital money that moves through a multiplicity of networks instead of the current bank system. It comes in lots of guises, is created by lots of individual parties, and is backed by anything constituents demand as an accepted medium of exchange: gold, dollars, yen, whatever. It is the ultimate, and inevitable, currency for the wired world. Competition is intense, producing rapid innovations. Using money downloaded to your PC or a palm-size electronic "wallet," you'll be able to zap money to merchants on the Net—or buy a newspaper faster than you can grab a greenback. If you're a business owner, you can bypass banks and move E-cash directly to customers and suppliers. The advantages: convenience, speed, cost savings. The technology is complex, but to the user, E-cash is as easy as pushing a button.

much as 20% of total household expenditures taking place on the I-way just 10 years from now. If any operation, whether Citicorp or a startup such as Mondex, gained control of a new medium for even part of those exchanges, it would have the opportunity to charge royalties or fees for its use and earn interest on the E-money sitting in its accounts. Even a tiny charge, when applied to millions of transactions, would be highly lucrative.

Cover Story

E-cash could also create a competitive free-for-all. Because the Internet knows no boundaries, a company offering E-money can gain direct access to millions of consumers and businesses—no matter what state or country they are in. "The retail banking market will collapse and give way to global competition," says Eric Hughes, president of Open Financial Networks, a Berkeley (Calif.) consulting firm. "Those [regional] separations don't work on the Internet."

WINNING CONSUMERS' TRUST. Governments' and central banks' control of money flows has already been loosened, as shown by recent currency and market crises in Mexico and elsewhere. But with the growth of E-cash, money could flow in and out of countries at lightning speed without being traced, weakening governments' ability to monitor and tax. "Over the long haul, this is going to lead to the separation of economy and state," declares Bill A. Frezza, president of Wireless Computing Associates and co-founder of the advocacy group DigitalLiberty.

The growth of E-money could also be bad news for banks. If other companies successfully offer their own brand of digital cash, they could bypass banks as primary providers of consumer financial services. The companies, not the banks, might be consumers' first contact when they wanted to obtain some digital money. "Banking is essential to the modern economy, but banks are not," says J. Richard Fredericks, senior managing director at Montgomery Securities.

Commercial banks are, of course, entrusted with the creation of money through the fractional reserve system. They lend out more than they have on deposit, and they are the only companies authorized to do so. If each unit of E-cash had to be backed by a corresponding unit of traditional currency, that would mean that lending out E-cash wouldn't create new money. But if nonbank money suppliers started backing just a fraction of their digital cash with traditional money—just as commercial banks today keep on hand only a fraction of the deposits on their books—nonbanks, which are largely unregulated, could create money just as commercial banks do now.

This could be bad news for banks. What if phone companies offered their own brand of E-money?

Bankers must move fast to keep up. Ronald A. Braco, head of electronic banking at Chemical Bank, estimates that banks have less than five years to come up with viable E-money products before other players carve out the biggest chunks of the market for themselves. "No question, it's for real," says Richard M. Rosenberg, chairman and CEO of BankAmerica Corp. In a couple of years, "it will take off fairly dramatically." The issues now: winning consumers' trust and getting them to change their buying habits.

The first step in that direction could be to get consumers used to using credit cards for purchases on the Internet. Once that happens, the thinking goes, they may be willing to start using E-cash systems.

One of the first purveyors of a Net credit-card system is First Virtual Holdings, run by onetime celebrity manager Lee Stein. Stein has launched a relatively simple system using E-mail that lets consumers use credit cards on the Internet without fear that their account numbers will be misappropri-

The New World Of E-Cash

THE GOOD

convenient and flexible than traditional money. It can be used by consumers and businesses, and for everything from buying wares on the Internet to lending a pal five bucks.

- Banks that issue E-cash could find it much cheaper than handling checks and the paper records that accompany traditional money.
- Consumers doing business on the Internet will find some forms of electronic money afford much greater privacy than using ordinary credit cards.

THE BAD

- Uncontrolled growth of E-cash systems could undermine bank- and government-controlled money systems, giving rise to a confusing and inefficient Babel of competing systems.
- E-cash may be less secure than bank money: Money stored on a PC could be lost forever if the system crashes.
- E-cash could foster a have and have-not society: Those with PCs would have ready access to the stuff, while those without, many of them low-income consumers, would not.

AND THE UGLY

- Money laundering and tax evasion could proliferate in stateless E-money systems as criminals use untraceable cyberdollars to hide assets offshore.
- Counterfeiters could create their own personal mints of E-cash that would be indistinguishable from real money.
- If computer hackers or other criminals were to break into E-cash systems, they could instantaneously filch the electronic wealth of thousands or even millions of innocent consumers.

DATA: BUSINESS WEEK

ated. The card numbers are stored away on a protected computer system and never pass over the network. Instead, consumers register with First Virtual by phone and receive I. D. numbers in exchange for their card numbers. When they want to buy something electronically, they simply supply their I. D. number to the merchant.

First Virtual, which became the first secure payment system on the Net when it handled its first transaction last October, is growing fast. Stein won't disclose activity levels, but he says volumes are increasing by 16% a week. "If you make it simple and safe, people will use it," he says. First Virtual has enlisted such merchants as Apple Computer, Reuters, and National Public Radio—which sells transcripts of programs.

Most electronic extensions of the credit-card system, though, are built around encryption—scrambling card numbers so they can pass safely on electronic networks. For example, CyberCash Inc., a Reston (Va.) startup, is cutting its teeth on a deal with Wells Fargo & Co. for encrypted credit-card transactions over the Internet.

Visa and MasterCard, not surprisingly, are also working to make credit cards usable on the I-way. Visa is, among other things, developing with Microsoft a system using encryption technology that they hope will become an industry model. "We want to be sure that the industry as a whole has certain standards," says Carl F. Pascarella, president and CEO of Visa USA. Meanwhile, MasterCard has teamed with Netscape Inc., a maker of security and browsing software for the Internet, to pursue a similar goal.

WILTSHIRE EXPERIMENT. Credit-card-based systems have the advantage of seeming familiar to consumers. But the card systems don't do everything cash can: They're not anonymous, they do not work person-to-person, and they have credit limits. They're also not suited for the grassroots economy the Internet makes possible, where any outfit or individual can sell its wares, whether a newsletter or a stock tip.

That's where E-cash comes in. But E-cash needs to be just as secure as credit cards for people to use it. David Chaum, CEO of pioneer DigiCash in Amsterdam, has done the most to solve this problem. He has devised a clever system that uses so-called public-key cryptography that, like encryption, makes it possible to send sensitive information over the Net. But Chaum's big breakthrough was "blinding" technology, which lets the issuing bank certify an electronic note without tracing whom it was issued to. The result: Your E-cash, unlike an encrypted credit-card transaction, is as anonymous as paper cash.

Chaum has yet to announce firm deals with companies to issue his E-money. But in a pilot, some 5,000 consumers are part of a DigiCash marketplace, using the equivalent of $1 million in E-money to do business with 50 companies, from Encyclopaedia Britannica Inc. to Ricky's Junk Shop. Chaum's technology is also at the heart of CAFE, a European Commission-sponsored project to develop an electronic wallet for pan-European use.

CAFE's setup is similar to Jones's Mondex system. "Imagine it's the same as physical money, and you won't be far off," says Jones. Mondex money will be created initially by NatWest and a partner, Midland Bank PLC, which will then "sell" it to customers. The E-money is loaded onto credit-card-size "smart" cards with embedded microchips. The cards can be used in point-of-sale terminals or fit into electronic wallets that can transmit money to merchants or—just as with traditional cash but not with credit cards—to other consumers. Mondex money is still in pilot form, but the company has signed up 40,000 consumers and over 1,000 retailers in the Wiltshire town of Swindon to test Mondex money beginning in July.

CREDIT CARDS IN CYBERSPACE

"If you make it simple... people will use it"

— LEE STEIN, CEO, First Virtual Holdings

CyberCash, too, is experimenting with E-cash in addition to its credit-card-based system. In the E-cash system, consumers will set up E-money accounts at their banks. Then, using proprietary software provided free of charge by CyberCash, they can go about their business on the Net. At the end of the day, CyberCash will clear all the E-money transactions and convert E-cash balances back to dollars.

No matter who develops the best E-cash, consumers and businesses alike stand to reap sizable benefits. No longer will consumers have to wait for change or scurry to automated teller machines for cash—out of sight, they hope, of the nearest mugger. E-cash will let businesses carry out transactions around the world without transferring bank funds—and they will be better able to reach a large population of technologically savvy, often affluent consumers.

Moreover, because E-money is basically software, it can be programmed to do things that paper money could never do. Microsoft's Myhrvold explains that electronic money could be

earmarked for special purposes, with conditions on where it can be spent. For example, a business could have an electronic version of petty cash to be used for supplies at an Office Depot—but not a beer at the local tavern. Or parents could wire to a college student E-money that is designated for rent or books. "There will be new forms of smart money and payment systems that can only be done online," says Myhrvold.

Along with the opportunities, though, comes huge uncertainty. Existing monetary regulations don't cover all of the potential uses of E-cash. Nathaniel S. Borenstein, a computer scientist and co-founder of First Virtual, says: "One of the hardest questions merchants ask us is, 'When do we owe taxes?'" That's not a trivial question: With E-money, the merchant could be in Guam and the buyer in Canada, while First Virtual's computers are located in Ohio. So whose sales tax do you pay? Borenstein's advice to merchants: "I tell them to consult a lawyer."

There's also a major potential for crime (page 78). E-money can be easily sent in and out of a country undetected, facilitating money laundering on a grand scale. Tax evasion could become a matter of pushing a button. And without foolproof cryptography, counterfeiters could replicate the series of digits that constitutes E-money. Governments would be hard pressed to monitor or control stateless E-money. "Digital cash is a threat to every government on the planet that wants to manage its currency," says David E. Saxton, executive vice-president of Net1, a startup that has developed a secure way to send electronic checks across the Internet.

BATTLE OF THE LOGOS. Even law-abiding citizens and companies using E-money could be victims of sophisticated hacker attacks. Says Colin Crook, senior technology officer for Citicorp: "We have to assume electronic money will be the subject of sustained attack from all kinds of people."

Another open question—and a large one—is the role of banks in the new electronic world. "E-cash will be offered by both banks and nonbanks," says Chaum. Sure enough, DigiCash or CyberCash could join forces with AT&T or Microsoft just as easily as with Citibank. Having one of those companies dispensing E-cash directly to consumers could do serious damage to banks' main link with their customers.

Even if banks are involved, they could find other players taking center stage. Early entrants to the E-money business could set the operating standards for digital cash. And the nonbanks could even devise systems that would make their logos the first thing people see. William M. Randle, senior vice-president at Huntington Bancshares, warns that banks could become "buttons on a network operated by other entities."

THE FLEXIBILITY OF CASH

"Imagine it's the same as physical money, and you won't be far off"

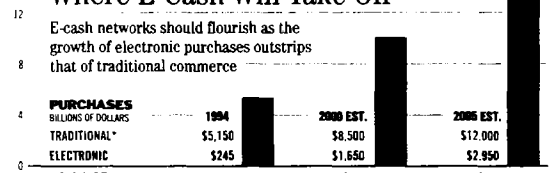
— TIMOTHY JONES, CEO, Mondex

Improbable? Not really. Take a look at credit-card processing. Twenty years ago, banks owned the card-transaction-processing business. Now, close to 80% of card transactions are processed by nonbanks such as First Data Resources Inc., says KPMG's Crone.

A similar erosion has occurred in wholesale banking, where banks have ceded to such outfits as General Electric Information Services and Electronic Data Systems Corp. nearly the entire market for transferring payment data to corporations, leaving themselves the mundane, low-margin service of transferring money between corporations. Today, says banking consultant

Where E-Cash Will Take Off

E-cash networks should flourish as the growth of electronic purchases outstrips that of traditional commerce



PURCHASES BILLIONS OF DOLLARS	1994	2000 EST.	2005 EST.
TRADITIONAL*	$5,150	$8,500	$12,000
ELECTRONIC	$245	$1,650	$2,950
• TV/CABLE TV	$ 45	$400	$650
• BUSINESS-TO-BUSINESS	140	450	650
• INTERNET	Negligible	600	1,250
• OTHER ONLINE COMMERCE	60	200	400
SHARE OF ALL PURCHASES	4.5%	16.2%	19.7%

*INCLUDES RETAIL, WHOLESALE, SERVICE, AND MAIL-ORDER PURCHASES

DATA: COMMERCE DEPT., ALLEN & ASSOCIATES

Edward E. Furash, although the situation is improving, fewer than 100 banks offer full-service electronic data interchange, as the data part of payments transmission is known. "We should do more of that," says Richard Matteis, head of Chemical Banking Corp.'s Geoserve unit.

Cover Story

Banks have one key advantage: a near lock on consumers' trust when it comes to depositing money. For that reason, many bankers tend to dismiss the threat implicit in E-money. "The reason financial institutions are going to win in the long run is trust," says Kawika Daguio, the American Bankers Assn.'s federal representative on operations and banking. Indeed, many E-cash makers are choosing to partner with banks because of that consumer trust. "We've positioned ourselves to work with the banking industry and make sure that if there are heroes in this, it is the banks," says William N. Melton, CEO of CyberCash.

But Microsoft's bid for Intuit last fall gave bankers a collective scare. And even though the deal did not work out, banks worry that Microsoft could hook its 70 million Windows customers into the electronic-commerce networks that

CALL IT E-MONEY MANAGEMENT

It's a Saturday morning sometime in the not-too-distant future, and you sit down at your PC to do a little end-of-the-month planning. First, you call up the balances from your various accounts—credit-card, checking, savings, and E-cash—and break down your spending by category. Oops, better cut down on those pricey dinners.

Your investments are offsetting some of those expensive habits—at least you hope so. Finding out is as easy as a few clicks of a mouse button, as you call up your investment portfolio. Hmmm, it may be time to get into a more aggressive mutual fund. So you quickly dispatch a software "agent" to rustle up profiles for the top-performing funds. By filling out an online form, you transfer some of your holdings into a hot overseas fund.

Just as technology is revolutionizing money, it is also set to transform the way we manage our money. "Complexity has gotten beyond the level that people can deal with," says Scott D. Cook, the founder and chairman of Intuit Inc. With programs like Quicken, Intuit's best-selling personal-finance software, Cook aims to make that complexity easier to deal with.

"AUTOMATIC AGENTS." Indeed, today's programs for personal-finance management and home banking are giving consumers unprecedented control over their financial life. But this is just the beginning. Gradually, programs are linking users to banks, electronic bill-paying services, and a broad array of vendors of financial advice that is starting to be offered online. Colin Crook, head of technology at Citibank, says software programs will be constantly at work for you, for instance, using information gleaned on the Net to optimize your portfolio. "You're going to hand off your personal affairs in cyberspace to automatic agents who represent you," says Crook.

A QUICKENING PACE

"Complexity has gotten beyond the level that people can deal with"

— SCOTT COOK, Chairman, Intuit Inc.

The competition to supply these services will be heated. Microsoft Corp.'s Bill Gates saw the potential—one reason why he was willing to shell out $2 billion for Intuit. With that deal blocked by the Justice Dept., Microsoft is throwing its considerable resources behind Microsoft Money, a home-grown personal-finance package already offered by Chase Manhattan and others. From Money, Microsoft expects to link customers to a variety of online financial services, including electronic bill-paying. Bank of America and NationsBank recently paid $35 million for Meca Software, which makes Managing Your Money. And Intuit, for its part, has just released new programs for selecting mutual funds and planning for retirement and children's college education.

Expect banks to jump into the fray. They are sitting on a gold mine of valuable data: their customers' payment information. The statements they send out, though, typically offer little value, and consumers' credit-card, checking and savings, and investment accounts are handled separately. "There is an opportunity to consolidate that," says Richard K. Crone, a banking consultant at KPMG Peat Marwick.

With so much available to help you manage your financial affairs, someday you may be able to bag those Saturday mornings at the computer and instead just take a long weekend.

By Amy Cortese in New York

it is developing—with or without banks' help. If Microsoft becomes a utility, "it will take a lot of business from the banks," says Montgomery's Fredericks.

Cover Story

Now several of the biggest banks are pushing hard to develop E-money. Citibank's Electronic Monetary System is one of the most advanced bank offerings, although officials there stress that it is still in development. It would allow retail and business customers of Citi—or any other bank that paid to use Citi's system—to convert money in their accounts to electronic cash. Citi customers would also have access to a credit line they could draw down in E-money, just as they would use a credit card. Banks "should be experimenting," says Sholom Rosen, vice-president for electronic commerce at Citi. "That's what we're doing."

Beside NatWest and Midland, Bankers Trust Co. has a group dedicated to electronic commerce. And even some regional banks see opportunities. There is Wells Fargo's work with CyberCash. First Union Corp., based in Charlotte, N.C., has created an electronic mall for Internet transactions. Even Cardinal Bankshares Inc., a $607 million Lexington (Ky.) bank, on May 24 formed a new subsidiary, Security First Network Bank, which aims to grow into a full-service interactive bank on the Internet. "We'll be a one-branch bank in Kentucky with potential customers all over the U.S.," says CEO James S. Mahan III.

While it's not clear who the players will be 10 or even 5 years from now, it is inevitable that much E-money will originate outside the purview of central banks such as the Federal Reserve or the Bank of England, which are largely responsible for traditional monetary regulation. And that has major policy implications.

To begin with, consumers using the stuff could be extremely vulnerable. When consumers lose their credit cards, they are only liable for the first $50 of charges on the card. But for now at least, if a consumer misplaced, say, a Mondex card, it would be like losing cash. Similarly, if your digital coins are stored on the hard drive of your PC, a system crash could wipe out your electronic savings.

HIP TO HACKERS' HEISTS

"We have to assume electronic money will be the subject of sustained attack"

— COLIN CROOK, technology chief, Citicorp

Electronic money also creates vast opportunities for tax evasion, money laundering, and other financial crime. "There is an imaginable potential for a serious challenge to the whole political and social order," says First Virtual's Borenstein. "I am not all that sanguine that the government has the control they think they do." For people trying to avoid paying taxes to a national government, the lure of a stateless currency would be powerful indeed. Already, "virtual currencies" serving electronic communities of people are springing up on the Internet.

Then there's the issue of the volatility of money. The effects of high-speed electronic trading have been painfully apparent in market crises over the past several years. Market swings could be magnified if consumers and businesses could send their money around the globe with the touch of a button on a PC.

The monitoring of national money supplies will also change. While some regulators dismiss the issue, arguing that E-money will inevitably convert back to traditional money and get counted, other experts disagree. Martin Mayer, a guest scholar at the Brookings Institution, says that he expects the Fed to lose control of a significant portion of the money supply.

One of the most pitched debates is likely to be over privacy. As a society, we have relied on a system that allows us to keep some transactions private by using cash, while others, such as big-ticket purchases, are entrusted to a credit-card company or a bank. Competing forms of E-cash offer wildly differing degrees of privacy: DigiCash's E-money offers virtually complete anonymity, while every dollar you spend using the credit-card-based systems would leave a trail. The problem will be balancing individuals' rights to privacy with government's need to monitor money flow and trace criminal activity.

BREAKING INTO THE E-MINT. More dire is the possibility of major break-ins to E-money systems—the electronic equivalent of penetrating the U.S. Mint. If someone were to crack the sophisticated code of, say, the DigiCash system, he could start minting unlimited amounts of his own DigiCash money.

That's why it is all the more alarming that some regulators and even some central bankers still seem unconcerned

Not for Sale

with the advent of E-cash. After a breakfast speech to several hundred business leaders in San Francisco last March, Fed Vice-Chairman Alan Blinder was asked whether the Fed is studying the regulatory issues surrounding digital cash. His answer: "Digital what?" Then, after pausing a moment, he added: "It's literally at the thinking stage."

Cover Story

Slowly, though, some regulators are beginning to explore the concept of E-money so they can set policies. The Federal Reserve's payment-systems committee is meeting with Chaum of DigiCash and other E-money pioneers. State tax collectors are looking at the issue of taxing electronic commerce. The Financial Crimes Enforcement Network is also weighing in. Even the White House technology office is taking a big interest.

It's not a moment too soon. "There's no going back," says DigitaLiberty's Frezza. "The genie's out of the bottle. The Internet doesn't have an off switch." And no amount of wishing by regulators will change that.

By Kelley Holland and Amy Cortese in New York, with bureau reports

PATROLLING THE BLACK HOLES OF CYBERSPACE

At first glance, the offer sounded legitimate. First Bank of the Internet began advertising to Net browsers in March, offering a new way to pay for goods over the Net. By sending First Bank a check for at least $20, cybershoppers would get a Visa automated teller machine card "loaded" with their money—less a hefty 5% commission—which they could then use to obtain cash or pay for their cyberwares.

First Bank got numerous inquiries—but it also drew some unwanted scrutiny. State banking regulators warned that it couldn't call itself a bank. The Office of the Comptroller of the Currency sent an advisory to banks and regulators warning them about FBOI. First Bank CEO Vinn K. Beigh, a 34-year-old computer technician in Des Plaines, Ill., says he will soon pull his Net listing. But he is still looking for a way to cash in on the wave of electronic commerce. "There is quite an interest in buying on the Internet," he insists.

TANGLES FOR THE TAX MAN

"If you go to a cashless society, it makes it very difficult tracking... reportable income"

— JOHN GIBBONS, President Clinton's top technology adviser

He's got that right. First Bank isn't the only upstart trying to cash in on the demand. Consider World Trade Clearinghouse Ltd., which offers a gold-backed cybercurrency with cashlike anonymity that offers "protection from bureaucratic snoops, nasty ex-spouses, and lawsuit-hungry lawyers." And officially opening this month is the Internet Online Offshore Casino, run out of the Turks and Caicos Islands, which says it will accept all manner of E-money and pay customers 10% annual interest on the balances they leave in an offshore bank the company recently bought.

These enterprises may never draw in a meaningful number of customers. And many raise red flags to regulators. But the government is also a long way from getting a good fix on the activities of the much larger number of ostensibly legitimate E-money players.

MONEY LAUNDERERS. The regulatory gaps are sizable. For example, Stanley E. Morris, director of the Treasury Dept.'s Financial Crimes Enforcement Network (FinCEN), points out that there are no laws that limit the balance of electronic currency that can be loaded onto an E-cash card. That could create a major opportunity for money launderers. And no one has determined how to define whose tax laws apply to transactions in cyberspace (page 8). Says John H. Gibbons, assistant to the President for science and technology: "If you go to a cashless society, it makes it very difficult tracking cash income or reportable income.

Right now, regulators are simply trying to understand the new technology and how the market is evolving. Last April, the Federal Trade Commission held a conference to examine the impact of electronic commerce on consumer protection. FinCEN is organizing a colloquium on electronic currency to be held later this fall. "We are nowhere near the issue of regulating it," warns FinCEN's Morris. "We're one step back." Given the speed with which the market is advancing, regulators don't have much time to close that gap.

By Amy Barrett in Washington

Chairman ARCHER. Thank you, Dr. Rahn.

Hon. Craig Roberts, you may proceed.

STATEMENT OF HON. PAUL CRAIG ROBERTS, INSTITUTE FOR POLITICAL ECONOMY AND FORMER ASSISTANT SECRETARY OF THE TREASURY FOR ECONOMIC POLICY

Mr. ROBERTS. Thank you, Mr. Chairman. I would like to congratulate you on holding these hearings. It is leadership that the American people have not seen in their lifetime.

The income tax must be abolished for two reasons. The first reason is that Americans will not again be a free people until they are shorn of the requirement to report their income and wealth to the IRS. The second reason is that the disincentives associated with income taxation make it the most costly method of raising revenues. Faced as we are with a new phenomenon, the rise of global capitalism, the United States will not be able to afford for much longer a tax system that reduces the rates of investment and productivity and makes the United States a relatively unattractive place to invest financial, physical and human capital. In the 21st century, we will not be protected against the folly of our own policies by the prevalence of socialism everywhere else on the planet.

To those born under the income tax, it might seem as American as apple pie. However, for most of our history, the United States had no income tax. One hundred years ago last April 8, the Supreme Court struck down the income tax as an unconstitutional measure. Justice Steven J. Field, a Democrat, went further. He condemned it as class legislation. He compared it to a 1691 English statute that taxed Protestants, Catholics and Jews at different rates. It required a constitutional amendment, the 16th, to establish the income tax in 1913, which is a relatively recent time for a country whose origin was 1776.

The 16th amendment passed as a political act directed at the Northeast. In other areas of the country, incomes were not large enough to produce any liability under the tax. In 1910, for example, William Shelton of Georgia wrote that southerners favored ratification of the amendment "because none of us here have $4,000 incomes."

The income tax is not as American as apple pie. It is a discriminatory tax. It discriminates against success, it discriminates against savings and investment and subsidizes consumption, it discriminates against work and subsidizes pleasure. There is nothing good that can be said about the leisure tax.

Socialist-minded folk used to say that the income tax was fair because it was a rich man's tax, but the income tax ceased to be a rich man's tax more than half a century ago. It is a mass tax. Some people still say the income tax is fair because it redistributes income. However, today income is redistributed through the expenditure, not the revenue side of the budget.

The method by which revenues are raised is independent of the question of redistribution. Sales tax revenues can be redistributed just as easily as any other kind. Not even regressive forms of taxation prevent redistribution of income to the poor.

For example, revenues from a tax that fell disproportionately on the poor could be used to provide food stamps, housing subsidies

and Medicaid only to the poor. Everyone would pay some tax, but only the poor would get the benefits of the expenditures. So even if income redistribution were a moral imperative, it does not require income taxation to achieve it.

Many of the income tax's unique disadvantages can be addressed by eliminating progressivity, lowering the rate and exempting saving from the tax base. A low rate flat tax that exempted from taxation all income that is saved would be a vast improvement over the current tax system. However, people would still have to report their income to the IRS, and this Committee should not underestimate the value to people of freedom from the requirement that they report their income to the IRS. I, for one, would be willing to pay a higher sales tax rate in order to ransom my freedom from the IRS. And I wouldn't be surprised if many people felt the same way.

How much time do I have, Mr. Chairman?

Chairman ARCHER. You technically have 1 minute, but we are not going to limit you rigidly to that.

Mr. ROBERTS. I am not going to go through the questions of the collection problems of the retail sales tax versus a VAT. If we adopt a value-added tax that calculates the tax liability by the credit or the invoice method that is used by the member countries of the EEC, then it would be a self-policing tax because businesses are refunded VAT paid on the inputs, and buyers and sellers would have no common interest to collude in falsifying invoices. This credit method would also make the border tax adjustment or the export rebate easy to calculate, as each firm would have a record of VAT paid on its purchases.

The great disadvantage of VAT is that unless the net of tax sales price is listed, VAT is an invisible tax, and therefore it is easy to raise it to excessive rates to support pork barrel spending. In contrast, an excessive sales tax rate would encourage massive evasion and be self-defeating. It is very difficult to evade a VAT calculated on the credit method.

Perhaps a solution would be to repeal the 16th amendment and substitute in its place a constitutional amendment that limits VAT to, for example, 10 percent. Simply limit VAT constitutionally to a fixed rate and then conduct the government with whatever revenues the economy brings in. This would guard against the gradual escalation over time of what could be a hidden tax.

In your deliberations, please keep in mind that the 20th century is not the norm but a departure from the ideal sought by the vast struggles in the 17th and 18th centuries to curtail rapacious government and make it accountable to the people. In the 19th century, we gathered fruit from these achievements, but the 20th century brought a return to big government with all-inclusive claims akin to the divine right of kings. Fascist, Nazi, Communist, Socialist and welfare states are the 20th century's contribution to misgovernment and human misery.

In the United States, Franklin D. Roosevelt finished off federalism with his New Deal, supposedly to save us from the failures of capitalism. All this proved to be a fraud, a turning away from modernity to a reactionary past.

Everywhere big government has failed. There is no longer any doubt of it. If we are to be an economically successful country in the 21st century, we need a tax system that does not discourage saving, deprive families of businesses that they create, disadvantage exports and impose large compliance costs. So in place of the existing taxes on income and wealth, a retail sales tax or a constitutionally limited VAT would be a great improvement.

Thank you, Mr. Chairman.

[The prepared statement follows:]

Testimony of Paul Craig Roberts
before the
Committee on Ways and Means
U. S. House of Representatives
June 8, 1995

Mr. Chairman, members of the Ways and Means Committee, I congratulate you for holding these hearings. It is leadership that the American people have not seen in their lifetime.

The income tax must be abolished for two reasons: The first reason is that Americans will not again be a free people until they are shorn of the requirement to report their income and wealth to the IRS. The second reason is that the disincentives associated with income taxation make it the most costly method of raising revenues. Faced as we are with a new phenomenon, the rise of global capitalism, we won't be able to afford for much longer a tax system that reduces the rates of investment and productivity growth and makes the U.S. a relatively unattractive place to invest financial, physical, and human capital. In the 21st century, we will not be protected against the folly of our own policies by the prevalence of socialism everywhere else.

It is fitting that this reassessment is coming from the House. The House of Representatives was conceived by our Founding Fathers as the body of government closest to the people. They endowed the House with the initiative power of government. The function of the House as the expression of popular will was destroyed by the income tax. The money from the income tax turned representative government into a vote-buying operation that obliterated the integrity of Congress. The House must now reclaim the government for the people.

It will not be easy to do. The status quo takes advantage of reasonable people and uses compromise to stifle change. However, change is coming, because it has already been initiated elsewhere--in Latin America, Europe and the far East. Even in what used to be called communist China, stock markets have displaced the Communist Party as the arbiter of investment. In Europe privatizations are creating competitive firms and industries in the place of nationalized sloth. Even the British Labour Party has officially abandoned its 77-year-old commitment to nationalized industry. We can adapt to these world-wide changes by again becoming capitalist ourselves, or we can attempt to hide behind protectionism and sink.

To those of us born under the income tax, it might seem as American as apple pie. However, for most of its history the U.S. had no income tax. One hundred years ago last April 8, the Supreme Court struck down the income tax as an unconstitutional measure. Justice Stephen J. Field, a Democrat, went further and condemned it as class legislation. He compared it to a 1691 English statute that taxed Protestants, Catholics, and Jews at different rates. It required a Constitutional Amendment, the 16th, to establish the income tax in 1913, a relatively recent time for a country whose origin was 1776.

The amendment passed as a political act directed at the Northeast. In other areas of the country incomes were not large enough to produce any liability under the tax. In 1910 William Shelton of Georgia wrote that Southerners favored ratification, "because none of us here have four-thousand dollar incomes."

This view proved to be short-sighted. The income tax ceased to be a rich man's tax and became a mass tax. Once this happened, economists found it easier to acknowledge its defects, and politicians could garner middle class votes by cutting tax rates. The two most popular presidents in the postwar era, John F. Kennedy and Ronald Reagan, are associated with income tax rate reduction. However, reductions in tax rates have not altered the share of income that Americans have to turn over to the IRS. The unrelenting burden of the tax, together with widespread public disillusionment with the waste and ineffectiveness of government programs and increased recognition of the income tax's harmful economic effects, have stripped the income tax of its hegemony over public policy thinking.

The income tax is not as American as apple pie. It was a crude act of class and regional warfare and was explicitly

recognized as such. Its terrible costs were not easily seen. Other countries lacked sensible economic policies, and there was no standard for comparison.

The income tax is a discriminatory tax. It discriminates against success and subsidizes failure. It discriminates against saving and investment and subsidizes consumption. It discriminates against work and subsidizes leisure. There is nothing good that can be said about an income tax.

Socialist-minded folks used to say that the income tax was fair because it was rich man's tax, but the income tax ceased to be a rich man's tax more than half a century ago. Some people still say that the income tax is fair because it redistributes income. However, today, income is redistributed through the expenditure, not the revenue, side of the budget. The method by which revenues are raised is independent of the question of redistribution. Sales tax revenues can be redistributed just as easily as any other kind. Not even regressive forms of taxation prevent redistribution of income to the poor. Revenues from a tax that fell disproportionately on the poor could be used to provide food stamps, housing subsidies, and medicaid only to the poor. Everyone would pay some tax, but only the poor would get the benefits of the expenditures. Even if income redistribution were a moral imperative, it does not require income taxation to achieve it.

Many of the income tax's unique disadvantages can be addressed by eliminating progressivity, lowering the rate, and exempting saving from the tax base. A low rate flat tax that exempted from taxation all income that is saved would be a vast improvement over the current tax system.

However, people would still have to report their incomes to the IRS. This committee should not underestimate the value to people of freedom from the requirement that they report their incomes to the IRS. I, for one, would be willing to pay a higher sales tax rate in order to ransom my freedom from the IRS, and I would not be surprised if most others felt the same way.

The virtues of a consumption tax over an income tax are now widely understood. I doubt if there is a single respected economist any place on earth who would deny them. However, the greatest advantage of a sales tax is not that it is a consumption tax, but that it gets the IRS out of the lives of most people.

As long as the government collects revenues from any source, there will be an IRS. Under a sales tax, the extent of the IRS's involvement in private life would depend on the sales tax base, and this would depend on the rapaciousness of the government. If services are subjected to the sales tax, then professionals who sell services would have to serve as sales tax collection agents for the government. Evasion is possible, and the higher the sales tax rate, the greater evasion would be.

It is sometimes suggested that states could serve as the collection mechanism for a federal sales tax. However, five states do not have a sales tax, and there is variability among the states as to the tax base. It is likely that the IRS would confront more collection problems from a federal sales tax than it does from the current system of income tax reporting. However, convenience for the IRS should never be the standard by which we design our tax system. Indeed, the convenience for the tax authority is the last consideration that representatives of a sovereign people should address. If we are to remain a free people, it is the IRS, not the taxpayer, who must awake each morning wondering if it is going to be drawn and quartered.

The collection and evasion problems of a sales tax and the problem of cascading or taxing items in the chain of production more than once--minimal in the case of a retail sales tax--can be avoided by moving to a value added tax (VAT). A value added tax that calculates tax liability by the credit or invoice method used by member countries in the European Economic Community is self-policing, because businesses are refunded VAT paid on their inputs and buyers and sellers have no common interest to collude in falsifying invoices. The credit method also makes the border tax adjustment or export rebate easy to calculate as each firm would have a record of VAT paid on its purchases. The subtraction method

used in the Nunn-Domenici tax bill is simpler for companies but not self-policing, and calculating the VAT rebate on exports would be complex.

However, VAT can have one great disadvantage: If the net-of-tax sales price is not listed, VAT is an invisible tax; therefore, it is easy to raise it to excessive rates to support pork-barrel spending. In contrast, excessive sales tax rates would encourage massive evasion and be self-defeating.

Perhaps a solution would be to repeal the 16th Amendment and pass a Constitutional amendment that limits VAT to, for example, a 10 percent rate and then conduct the government with the revenues that the economy brings.

In your deliberations, keep in mind that the 20th century is not the norm, but a departure from the ideal sought by the vast struggles in the 17th and 18th centuries to curtail rapacious government and make it accountable to the people. In the 19th century we gathered fruit from these achievements. But the 20th century brought a return to big government with all-inclusive claims akin to the divine right of kings. Fascist, nazi, communist, socialist and welfare states are the 20th century's contribution to misgovernment and human misery. In the U. S. Franklin D. Roosevelt finished off federalism with his New Deal, supposedly to save us from the failures of capitalism. All of this has proved to be a fraud, a turning away from modernity to a reactionary past. Everywhere big government has failed. There is no longer any question of it.

If the United States is to be economically successful in the 21st century, the country needs a tax system that does not discourage saving, deprive families of businesses that they create, disadvantage our exports, and impose large compliance costs. In place of the existing taxes on income and wealth, a retail sales tax or a constitutionally limited VAT would be a great improvement.

A retail sales tax or a VAT would be easier to comply with than our complex income tax system that forces taxpayers to hire experts to compute their tax liabilities. A retail sales tax or a VAT would end the tax bias against saving and, thereby, encourage more investment and a higher saving rate. A tax that can be legally rebated on exports under GATT would improve the international competitiveness of U.S. labor and goods. A retail sales tax or a VAT would also pick up revenues from the cash economy, for example, illegal drug profits that are spent on consumption items, but not reported as income. When the further advantages of more freedom and less government intrusiveness are added, the case for a retail sales tax or a VAT is overwhelming.

Chairman ARCHER. Thank you.

Mr. Hayes, you may proceed.

STATEMENT OF STEVEN L. HAYES, PRESIDENT, CITIZENS FOR AN ALTERNATIVE TAX SYSTEM, LOS ANGELES, CALIF.

Mr. HAYES. Thank you, Mr. Chairman.

I would like to start off and tell you that I really believe the country owes you a great debt of gratitude for bringing this issue to the fore. I want to thank you personally and on behalf of the organization I represent, Citizens for an Alternative Tax System. We are truly a grassroots organization. None of us are paid; we are all volunteers, devoting our time because we believe very firmly that this country needs the elimination of the income tax, the elimination of the IRS, and its replacement with a retail sales tax as a way of gathering revenue for the government.

I have worked as an attorney for a number of years, and I have spent time dealing with the Tax Code. I became so disgusted with the Tax Code that in 1986 I decided I wasn't going to do it anymore, and I started looking at alternatives.

What I think is important, having dealt with the system, is that we look at an alternative that does a number of things. We look at an alternative that is simple. We look at an alternative that is fair, because the devotion of the people to any law is what makes it enforceable; if it is not perceived to be fair it will not be enforceable. We must look for something that really helps savings and helps work, instead of penalizing savings and work. And we look at something that, perhaps most importantly, gets the IRS out of our lives, that totally, as the Chairman says, tears the income tax up by its roots and throws it away. Because, Members of the Committee, I believe that no matter what is said about a flat income tax, one of the problems, perhaps the greatest problem, is that it keeps the IRS mechanisms in place and it keeps the ability for you gentlemen, for other Members of Congress, to be replaced at some point, and then it would be very simple to reinstitute the dreaded system that we have. We need to get rid of the income tax and we need to get rid of the IRS.

Now, all of the tax proposals are calling themselves consumption taxes. They are all saying, obviously we need to be a consumption tax. A consumption tax which like the Nunn-Domenici program, requires all of us to fill out essentially the same 1040 that we do now and requires 120 million tax returns to be filed this year isn't really much of an improvement.

The flat income tax, as proposed by Congressman Armey, requires us to fill out a tax return every month. If you do the math on that, that is over 1.5 billion tax returns per year that have to be filled out. All of those require, in order to be enforced and collected, the retention of the IRS and the retention of the mechanisms which they use to collect the income tax, the mechanisms which you hear complaints about on a daily basis. Under the IRS rules, the only way you can collect an income tax in this country, is you have to be guilty until you are proven innocent by yourself. That is just not right in a free society.

We have heard some talk about the underground economy and how we are going to get at the underground economy. The Chair-

man has stated that we have to get at the underground economy because the conservative estimate by the IRS is that $120 billion of income taxes are being evaded each year. I have worked in the tax area and I suspect that the real estimate of cost of the underground economy is probably closer to $200 billion a year, and any tax system we have needs to address the underground economy.

The national retail sales tax, I believe, does the best job because it taxes what a person buys. A quick example: In California, 90 percent of the revenues raised by the sales tax, 90 percent, are paid by 8 percent of the merchants. So you are talking about most of the revenues coming from merchants where they don't have much of an evasion problem. We are going to get at the underground economy.

I do a lot of radio shows. I talk to a lot of Americans who call up and who say, How are you going to get rid of the income tax?

One of them called me and said, You know, Congress has put us in slavery. I said, What are you talking about? He said, We have to fill out an income tax return. I said, Well, how is that slavery? He said, Slavery as far as I am concerned is being compelled to do something you don't want to do for which you are not compensated and for which you are punished severely if you do it wrong.

Well, Members of the Committee, I believe you certainly have the power to continue a system that requires Americans to fill out and spend not 5.5 billion hours but probably 8 billion hours now, but you don't really have the right to compel us to do so. What I believe you have the obligation to do is to free us from the income tax, get rid of the IRS and tear the income tax out by its roots so it won't come back.

With a retail sales tax in place, we will become a magnet for capital from around the world and we will see a boom in this country the likes of which we have never known because instead of taxing incentive, instead of taxing savings, we are going to reward them. You get to keep what you earn, you get to keep what you save, and you get to make the choice for the first time since we have had an income tax.

Thank you.

[The prepared statement follows:]

REVITALIZE THE AMERICAN ECONOMY

REPLACE THE INCOME TAX WITH A NATIONAL RETAIL SALES TAX

By Steven L. Hayes

Mr. Chairman and Members of the Committee, it is a privilege to be asked to testify. My name is Steve Hayes. I am an attorney who dealt with the Internal Revenue Code for over 20 years. For most of those years, I complained about the insanity of the income tax and how it was damaging not only our economy but also our American way of life. In 1987, after the passage of the 1986 Tax Reform Act, I made the decision that it was indefensible for me to continue practicing in an area of law which I believed was wrong. Accordingly, I phased out the tax law portion of my practice and now our firm only practices business law and business litigation.

I am also serving as the president of Citizens For An Alternative Tax System ("CATS"), a grass roots organization formed in 1990. We are all volunteers. Neither our officers, our chapter directors nor our members receive salaries or cars or other perks. All of us are taking time away from our families and jobs because we believe that the current income tax system must be changed. Our supporters can be found at all points of the political spectrum, but we have one common goal—the replacement of the individual and corporate income tax and the estate and gift tax with a national retail sales tax. This change is vital to reviving our nation's economy and freeing each of us from the tyranny of the income tax.

In response to the over 5,000 radio and TV appearances made by our spokespersons in the past five years, thousands upon thousands of people have called and written us asking for information about our proposal to replace the detested income tax with a national retail sales tax. Americans are demanding a tax system that causes the least amount of government intrusion in our lives and that has the least negative impact on the economy. The American people are frustrated, impatient and angry because they know that the income tax system is beyond repair and believe that this should be obvious to everyone but, until recently, no one in Washington seemed to hear.

As these hearings so eloquently state, Washington is now listening. Many Members of Congress are commenting that when they return to their districts and conduct town meetings, their constituents are demanding tax reform. When they explain the alternatives, these Members are finding that an alternative that provides for the elimination of the income tax and eradication of the Internal Revenue Service is preferred by margins of more than 2 to 1.

In its January 8, 1995 issue, *Parade* magazine ran an article entitled "What If We Abolished the Federal Income Tax?". This article discussed replacing the income tax with a national retail sales tax and invited readers to comment. In response, over 40,000 letters were received. 96% were in favor of abolishing the income tax and replacing it with a national retail sales tax and 4% were opposed.

Although many in Washington seem to doubt this, Americans really do understand the effects of taxes on their lives. They know that the right type of federal tax will encourage savings and investment, reward hard work, remove an enormous and expensive compliance burden from businesses and individuals, be perceived as fair, tax the underground economy, be obvious and not hidden, and get the IRS out of our lives. Our alternative, the national retail sales tax, meets the above criteria better than any of the other alternatives being discussed. The national retail sales tax is simple—a flat rate applied to all retail consumption of goods and services, and obvious—when you make a retail purchase of a good or service, the national retail sales tax is clearly shown on the sales receipt. If you want to know how much federal tax you paid, all you have to do is look at the receipt.

What national retail sales tax rate would be needed to replace the revenue currently generated by the individual and corporate income tax? Dr. John Qualls, adjunct Professor of Economics and International Affairs at Washington University in St. Louis, Missouri, used the COREMOD policy simulation model to delineate the economic effects of replacing the income tax with a national retail sales tax. He found that a 16 to 17 percent sales tax rate was needed to replace the income tax collections of $587 billion in 1990, given a consumer spending level of $3.605 trillion in that year.

There has been a lot of discussion about the fairness of one alternative or another. The national retail sales tax has been labeled "regressive" and the income tax alternatives have been labeled "progressive." This is a distortion. Some people are concerned that the national retail sales tax

will collect most of its tax revenues directly from lower income groups. This is not true. According to the Current Population Reports published by the Department of Commerce, American families with annual incomes under $18,149 account for only $500 billion of the $3.605 trillion of consumer retail spending. As with the present income tax, middle- and higher-income families will pay the great majority of the national retail sales tax.

Economists maintain that the regressivity of the national retail sales tax is overstated because it should be measured over a person's lifetime not each year. Although in some years consumption will not equal income, the consumption of most households roughly equals their lifetime income. The national retail sales tax is really a proportional tax.

However, replacement of the income tax with a national retail sales tax will have initial effects on people with fixed or lower incomes. There are simple ways to prevent unwanted burdens on these people. With the national retail sales tax, the federal government collects our taxes in the simplest and fairest way. While there are a number of proposed methods for creating a safety net for our citizens, we believe that the most effective will be through cash rebates. Through the use of cash rebates we can ensure that a family of four would essentially pay no national retail sales tax on the first $15,000 of retail purchases in a year, approximately the equivalent of the standard deduction and the personal exemptions currently allowed by the present income tax system.

My testimony will address the national retail sales tax, the flat income tax proposal sponsored by Congressman Armey and the consumed income tax proposal sponsored by Senator Nunn and Senator Domenici.

Chairman Archer has asked that our testimony address the following points:

1. Is the proposed alternative easy to comply with and does it reduce the role of the Federal Government in our lives?

2. Does the proposed alternative encourage greater savings and investment?

3. Does the proposed alternative improve the international competitiveness of American workers and businesses?

4. Does the proposed alternative pick up revenue from the underground economy and others who currently do not comply with the tax laws?

5. Does the proposed alternative tear the income tax out by its roots?

IS THE NATIONAL RETAIL SALES TAX EASY TO COMPLY WITH AND DOES IT REDUCE THE ROLE OF THE FEDERAL GOVERNMENT IN OUR LIVES?

Compared to the income tax, all three alternatives promise a reduced compliance burden. However, the national retail sales tax is clearly the easiest with which to comply and will most reduce the role of the federal government in our lives.

While on a radio talk show, a caller told me that preparing tax returns was government-imposed slavery. He explained that slavery was being compelled to do work that you didn't want to do without being paid for it and being punished severely if you did not obey. He was right. The foremost goal of any alternative to the present income tax should be the freeing our citizens from government-enforced "slavery." Our intention to free Americans from the slavery of an insane tax system has led some journalists to label us as the "New Abolitionists." This is a label of which we are proud.

As a professional well acquainted with the problems of complying with our present income tax system, it is frustrating to me when "experts" attempt to show the costs of a tax system by merely compiling the costs of the government agencies collecting the tax and enforcing the tax law. This method only reflects a small portion of the actual costs. Compelling taxpayers to amass records and prepare any type of tax return takes taxpayer time that is, in essence, an additional cost of the tax system. Time thus expended could have been devoted to productive activities. According to the Tax Foundation, corporations with assets of $1 million or less (more than 90 percent of all corporations) paid a minimum of $387 in compliance costs for every $100 they paid in income taxes ($14 billion in compliance costs for $3.7 billion in income taxes). Ironically, if this time and money could have been devoted to the production of goods and

services and not to the preparation of non-productive paperwork, the economy would grow even more which would in turn lead to more taxes being collected.

Our current federal income tax system is beset with administrative problems. In 1992, Americans filed 113,604,503 individual income tax returns (including 15,495,419 nonfarm sole proprietor returns), 1,484,752 partnership returns and 3,869,023 corporation returns for a total of 118,958,278 tax returns. According to GAO reports, IRS employees err on one out of every ten income tax returns they enter into the IRS computers, and the IRS has more than $200 billion in misstated payments from taxpayers and refunds. Most troubling, the National Research Council predicts a major breakdown could occur in the present income tax system before the year 2000.

Which of the three alternatives is the easiest with which to comply and most reduces the role of the federal government in our lives? Each of the three alternatives should answer the following questions:

(a) What is taxed, who files the return and who administers the tax system?

(b) Who files the tax return and how often?

(c) How complex is the tax return?

WHAT IS TAXED, WHO FILES THE RETURN AND WHO ADMINISTERS THE TAX SYSTEM?

National Retail Sales Tax

Under the national retail sales tax, most Americans will not file any type of tax return. Only an estimated 10 million providers of retail goods and services will be required to file sales tax returns. Most of them will file monthly sales tax returns but the larger retail establishments will, as they do with state sales taxes, file more frequently. The states will collect the national retail sales tax and send the taxes collected directly to the U.S. Treasury. The Internal Revenue Service is not involved and will no longer interfere in the lives of ordinary Americans.

Flat Income Tax

Each American must file a tax return each month and then a thirteenth return on April 15. Owners of businesses must prepare thirteen tax returns for their personal taxes and thirteen more tax returns for their businesses. Enactment of the flat income tax will require Americans to file a minimum of 1.5 billion income tax returns each year. The flat income tax is collected through the IRS which will at least retain the powers it now has under the federal income tax. However, many tax practitioners believe that the IRS will have to be granted even more coercive powers because many people will not make their monthly tax payments on time. Obviously, this does not get the IRS out of our lives but ensures a continuing and ever-increasing involvement of the IRS in our lives. This is just the opposite of what any alternative should do.

Consumed Income Tax

Under the consumed income tax system, everyone must file a tax return with the IRS, which will still retain the powers it now has under the federal income tax. Enactment of the consumed income tax will require about 118,900,000 income tax returns in the first year. Like the flat income tax, the consumed income tax does not get the IRS out of our lives but ensures a continuing and ever-increasing involvement of the IRS in our lives. This is just the opposite of what any alternative should do.

HOW COMPLEX IS THE TAX RETURN?

National Retail Sales Tax

The national retail sales tax return will be simple. For example, the Texas sales tax return measures 3.5" x 8.5". Revenue from retail sales for the period is totaled, returns are subtracted, and the remaining balance is multiplied by the rate of the retail sales tax. The only record keeping required will be to total the retail sales, the amount of sales returns or refunds and the amount of the national retail sales tax collected from customers.

Flat Income Tax

Except for having to prepare tax returns thirteen times per year, the flat income tax return will be simple for wage earners if they have no self-employment income. The self-employed and all businesses must add up their total revenue from operations, subtract the inputs from other firms, subtract the amount of wages, salaries and pensions paid to workers and subtract the purchases of plant and equipment. The remaining amount is then taxed at the flat rate.

How complex will business returns be? The business returns will be much more complex in actual practice than in theory. Are we simply going to let businesses fill in a total amount for goods and services purchased from other firms or for the purchases of plant and equipment? It seems naive to me that, in the interest of fairness, we aren't going to enforce diligently the limits of what is deducted from income. Is it acceptable for a business to purchase cars for personal use through the business or for the owner to purchase computers for each of his twelve children through the business and thus reduce the taxes of the business?

Consumed Income Tax

The consumed income tax return for individuals will be very similar to the tax returns we are now used to preparing. An individual will calculate his gross income from wages, interest, dividends and amounts received from the sale of assets. From gross income the individual will subtract a family allowance, all "qualified savings and investments", a higher education deduction, and home mortgage interest, charitable contributions and alimony paid. Then the initial tax is calculated and a credit for social security taxes is deducted. The resulting amount is then paid to the IRS.

Businesses total the revenues received, deduct the amounts paid to other firms for the goods and services purchased from them, including plant and equipment as well as inventory, parts, supplies, outside services and utilities but not wages paid to employees. This resulting amount is multiplied by 11%. Then a credit for the 7.65% employer portion of FICA for its employees is deducted and the resulting amount is the tax owed.

This is the most complicated of the three alternatives being discussed. It will require individuals to keep extensive records to be able to file income tax returns. It will also require all businesses, not just those providing retail goods and services, to file income tax returns.

Summary

Clearly the alternative that is the easiest with which to comply and that most reduces the role of the federal government in our lives is the national retail sales tax. Over 90 million Americans file no tax return of any kind under this system. The 10 million returns to be filed will be much simpler than the tax returns retailers must file under either the flat income tax or the consumed income tax. The IRS is required to enforce and collect the flat income tax and the consumed income tax but can be dismantled under the national retail sales tax.

DOES THE NATIONAL RETAIL SALES TAX ENCOURAGE GREATER SAVINGS AND INVESTMENT?

The rate a nation saves is directly correlated with its rate of economic growth and the health of its economy. More savings reduces the cost of investment capital and increases its availability. Our people are taxed when they earn income, and if they then manage to save or invest some of it, they are taxed again on the earnings from the savings and investments. When income tax and inflation are subtracted from the earnings on savings and investments, many Americans are actually losing purchasing power when they choose to save and invest. Therefore, it should be no surprise that the U.S. has had the lowest personal savings rate of any industrialized nation for the past 17 years.

This lack of availability of capital directly affects our productivity. To become more productive, American businesses must continually modernize their plant and equipment, which requires capital. The Office of Technology Assessment estimated that each year from 1977 to 1988 the cost of capital in America averaged 3.4 percent higher than the cost of capital in Japan for investments in machinery and equipment with a physical life of 20 years, 4.9 percent higher for a factory with a physical life of 40 years and 8 percent higher for a research and development project with a 10-year payoff. It is not merely a coincidence that countries with higher savings rates have higher rates of sustained productivity growth.

Productivity is important to America. Dr. Qualls calculated that if the rate of productivity growth had continued at the same rate in the 1970's and 1980's as it was for the period 1950 to 1967, we would live in a much different America today. At current levels of spending, there would not be a budget deficit or a national debt and the average family would have $10,000 more each year in real disposable income.

Although there are some significant differences, each alternative would encourage savings and investment and allow for increased productivity much better than the current income tax.

National Retail Sales Tax

Under the national sales retail tax, savings and investment will dramatically increase. In a study by Dr. Laurence J. Kotlikoff, Professor of Economics at Boston University, entitled *THE ECONOMIC IMPACT OF REPLACING FEDERAL INCOME TAXES WITH A NATIONAL SALES TAX*, Dr. Kotlikoff stated, "The shift in tax structures is predicted, in the long run, to raise the stock of U.S. capital by at least 29 percent and potentially by as much as 49 percent and to raise U.S. living standards by at least 7 percent and potentially by as much as 14 percent.." Dr. Kotlikoff calculated that a 16.9 percent national retail sales tax rate would be needed but that it could decrease to 11 percent as the economy grew.

Both Dr. Kotlikoff's and Dr. Qualls' studies found that the national retail sales tax causes the private savings rate (both personal and business savings) to rise substantially and produces faster economic growth and higher productivity. In both studies, the higher level of capital stock created under the national retail sales tax results in more job creation. More earnings by employees in the private sector fuels more consumer spending. Consumer spending thus rises from its current level but actually declines as a percentage of GNP.

There will also be what some economists call the "sponge effect". The U.S. is the world's largest market and has the best infrastructure of any country on earth. When the income tax is replaced with the national retail sales tax, it will become the world's largest tax haven and a "sponge" for capital from around the world. According to Martin Armstrong of the Princeton Economic Institute, replacing the income tax with a national retail sales tax will create an inflow of foreign capital into this country like we have never seen. Mr. Armstrong points out that the nearest comparable period in modern history was in 1940. Seeking to avoid the ravages of World War II, capital flooded into the United States and government bond rates were at one percent.

A more conservative estimate is that the adoption of the national retail sales tax will lower interest rates between 200 and 300 basis points. Overnight we will see the debt service on our national debt reduced, perhaps enough to bring the budget in balance. Our businesses will be more able to purchase equipment and rapidly increase productivity. Our citizens will be able to refinance their homes and save hundreds of dollars per month. In short, the United States will experience the greatest economic boom in our history.

Flat Income Tax

Under the flat income tax savings and investment will increase because income from savings and investment will not be taxed. However, the rate of increase in savings and investment will be slower than under the national retail sales tax because all income and business profits are taxed as the money is earned. Only the amount remaining after the income tax is deducted will be available for savings and investment. While there will be an influx of foreign capital under the flat income tax, the complexity of the tax and the concern that it will revert back to a regular income tax will cause the increase to be less than under the national retail sales tax.

Consumed Income Tax

Savings and investment will increase under the consumed income tax. The consumed income tax allows taxable income to be reduced by the amount of money saved or invested. While there will be an influx of foreign capital under the consumed income tax, the complexity of the tax and the concern that it will revert back to a regular income tax will cause the increase to be less than under the national retail sales tax.

Summary

As the economic studies show and as common sense predicts, savings and investment will grow much faster under the national retail sales tax than under either of the other alternatives.

DOES THE NATIONAL RETAIL SALES TAX ENCOURAGE INTERNATIONAL COMPETITIVENESS OF AMERICAN WORKERS AND BUSINESSES?

The income tax seriously harms our ability to compete in the global marketplace. Our major trading partners around the world rely heavily on consumption taxes that are applied to all products sold in their countries, whether domestically made or imported, and are "border-adjustable," meaning that the taxes on exported goods are rebated to manufacturers within their borders. (GATT does not allow rebates of income taxes.)

Congressman Sam Gibbons (D-FL) has stated that our income tax system has caused us to be a nation of exporters of jobs. High-paying American jobs are vanishing overseas at an alarming rate. Without a border-adjustable tax, we handicap our exporters because their goods contain the cost of our government, whereas imported goods do not contain any cost of our government. Therefore, the income tax penalizes American products and exports and subsidizes imports.

To illustrate the problem, assume that an American-made product and an identical foreign-made product each have a selling price of $1.00. Both products have, as a component of that price, built-in tax increases of approximately 20 percent or $0.20. (In the U.S. this 20 percent is due to income taxes; in countries such as European Common Market countries the increase is due to consumption taxes.)

When the foreign-made product is exported to the U.S., the consumption taxes are rebated to the foreign manufacturer as the product leaves the country. It thus arrives in the U.S. at a net cost of $.80 and the U.S., for all practical purposes, does not require the product to pay any income tax. (Former Congressman Richard Schulze stated that in 1989 the $600 billion of imports that year paid an income tax of only 0.1 percent.) Thus, this product with a cost of $0.80 competes against U.S.-made products costing $1.00.

Further inequities occur when a U.S. product is exported to a foreign country. U.S. manufacturers receive no rebate of the income tax component of the cost, and to compound the problem, the foreign country will tack on their consumption tax (say an average of 20 percent) to the cost of the good. So the $1.00 exported item now costs $1.20 and is competing against similar foreign products at $1.00.

Why is this important? It is estimated that each $1 billion in exports supports 19,000 jobs in the U.S. While our OECD competitors' exports range from 15 percent to 30 percent of their GDP, our exports only total 6 percent of U.S. GDP. By increasing exports, the U.S. can create hundreds of thousands of the type of high-wage jobs that our country desperately needs.

Our international competitiveness will be affected by each of the three alternatives but in widely disparate ways.

National Retail Sales Tax

With the national retail sales tax, our international competitiveness will be greatly enhanced. The national retail sales tax is only levied on sales in the U.S. Our exports will pay no U.S. tax nor include U.S. taxes in their prices. Imports into our country that are sold at the retail level will be taxed in the same manner as U.S. retail products. Our companies will no longer be forced to locate factories in other countries in order to compete in a global economy. More higher-paying jobs that would have otherwise gone to foreign citizens will stay in the U.S. With the national retail sales tax , we will no longer be exporting jobs to foreign countries, and our economy will rapidly grow.

Flat Income Tax

Like the current income tax and the consumed income tax, the prices of U.S. exports will include income taxes. Unlike the national retail sales tax, the flat income tax does not prevent imports from utilizing transfer pricing to largely avoid paying U.S. taxes. Under the flat income tax a company can still produce a product for $.25 in country Y but sell it to its U.S. subsidiary for $.80 and then sell it in the U.S. for $1.00. The only portion of the profit taxable under the flat income tax will be the difference between $.80 and $1.00.

Consumed Income Tax

Under the consumed income tax, a U.S. company's earnings on exports are not taxed. Like the

current income tax and the flat income tax, the prices of U.S. exports will include the cost of consumed income taxes paid by all the company's suppliers in the U.S. The consumed income tax imposes a flat 11% import tax on the sale in the U.S. of foreign imports.

Summary

In the arena of international commerce, the national retail sales tax is the clear winner. U.S. exports are not taxed at all and imports will be subject to the same 16% to 18% national retail sales tax that U.S. products carry. In addition, unlike the flat income tax and the consumed income tax, U.S. exports will not have to include in their prices the amounts of income tax paid by everyone in the chain of production.

DOES THE NATIONAL RETAIL SALES TAX PICK UP REVENUE FROM THE UNDERGROUND ECONOMY AND OTHERS WHO CURRENTLY DO NOT COMPLY WITH THE TAX LAWS?

We must remember the old adage that laws are no stronger than the devotion of the people to them. The present income tax is increasingly viewed as being anything but fair and the devotion of the people is becoming severely strained. Once our voluntary compliance rate was the envy of the world. Now, even many in the IRS admit that substantial voluntary compliance with the federal income tax is a thing of the past. In 1994, an estimated 10,000,000 taxpayers elected to drop out of the system altogether.

The underground economy is the fastest growing segment of our economy. It is estimated that $127 billion of taxes went uncollected in 1992 due to the underground economy. Many analysts believe that estimate is too conservative and that a figure of $200 billion is closer to the truth. The underground economy encompasses not only illegal sources of income, such as drug dealing, gambling and prostitution, but also the average ordinary citizen who accepts a lower price for cash payments and doesn't report the income; the businessman who keeps two sets of books and pockets a portion of the sales or takes improper deductions; or the self-employed person who charges personal expenses through the business.

National Retail Sales Tax

There will be an element of noncompliance under any tax system, but the national retail sales tax will be much harder to evade. Taxpayers who take improper deductions, drug dealers and people who refuse to file income tax returns or report all of their income have one thing in common--they all purchase goods and services. The national retail sales tax ensures that each of these groups pay their fair share when they buy their automobiles, yachts, televisions, etc.

Will there be people who refuse to pay the national retail sales tax? Yes. There are always going to be people who refuse to pay any tax. However, it is much more difficult to avoid the national retail sales tax than any income tax. In California, the State Board of Equalization's statistics show that 90% of the state sales taxes are paid by 8% of the providers of retail services. California sales tax officials believe that there is little or no evasion from this 8% of the retailers because of their size and their accounting systems. Since it is unlikely that all of the remaining 92% of the retailers will be dishonest, the amount of evasion, even if the rate was increased to 18%, will likely be between 5% to 7%—far better than the 17% to 25% experienced under an income tax.

Flat Income Tax and Consumed Income Tax

To the extent that deductions are eliminated, the flat income tax or the consumed income tax may have some effect on reducing the portion of the underground economy that is caused by people who take improper deductions under the present income tax. However, there is a high likelihood that this reduction may be offset by an increase in improper business deductions because of the way both alternatives propose to tax business. In addition, the only way for either alternative to even tax a small part of the remainder of the underground economy is to increase the coercive powers of the IRS against all citizens whether they are honest or dishonest, and our country will slide further away from freedom toward "Big Brother."

Summary

The national retail sales tax is clearly better at ensuring that all Americans pay federal taxes and it accomplishes this without having to increase the harassment of our citizens or involve the IRS.

DOES THE NATIONAL RETAIL SALES TAX TEAR THE INCOME TAX OUT BY THE ROOTS?

The IRS has the ability to summons nearly all of our financial records without our consent and pry into each of our private lives. Taxpayers are presumed "guilty" until they can prove their "innocence". Yet, it has become apparent that the only way the IRS can continue to collect the income tax from our citizens is to become more and more coercive and intimidating. This is unacceptable and cannot be tolerated if we really are a free society.

National Retail Sales Tax

The national retail sales tax is the only one of the alternatives that allows us to "tear the income tax out by its roots." The national retail sales tax will be administered by the states. Over 100 million Americans will be freed from the obligation of filing tax returns and being subjected to IRS harassment and audits. The remaining 10 million will file much simpler and easier tax returns than under the flat income tax or the consumed income tax.

Flat Income Tax and Consumed Income Tax

The flat income tax and consumed income tax are still income taxes. They require all of us to file income tax returns with the IRS. All of the IRS apparatus and computers and dossiers will still be in place. A future Congress will only have to slightly modify this and change that and suddenly we have the same type of horrible income tax system that we are eagerly discussing eliminating at these hearings because the forms, the computers and the enforcement apparatus will still be in place.

Is this an unlikely scenario? I think not. Since the 1986 Tax Reform Act, Commerce Clearing House has counted more than 5,000 changes to the Internal Revenue Code. If there is an income tax, there will be a huge temptation to direct investment or activities and there will be an unlimited amount of contributions to be reaped from constituents and lobbyists who want tax favors.

Summary

The national retail sales tax allows for the elimination of the IRS. The flat income tax and the consumed income tax ensure that the IRS will continue to be involved in our lives.

CONCLUSION

We believe that repealing the income tax and tearing the IRS out by its roots is the most important ingredient in an alternative tax system. An income tax and the IRS are anathema to a free society. In *For Good And Evil*, Charles Adams' important work on the impact of taxes on civilization, he points out that the astute Greeks observed that tyranny (oppressive government) was the consequence of the wrong kind of taxation; conversely liberty was the consequence of the right kind of taxation. And what was the right kind? Sales and customs taxes, said the Greeks. The wrong kinds of taxes that produced bad government were direct taxes like income and production taxes. The Greeks came to these conclusions, not from reason, but from the examples of history.

Our income tax has proven that the Greeks were right. Much of our liberty has been lost to make our income tax system work, exactly as the Greeks predicted. Selection of the best alternative to the income tax is important to the cause of freedom and man's dignity.

America has remained free because men and women have been unwilling to allow tyranny and oppression to dim the light of freedom. Citizens For An Alternative Tax System believes that the opportunity to eliminate a system of taxation that has become oppressive everywhere it has been used in history—the income tax— exists today.

We must not let this chance be lost. If we allow the income tax to continue, we will be harshly judged not only by Americans living today but also by future generations. Replacement of the income tax system with a national retail sales tax is the solution that is needed by America.

Chairman ARCHER. Mr. Moore, you may proceed.

STATEMENT OF STEPHEN MOORE, DIRECTOR OF FISCAL POLICY STUDIES, CATO INSTITUTE

Mr. MOORE. Thank you, Mr. Chairman. I am Stephen Moore, director of fiscal policy studies at the Cato Institute. I thank you for holding these truly historic and revolutionary hearings. I must say that I never thought I would see what we have seen in the last 3 days in this room any time in my lifetime or at least any time in this century.

I also thank you for coming up with a proposal that I think is probably the most liberating public policy idea that this country has seen in several decades—Ronald Reagan, God bless his heart, never came up with an idea—this liberating idea of getting rid of the income tax, and I use that word purposefully, "liberating," because that is what this idea is about.

About 4 years ago the Cato Institute got very involved in the issue about whether we should abolish the income tax. Interestingly enough, when we came up with this idea we had Larry Kotlikoff, whom you heard from earlier, do a study for us looking at the impact of this. People used to roll their eyes and say, there goes the Cato Institute with one of their utopian fantasies.

It is very interesting to me how this issue has developed. We don't see it as a utopian fantasy anymore. In fact, what we used to say, to borrow a phrase from a fellow Texan of yours, if we adopted a national sales tax idea and had zero tax on corporate income, zero tax on personal income and zero capital gains tax, that that giant sucking sound you would be hearing would be capital from all over the world flowing into the United States.

Imagine that there was no income tax, that there was no April 15 to dread any longer, that there was no H&R Block to deal with every year. Our cities would begin to look like gleaming versions of Hong Kong. I truly believe that our problem in this country would be that we would have a shortage of stocks and businesses to invest in, a shortage of workers. We would make Japan and Germany look like they were standing still. And I think that our foreign rivals would be forced to either comply and join us in getting rid of their income taxes, or fall further and further behind economically.

I think this is an issue where the public, notwithstanding you, Mr. Chairman, is way ahead of the politicians. I have worked with Steve Hayes and CATS over the last 4 years and have been amazed at the extent to which this is a populous issue, very much like term limits. You see very strong, deeply rooted interest and support for this issue among grassroots Americans.

It is interesting, because I have heard over the last 3 days a lot of the opponent talk about how this is an idea that will just help the rich "fat cats." If you go to a CATS meeting in Cleveland, Ohio or Houston, Tex., and you go to one of their townhall meetings, it is not rich Wall Street "fat cats" that want to get rid of the income tax; it is busdrivers and schoolteachers and grandmothers, real people with real jobs, and they are very concerned about our current system.

So let me say, the proposal that we have come up with—and everyone has a different version of the national sales tax, but there are basically four features of the proposal that we have come up with. First, we would eliminate the entire personal income tax, corporate income tax, capital gains tax and the estate tax. And by doing that, you can replace that with about an 18 percent flat rate national sales tax. This would apply to all final-use goods and services. The only thing that would be exempted would be housing, under our plan.

The second feature of our proposal—and this is important because it gets to the idea of regressivity of a sales tax—is that we would provide a $5,000 per person exemption or what you should call a "rebate." So if you are talking about a family of four, $20,000 of their first purchases would be exempt from the tax in a given year. This makes the system a nonregressive tax.

In a sense, what we are coming up with is the equivalent of what Mr. Armey has in his plan with the zero bracket up to $36,000, although we would make it $5,000 per person. His is, I think, $36,000 for a family of four. But if you wanted to make your exemption as generous as his, you could do that very easily. Just make the exemption $9,000 per person. The bottom line is that there is no reason that a national sales tax has to be regressive.

The third feature of this is that we would bring about the dismantling of the IRS by having the States collect the sales tax. As you know, Mr. Chairman, 45 States already have sales taxes in place, and one of our worries is that we want to make sure that we don't get a sales tax and an income tax. One of the ways of doing that, I think, is when you bring in place the national sales tax, we dismantle the infrastructure of the income tax in Washington, to have the States collect it, and I think the States would simply then piggyback off of the Federal tax system. By the way, this would not be an unfunded mandate. Under our plan, we would reimburse the States for the cost of collecting the tax.

Finally, and I think most importantly—and I haven't heard too much talk about this over the last 3 days—we would require a supermajority vote to either raise the sales tax or to reintroduce any other of the taxes that have been eliminated. I think that a very key feature, if you want to get support for this idea, is a supermajority, something like a two-thirds vote requirement in both Houses.

I am sure you are familiar with the Kotlikoff plan we have come up with. I am not going to go over the economics of that. Let me conclude by saying this, and this is one area where I may disagree. If you look over the last 3 days of these hearings, there is vast similarity between the plans that have been introduced—the Armey plan, the Nunn-Domenici plan and the Archer idea. While I am totally committed to a national sales tax, I also don't think we should let the ideal be the enemy of the good. If you can pass an Armey flat tax plan this year, do it. I think that would certainly be a very strong movement in the right direction, and I think that this is one of those canyons; to get to a national sales tax, we may have to leap this canyon in two leaps, go to the Armey flat in leap one, and once we have established the principle, both flat rate tax systems

with no deductions, then I think it is a logical conclusion to say, what do we need an income tax system for?

Thank you very much for holding these hearings, Mr. Chairman.

[The prepared statement follows:]

TESTIMONY OF STEPHEN MOORE
CATO INSTITUTE

Thank you Chairman Archer for the opportunity to testify during these three days of congressional hearings on radical overhaul of the U.S. tax code. I commend your leadership and courage for convening these historic hearings.

A revolutionary change in our tax system is fundamental to re-energizing the American economy and restoring the American dream. Although Congress may not be ready quite yet to enact a flat tax or a national sales tax, let me assure you that the public is. Americans are entirely exasperated with the current income tax--they want a system that is simpler, fairer and more pro-growth. A recent article in Parade Magazine asked readers whether they would favor a national sales tax over the current income tax. More than 50,000 responses have been received. They are running 50 to 1 in favor of abolishing the income tax. Even IRS agents are writing in saying we should scrap the income tax.

Let me state my overall conclusions from the start.

1) The entire personal income tax, corporate income tax, capital gains tax, and estate tax can and should be replaced with an eighteen percent national sales tax that protects the poor. Eventually, as we cut down on the size and scope of the federal government and accrue the dynamic revenue feedback effects of hyper-charged economic growth that would result from abolishing the income tax, the sales tax rate could be lowered to well below 15 percent.

2) We ought to consider enacting the Armey flat tax plan as an intermediate step to abolishing the income tax completely. Although there is much disagreement over the merits of a flat tax versus a sales tax, what is most remarkable in this debate is not how different these two plans are, but how similar they are. For example:

* The Armey plan and the sales tax plan both vastly simplify the tax code.

* The Armey plan and the sales tax plan both have a 17 to 20 percent flat tax rate.

* The Armey plan and the sales tax plan both eliminate all deductions in the tax code. This means that both plans are fighting a common enemy: the army of special interest groups who have spent decades carving out their special interest exemptions and loopholes.

* The Armey plan and the sales tax plan both have virtually an identical tax base: consumption. The economic impact is very similar and explosively positive.

Mr. Chairman, it is my view that you and Mr. Armey agree on far more than you may think.

The only real dispute--and this is certainly an area of enormous consequence--is whether we should collect the tax through a postcard income tax return or at the cash register. This is where the sales tax in my opinion is far superior in the longterm to the flat tax. I favor a national sales tax because I believe that the income tax is incompatible with a free society. The IRS routinely intrudes on our basic civil liberties and privacy rights--and it's intrusions are getting worse all the time. I want an America where it is no longer the government's business how much money you make and what you do with it.

Still, it may make sense to enact the flat tax immediately and the sales tax later--as Cato has advocated in our Handbook for Congress. Once we have established the principles of a low flat rate tax on consumption with no deductions--and all the special interest lobbies have been steamrollered--it is a logical

next step to scrap the income tax entirely. This may be a canyon that needs to be crossed in two leaps. The first leap should be the flat tax. The second the sales tax.

In earlier testimony the case against the income tax and for a national sales tax has been eloquently presented. I will therefore discuss not the issue of whether a national sales tax, but how. I also want to debunk some of the common myths circulating about the alleged impracticalities of a national sales tax.

The Cato Institute has developed a national sales tax plan with the following four features:

* An 18 percent sales tax on all final use goods and services (this is not a retail sales tax) except housing and securities. Over time the rate would gradually decline to below 15 percent.

* Every American would receive an annual rebate on the tax paid on the first $5,000 of purchases. This would mean that for a family of four, the first $20,000 of consumption during the year would be tax free.

* The states--45 of which already have an income tax--would be responsible for collecting the national sales tax. (The federal government would reimburse the states for the cost of collection. This would not constitute an unfunded mandate.) With the states collecting the tax, the federal IRS police force would be largely disbanded. With the infrastructure of the income tax system dismantled, it would be very difficult for a new income tax to be reinvented.

* A two-thirds supermajority requirement in both houses to raise the sales tax or any other federal tax.

The national sales tax is the only plan that fixes all of the defects of the current income tax system. Here is how:

1) Because the sales tax exempts all savings and investment, the double taxation problem would be eliminated. Because the sales tax is a single flat rate, the disincentive effects from high marginal rates would be eliminated. That giant sucking sound you would be hearing would be investment capital from across the globe sweeping into the United States.

2) By eliminating the income tax entirely, compliance costs--estimated at $200 billion a year--would be substantially reduced.

3) The sales tax would virtually eliminate the Internal Revenue Service. The sales tax is the only plan that solves the intrusiveness of the current system.

4) A sales tax would be paid by consumers every time they purchased a good or service at the cash register. Because the tax would appear on the receipt, the sales tax would be highly visible to taxpayers. All purchases--from an 89 cents grape slurpee at seven-11 to a $20,000 Ford Bronco--would be taxed. Taxpayers would be constantly reminded of what a hefty price we pay for government in America today.

A common question that I am asked about this plan is: Do the numbers really add up for the sales tax to raise as much revenue as the income tax does? To answer that question, in 1993 the Cato Institute commissioned a study by economist Lawrence Kotlikoff of Boston University to examine the economic impact of replacing federal income taxes with a national sales tax--roughly as described above. The purpose of the Kotlikoff study was to determine a) What would be the impact of the sales tax on

economic variables such as savings, wages, and output? and b) What is the necessary sales tax rate to completely replace on a revenue neutral basis the federal personal income, corporate income, and estate tax?

Kotlikoff discovered that to completely replace federal income taxes would require an initial sales tax rate of 17.4 percent. After five years the rate could be reduced to 15.4 percent, and after ten years the rate could be lowered to 13.9 percent. The reason the rate can be lowered is that the study finds a very positive economic feedback from the tax change. Specifically, the Kotlikoff study finds that after ten years, a national sales tax would:

1) More than double the national savings rate.

2) Increase the capital stock by 8 percent above the level attained under the current tax system.

3) Raise income and output by 6 percent more than would be achieved under the current tax system. That would increase national output by almost $400 billion per year.

4) Lift the real wage rate by 3 percent.

5) Reduce interest rates by 50 to 100 basis points.

Kotlikoff concludes the Cato study by issuing the following endorsement for a sales tax: "A shift to a national sales tax has the potential for dramatically improving incentives to save. The distortion to save is so great under our current system of income taxation, that it appears we could switch to consumption taxation...and end up with much higher rates of saving and capital accumulation and a higher level of per capita income."

What then, are the arguments against the national sales tax? Here are the most common objections, and the reasons these objections are exaggerated, or in some cases, just plain false.

Objection 1. The sales tax is regressive.

The rebate feature of the national sales tax makes this proposal nonregressive. Remember, a family of four would pay no tax on its first $20,000 of purchases each year. This is the equivalent of a zero bracket under the income tax. It is similar to the Armey personal deduction--though not as generous.

There are various ways of providing this rebate. Assuming that the sales tax were set at 18 percent, a family of four would be entitled to a rebate of $3,600 ($20,000 x 18 percent) for the year. The government could send a quarterly rebate check of $900 to every family of four; a $450 check to every family of two; and so on.

Another possibility would be to provide every family with an annual "smart card" that would have a sales tax credit based on family size. A married couple with no kids would receive a $10,000 credit on its card. Each time the couple made a purchase, the smart card would deduct that amount until the card's $10,000 credit was used up. After the first $10,000 of purchases, the family would begin to pay the sales tax.

So it dead wrong to argue that a sales tax is inherently regressive.

Objection 2: A sales tax of 18 percent would entail large-scale evasion.

A national sales tax of 18 percent, when added to the existing states sales taxes, would bring the total sales tax to

between 20 and 25 percent.

Critics are right when they argue that a sales tax this high would encourage evasion. But compared to what? Evasion is already a huge problem with the income tax. An estimated $150 billion of income tax goes uncollected each year--according to the IRS's own calculations. Moreover, states report that the their sales taxes are generally easier to collect than their income taxes, because there are so fewer points of collection.

I believe that much of the evasion that goes on with our tax system is a result of the correctly perceived unfairness of the system. Once we move to a national sales tax that is perceived as fair, simple and just, compliance rates will climb substantially. This is also true of the Armey flat tax as well.

Objection 3: the sales tax may not be a replacement, but rather an add-on to the current income tax.

A very legitimate concern voiced by many conservatives is the danger that America will end up with both a sales tax and an income tax. This has been the experience with the consumption tax VATs in Europe. For this reason, some critics argue that the sales tax is only acceptable if the 16th Amendment to the Constitution authorizing a federal income tax were repealed. That would certainly be highly desirable, but is not necessary. To protect against the reintroduction of the income tax, I would insist on a supermajority tax raising requirement.

Objection 4: The national sales tax has been a political and economic disaster in Europe and Canada.

VATs have had highly negative consequences in Europe. They have not raised savings rates, they have not reduced income tax burdens, and they have been an engine of growth of government. For these reasons, I strongly oppose a value-added tax. But no European nation has implemented a national sales tax as a complete replacement for the income tax. This is the critical difference between our proposal and what has occurred in Europe and Canada.

I believe that the national sales tax is the superior tax reform proposal on the table. Many of the reform ideas now in the mix--including the Nunn-Domenici plan--will soon fall out of the picture and the national debate will begin to revolve around just two proposals: the flat tax and the national sales tax. My preference is the sales tax, but either of these would be vast improvements over the current system.

Chairman ARCHER. Thank you, Mr. Moore.

Our last witness of the day is Michael Rothschild.

STATEMENT OF MICHAEL ROTHSCHILD, PRESIDENT, BIONOMICS INSTITUTE, SAN RAFAEL, CALIF.

Mr. ROTHSCHILD. Thank you, Mr. Chairman. My name is Michael Rothschild; I am president of the Bionomics Institute located in San Francisco. Our work is to help both the general public and policy leaders such as yourselves understand the profound nature of the changes taking place in our economy because of the invention of the microprocessor. I also work as a consultant and as a businessperson in Silicon Valley.

Let me cite one fact to you. Since 1971, when the microprocessor was invented, the cost of dealing with information has fallen 10 millionfold. That is like dropping the price of a barrel of oil from $20 to 2 cents. That is like being able to buy a brandnew 747 for the price of a large pizza. This collapse in the cost of information is leading to a complete and total transformation of our economy. We are leaving the machine age and entering the information age, and because of that, are now in a period in our country and indeed around the world where we have literally an unlimited number of investment opportunities for a complete transformation of the economy and a much higher level of prosperity than any of us can really imagine. But to bring that into existence, we have to have a level of savings to marry up with new ideas, because you can't just have a new idea and turn it automatically into products. You have to be able to invest capital to create the laboratories, to write the software to create those new products. In that regard, we have done grievous harm to ourselves over the years by punishing savings tremendously through the income tax system.

As a matter of fact, I do not even like to use the phrase, "the income tax." I call it a "family savings tax"; it is not an income tax, it is a family savings tax system. Think of it this way, the first $15,000 or $16,000 of income to a family is not taxed. That is about the level computed as required to have a minimum level of existence. It is only when a family has enough revenue to begin to be able to save, has potential savings, that the so-called "income tax" kicks in.

So, in effect, our system really exists as a tax on family savings. And it is no wonder that we have among the lowest saving rates among industrialized nations, and we are near our all-time low in savings rates. This is, in my view, a catastrophic condition at a time when we face virtually unlimited investment opportunities.

The problem with the flat tax—and I must disagree with my friend Steve Moore—is that it is still a family savings tax, in my view, even though the rate starts off being flat. It will inevitably lead to great complexity. As you have pointed out, Chairman Archer, we have to pull the income tax system out by its roots or it will grow back.

I brought this chart to show why it is so essential to change the basis of tax to consumption rather than taxable income. What I show is that when you try to compute taxable income, the larger circle representing a family, salary comes in, a portion of it is

saved, becomes investment, spins off interest, dividends, capital gains and the rest is consumed.

When you have four flows in the middle of the chart, it is through that area that we try to calculate so-called "taxable income," and that is where the special rules, regulations and loopholes come in.

It is inevitable that people will always have a good reason why a certain piece of their income or their savings ought to be exempted. That is why we generate such incredible complexity in the Tax Code. It is only when you go to the end of the system, to the final purchases level, that it is quite clear what the basis of the tax ought to be. The cash register receipt for a sales tax system automatically calculates that. There is no definitional problem, and we have not seen an issue of creeping definitional complexity in any of the 45 States which has a sales tax.

I am concerned that even though the proponents of the flat income tax talk about being able to file on a postcard, that that postcard sized tax return would soon grow to poster size.

Last, I would like to talk about fairness and morality. I agree with Steve Moore's idea of what I call a universal rebate, not to exempt certain types of items, food, medicine, what have you, but simply to say that perhaps for the first 15,000 dollars' worth of spending that there is a full rebate. So for a 16 percent rate, that would be 2,400 dollars' worth of taxes, so every quarter we would automatically send back $600. What would the family have to do in order to get that? Simply send in an honest to God postcard size filing like the top half of the 1040 which simply lists the people in the family, and their Social Security numbers, that is it.

After a universal rebate takes regressivity out of the problem entirely, then you are in a true ability-to-pay system. Obviously, if I go out and buy an $80,000 Mercedes, which I have never done, but if I were to do so, I am demonstrating my ability to pay in the process of making that kind of consumption. So this is the fairest of systems in that sense.

And finally, let me close on this point. Some would have us believe that it is not good enough to simply have taxes proportionate, if you would, depending on one's ability to pay as demonstrated by the rate of consumption. Their concern is that some people simply shouldn't get richer than other people, that getting wealthier, saving your money, and making something for your family is somehow immoral. I believe this can be traced back to thinking of the machine age, of Karl Marx, who believed that the economy was a zero sum game. In the machine age view, for you to get richer I had to get poorer, the great steam engine of the economy could only run so fast and produce so much.

But we have entered the information age. It is a positive sum economy because of the vast technological change I alluded to earlier. You can get richer as I get richer. There is no limit unless we are unable to save money. Today, we are unable to save in America because of the family savings tax system we call an income tax, and I hope that you are very successful in your leadership on this issue and bring us into the 21st century with a national sales tax.

Thank you.

[The prepared statement and attachment follow:]

Redesigning the Federal Tax System for the Informaton Age Economy

by Michael Rothschild
President, The Bionomics Institute

Introduction

Mr. Chairman and Members of the Committee, it is a great privilege to testify at these hearings on fundamental tax reform. My name is Michael Rothschild. I am president of The Bionomics Institute, an educational foundation based in San Rafael, California. The mission of The Bionomics Institute is to help policy makers and the general public understand how the radical technological breakthroughs of our age are transforming the fundamental nature of economic life. Our work is supported by hundreds of private individuals, including many high-tech entrepreneurs, committed to helping bring about a new era of freedom, opportunity, and prosperity for all Americans.

We believe that recent breakthroughs in information technology have created an historically unprecedented opportunity for an explosive increase in human prosperity. Not all nations, however, will seize this moment and make the most of the stunning opportunities presented by the rise of the Information Age. Indeed, we believe that unless the United States quickly abandons obsolete economic policies-like the federal income tax-that were originally designed for the conditions of the Machine Age, the American people may miss their chance to achieve the great prosperity promised by the Information Age. Along with balancing the federal budget, we believe that replacing the federal income tax with a non-regressive National Sales Tax is the single most vital economic reform Congress can make in creating an environment that nurtures rapid and sustained economic growth.

The Microchip Revolution: From the Machine Age to the Information Age

Just as the fall of the Berlin Wall marked a new epoch in world affairs, last November's election (following the Wall's collapse five years to the day) opened a new era in American political life. Almost no one predicted it, but we are now living through a period of sudden, discontinuous change-a radical transformation of human society. We are leaving the Machine Age and entering the Information Age.

Grasping the economic policy implications of this transformation must begin with an understanding of its root cause: a technological innovation of unprecedented magnitude. Consider this fact: Every week, without pause, one billion new microchips flow from factories around the world. A billion a week. By the year 2000, that number will be two billion a week. Just 25 years ago, the number was zero.

Microprocessors, DRAM memory, SRAM memory, ASIC chips, microcontrollers, electro-optical converters, and a menagerie of other specialized chips pour out of assembly facilities to be immediately stuffed into personal computers, cellphones, pagers, fax machines, satellites, CAT scanners, camcorders, cars, and an ever-expanding list of intelligent machines.

Services that we already take for granted-paying by credit card at the gas pump or drawing cash from an automatic teller machine-were inconceivable in 1969, when Neil Armstrong set foot upon the moon. The Internet. Desktop videoconferencing. Genetically engineered foods. Direct satellite broadcasting. The future is coming on so fast it seems like someone's jammed history's fast forward button. What was technically impossible yesterday is here now and it's cheap-all because of the microchip.

Since the computer-on-a-chip was invented in 1971, the cost of handling information has plunged ten million-fold. That's like being able to buy a brand new $175 million Boeing 747 for the price of a large pizza. Never before in human history has the cost anything dropped so far so fast. And given what the semiconductor technologists already know how to do, we will witness another thousand-fold cost plunge in the next five years.

If the price of crude oil were projected to drop a thousand-fold—from $20 to 2c a barrel, every economic forecaster would predict an enormous boom. Lower prices for gasoline, heating oil, and the energy absorbed in making industrial products would free consumers to shift their consumption to goods and services now beyond their reach. As the cost of basic necessities collapsed, living standards would surge.

Airlines and electric utilities, among the major oil users, would have a field day. But energy-producing competitors, like coal mines and solar energy firms, would be wiped out. Job losses and bankruptcies would devastate the energy sector, while the rest of the economy grew by leaps and bounds.

No oil price plunge is on the horizon, but the collapsing of cost information is working in much the same way. From biotechnology to finance to the media, America's information intensive industries are experiencing stunning rates of growth. At the same time, traditional industrial organizations are going through wave after wave of downsizing and consolidation. The Sunday classifieds are choked with ads begging for workers with advanced information-technology skills, while unskilled workers have precious few options. In effect, the American economy is spontaneously reorganizing itself around the profits generated by cheap information just as it once organized itself around cheap land or cheap energy.

Like the steam engine that ended the Agricultural Age and ignited the Machine Age, the microchip deserves both the blame and the praise for these ineluctable trends. But it is not widely appreciated that the forces unleashed by the microchip dwarf even the transformative power of the steam engine. The development of a more powerful engine had only a marginally positive impact on the rate of progress in other fields. But faster computers and enhanced software help improve engines as well as all other technologies.

To recast a conventional economics term, of all technologies, it is information technology which has the highest "multiplier effect." Because better information technology accelerates the rate of innovation in every field of science and technology, and because the cost of information technology is imploding, the microchip's multiplier effect is magnified, unleashing the most powerful wave of economic growth in all human history. In a way not seen since the last great information technology breakthrough-Gutenberg's printing press-ended the Dark Ages and launched the Renaissance, the microchip is an epochal technology with the most profound economic, social, and political consequences. For decades to come, our economy has the potential to grow far faster than our population-if we do not cling to outmoded economic policies that unintentionally stymie this growth.

The Bionomic View: From "Economy as Machine" to "Economy as Ecosystem"

Since economic growth of such magnitude is beyond our historical experience, it is hard to imagine. But our inability to grasp the economic implications of the microchip revolution is rooted in something more subtle than a lack of comparable experience. My own view is that most of us are blinded by an outmoded economic mindset, a worldview that we inherited from the Machine Age, a paradigm that I call "economy as machine."

Just consider the language that circumscribes conventional economic discourse-on the Left as well as the Right. The economy is always "losing steam" or "picking up speed." Congress uses subsidies, taxes, and regulations to tinker with "broken market mechanisms," while the Federal Reserve "primes the pump," "fine-tunes the engine," and "brakes inflation." Indeed, every time new technology shows signs of creating too many new jobs and rewarding workers for higher productivity with higher real wages, all the experts nod and agree that "the economic engine is overheating."

The philosopher Ludwig Wittgenstein once wrote that "The limits of our language are the limits of our reality." By this he meant that human beings cannot conceive, much less discuss, an idea unless that concept has first been made accessible through language. If we don't have a word to convey an insight, that insight simply doesn't exist. How can we possibly hope to understand the nature of economic growth when we insist on describing the economy as a machine? Have you ever seen a machine grow?

At a time when mind-boggling new technologies make possible unheard of economic growth rates, we remain trapped inside a Machine Age metaphor that precludes any intelligent discussion of economic growth. As The Economist recently put it, "Economists are interested in growth. The trouble is that, even by their standards, they have been terribly ignorant about it. The depth of that ignorance has long been their best-kept secret." The culprit, in my view, is the "economy as machine" paradigm.

Making sense of the Information Age economy will require more than a minor revision of this old economic paradigm. We need radically new thinking. As the social commentator Peter Drucker put it in a recent Atlantic Monthly, "We need to develop an economic theory appropriate to a world economy in which knowledge has become the key economic resource and the dominant, if not the only, source of comparative advantage."

Recognizing this challenge and the inherent limitations of "economy as machine" thinking, I put forward a radically new view of economic life in my book Bionomics: Economy as Ecosystem (Henry Holt & Company, 1990). Bionomics argues that a market economy is remarkably similar to an evolving rainforest. Populated by organizations rather than organisms, the economic rainforest is a staggeringly complex network of feedback loops, relationships that are competitive, symbiotic, predatory, and parasitic.

Just as the genetic code inside organisms evolves through mutation and natural selection as those organisms adapt to particular ecologic niches, the technologic code inside organizations-blueprints, databases, algorithms, check lists, and procedure manuals-evolves through innovation and competition as those organizations reshape themselves to fit specific market niches. In the most abstract sense, both rainforests and economies are self-organizing information networks.

Neither the natural nor the economic rainforest was planned. Both economies and ecosystems evolved spontaneously. The mind-numbing complexity of each system means that neither can be planned or controlled by some central authority.

>From the bionomic perspective, technological evolution is the ultimate source of all progress and economic growth. By applying an ever expanding stockpile of scientific knowledge to real world problems, human beings discover ways to squeeze better results from less input. More from less-without limit. For example, instead of devastating the planet by smelting the mountains of copper that would have been required to create a global communications network, we've turned beach sand into microchip-packed satellites and optical fibers. In a bionomic economy, new technical know-how substitutes for labor, energy, and materials. Units costs fall. Living standards rise. In the final analysis, the growth of the economic rainforest is constrained only by human creativity.

Recycling Today's Profits and Savings Sustains Tomorrow's Economic Rainforest

In practical terms, however, a great new idea cannot generate economic growth on its own. Until that new idea has matured into a product that yields a stream of profits, the business organization nurturing that idea must keep investing capital its development. We see the same phenomenon in nature. Every seed has two parts: an embryonic plant and the sugar-packed tissues of the fruit that surrounds it. Until that seedling has spread its first leaves and begins producing energy from sunlight, it must draw all of its sustenance from surplus energy that was stored by the previous generation.

In the economy, the savings of families and the profits of businesses are the surplus economic energy essential to the continuing evolution of the economic rainforest. If the stream of savings and profits being recycled from one economic generation to the next is diminished, the economic rainforest of the future will shrivel.

Needless to say, the existence of taxes makes for a crucial distinction between nature and in the economy. Of course, human societies are not ecosystems. They are communities of conscious beings who have established governments to deal with problems that cannot be managed effectively through private means. Like all other organizations, governments must have revenues. Taxes imposed by law meet that need. Nonetheless, since past savings and profits support technical innovation, and since new technology is the ultimate source of rising living standards, does it make good sense to tax savings and profits as the primary source of government revenue?

Students of taxation might properly point out that companies don't actually bear the ultimate burden of taxes. Through higher prices for the goods they sell, firms shift the final tax cost onto their customers. In the end, individual Americans bear all the costs of government. Firms serve as tax collectors, but they do not actually pay taxes.

The So-Called "Income" Tax is Actually a "Family Savings" Tax

Though it is labeled an "income" tax, the federal system actually taxes potential family savings. To calculate the tax bill, total family revenues (all sources of income) are offset by various allowances, exemptions, and deductions which in effect represent the government's estimate of basic living costs. At present, tax law adjustments work out to roughly $15,000 for a family of four. Four member households pay income taxes only on revenues over $15,000, because that is when they start generating potential savings. Since tax payments could be saved if they were not taxed away, the "income" tax is, in reality, a tax on potential family savings.

Consequently, the U.S. government's single most potent economic policy is designed to discourage family savings and encourage consumption. Few Americans have much day-to-day control over their earnings. Wages levels are determined largely by one's previous investment in education and skills. But people can control how much they consume and how much they save. Teenagers decide between more stylish clothes and a larger college savings fund. Families choose between larger homes and more retirement money. Congress chooses between farm subsidies and scientific research. A single consume/save decision may redirect a few dollars or a few billion dollars, but all decision-makers face the same basic trade-off: now or later.

Of course, economic choices are rarely "all or nothing" decisions. Teenagers don't choose between no clothes and too much college savings. Few families opt for opulent mansions but no retirement funds. Economic choices are made at the margin, as decision-makers to try to find the best mix. Should your revenues be allocated 95 percent consumption/5 percent savings or 92 percent consumption/8 percent savings?

The design of the tax system is crucial to an economy's long-term growth rate, because it powerfully influences countless millions of consume/save decisions. The tax on family savings raises the effective price of those savings, making it harder to accumulate wealth. When people save less, they must consume more. There's nothing else to do with the money.

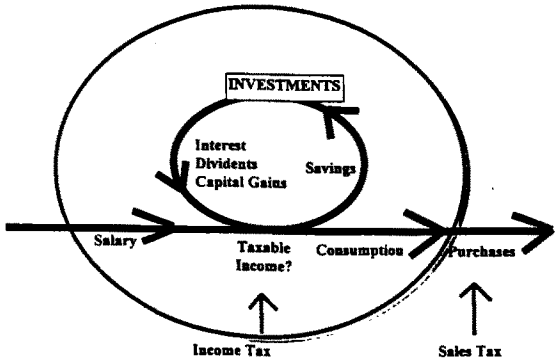
The Urge to Avoid the "Family Savings" Tax Drives Ever Increasing Tax Law Complexity

When the federal income tax was first enacted, it was a simple "flat tax" on the wealthiest Americans. But as federal spending grew, particularly after World War II, people further down the income ladder began to be taxed. Gradually, an income tax designed for the wealthy became a tax on everyone. Today, "income" taxes, together with social security taxes, comprise over 90 percent of all federal revenues. A nation that began the 20th century without taxes on household savings ended up with a government utterly dependent on such taxes.

As the income tax began to impact more Americans, the tax law's complexity grew. Today, the Internal Revenue Code and regulations weigh in at one million words and 5000 pages. On average, the law is "reformed" once every 1.3 years. Just since the 1986 flattening of tax rates, several thousand sections have been added.

Evil special interests, their Gucci-shod lobbyists, and PAC hungry politicians take the blame for punching loopholes in the tax code. But these folks are merely acting out roles made inevitable by a tax system that is based on the word "income" but works to choke off the accumulation of family savings.

Virtually anyone can make a reasonable case as to why at least some of their "income" should not be defined as taxable "income" or why some of their expenses ought to be deducted from the calculation of "income." Is it fair to treat as taxable "income" money saved for retirement? What if it's "too much" savings? What about mortgage interest? Or college tuition? Or equipment depreciation? Or research and development?



Setting a tax rate is easy. But if it's an "income" tax, the hard part is defining precisely what that rate should apply to. This is why virtually every word in the tax rules attempts to distinguish "taxable income" from "non-taxable income." Rules and exceptions. Exceptions to exceptions. This is the shadowy domain inhabited by tax accountants, tax lawyers, tax lobbyists and Congressional staffers, who like Talmudic scholars, pour over holy IRS texts, contorting the language to free their clients from tax hell.

Because an "income tax" is in reality a tax on potential family savings, taxpayers will be endlessly creative in arguing why some of their own savings should properly be excluded from the tax calculation. No matter how "flat" it is when it starts out, an "income" tax, by its very nature, must inexorably evolve into hideous complexity, political corruption and public cynicism. Year after year, the loophole-ridden income tax law erodes the public trust on which our democracy is founded-even as it shrinks the flow of savings.

Too few of the experts seem to realize that if a tax system must be riddled with loopholes to make it economically workable and politically tolerable, then perhaps its basic design is wrong to begin with.

A National Sales Tax Would Promote Family Savings

The only way to stop taxing family savings and end the politically corrosive effects of tax law complexity is by abolishing the federal income tax. In its place, we should enact a consumption tax; specifically, a non-regressive National Sales Tax on final retail purchases of products and services.

A National Sales Tax would end the present tax law's assault on family savings. Every dollar a family saves would be tax free. Obviously, such a radical reversal in tax policy change would have a dramatically positive impact on the national savings rate. As depicted in a frightening front-page story in this Monday's Wall Street Journal, the share of disposable income saved by American families is near its all-time low. Millions of baby boomers, only a decade or so away from retirement, have virtually no savings.

Precisely at the moment in history when stunning breakthroughs in information technology hold the promise of a great new era of American prosperity, we as a nation stand at the threshold of the future with our pockets empty. The only way to completely

reverse the bias against savings, take advantage of the extraordinary investment opportunities before us, and rescue the baby boom generation from financial oblivion is by switching over to a National Sales Tax as soon as possible.

A National Sales Tax Would End the Cycle of Ever Increasing Tax Law Complexity

A National Sales Tax would not only stimulate a vast surge in family savings, it would also put an end to the politically destructive process of ever increasing tax law complexity. Forty-five states, home to 98% of all Americans, already rely on sales taxes and not one state has suffered from the creeping definitional complexity that has characterized the federal income tax system. Every final retail purchase triggers a known tax. Cash registers figure it out and merchants send it in.

Many consumption tax supporters endorse the VAT (Value-Added Tax), instead of an NST. Under this system, taxes are added into a product's price as it moves through each stage of production. Two problems weaken this approach. First, the VAT requires a large bureaucracy to handle the paperwork. Second, and more important, the VAT is buried in the price of final goods and services. The car buyer cannot tell what portion of the car's price is for the car itself and what portion reimburses the dealer for the VAT. In a democracy, taxes-like prices-should be clearly labeled. For a society's financial signaling system to work effectively, citizens must know how much tax they are paying for a given quality and quantity of government services.

Only a National Sales Tax offers the kind of profound, transformative change that Speaker Gingrich and his colleagues promised the American people last November. No matter how well-intentioned, any reform of the "income" tax-whether its labeled flat, simplified, or consumption-based-will come back to haunt those who champion it. Back in Gorbachev's time, such economic reforms were called "half-measures." Rather than face up to the need for genuine change, these so-called "reformers" sought to rescue the destructive system they had inherited. This Congress must not repeat this mistake.

A Universal Rebate Will Make the National Sales Tax Non-Regressive

If a National Sales Tax is so dramatically superior to any form of income tax, why are so many otherwise clear-thinking people so afraid of it? Simply put, because they see no way to avoid the harsh impact that sales taxes typically impose on low-income families. Since lower-income families spend virtually all their earnings on basic consumption, critics contend that an NST would be severely regressive, taxing away a larger share of the income of the poor than of the rich.

But this problem easily solved with a universal rebate. Assuming a family of four spends $15,000 (or $3750 per person) on basic consumption, at a 16% rate, the NST would cost them $2400. But that $2400 would be rebated in quarterly payments of $600. Simply listing their names and social security numbers on a postcard would qualify a family for a rebate adjusted by family size. Regardless of income level, every family would get a rebate that made their basic consumption free of federal tax.

Some older Americans argue that instituting an NST would be unfair, because they spent their whole lives paying taxes on income and now that they're only consuming, they'd be hit again. This problem is easily handled. Instead of a rebate based on the first $3750 of per person consumption, that amount could be higher for those born before certain cut-off dates. As these seniors die off, this transitional feature would disappear, and all Americans would then get a universal rebate based on the same per person amount.

With the universal rebate in place, the NST would be completely non-regressive. Taxes would be based on a clearly demonstrated ability to pay. If you splurge on that $80,000 Mercedes, you'll pay $12,800 in NST, while I pay just $1600 on my $10,000 Plymouth Neon. With elegant simplicity, the NST punishes the spendthrift while rewarding the saver.

Rethinking the Morality of Taxation

For some, even a non-regressive NST is not "fair" enough. These critics contend that tax system must not only be non-regressive at the low end of the income spectrum, it must be progressive at the high end. And if not progressive in the sense of higher tax rates at higher income levels, then at least those with higher incomes should pay a "flat" rate on all their incremental income. Or, to put it more accurately, we should tax potential family savings and slow the accumulation of wealth. The unspoken, but widely shared belief among those who take this position is that becoming rich is somehow evil.

When Karl Marx published the Communist Manifesto in 1848, "a heavy progressive income tax" was his second priority after the "abolition of property." Marx opposed the accumulation of wealth because he saw the economy as a zero-sum game. Like some thundering steam engine, Marx's economy could only run so fast and produce so much. For me to win, you had to lose. Win-win outcomes were impossible. Income-the accumulation of wealth-was inherently evil, because it could only be gained by grabbing it from the weak. All profit came from exploitation. This is the very essence of "economy as machine" thinking.

Today, we know better. Or at least we should. Though zero-sum, class war rhetoric still shapes the mindset of liberal democrats, the Information Age economy is a positive-sum game where win-win outcomes are the norm. New wealth flows from higher performance at lower cost, a phenomenon driven by technological innovation. Newt Gingrich's recent comparison of an optical fiber and wire cable leaps to mind. More like a rapidly evolving rainforest than a steam engine, the economy is a complex, living system whose growth is limited only by human creativity and the availability of the savings needed to turn new ideas into reality.

Rejecting Marxist envy and zero-sum, Machine Age thinking, the moral message conveyed by a National Sales Tax is, "No matter how rich you get, if you continue to save and help grow the economic rainforest by financing new technologies and jobs, you'll pay no tax. You only pay when you take resources out of the economy and consume above a basic level."

If Congressional leaders truly mean it when they promise Americans a new "Opportunity Society," they must begin by eradicating the federal income tax . Notwithstanding Karl Marx, there is no shame in getting rich. There is only shame in "reforming" an income tax designed to prevent all Americans from doing so.

THE BIONOMICS INSTITUTE

The Economist

MAY 27TH-JUNE 2ND 1995

Down in the jungle, something stirs

WASHINGTON, DC

COMBINE a clever name with a receptive market, and you have the makings of an entertaining new trend. The name is "bionomics", which has nothing to do with giant greenhouses, artificial limbs or releasing the awesome power of the mind. It is about the economy. The receptive market consists of politicians of various stripes, eager to be seen as catching the wave of the future.

Bionomics is the creation of Michael Rothschild, a Harvard MBA and lawyer-turned-consultant. In a book of the same name, published by Henry Holt & Co in 1990, he complains that people have grown used to thinking of the economy as a huge machine, always either heating up, cooling off, or humming along. Mr Rothschild argues that, because machines are man-made and static, these images are confusing. A better metaphor is the economy as rainforest, in which a wondrous variety of species (firms), in fierce competition for limited resources, endlessly mutate and adapt to carve out new niches for themselves.

Uncontentious ideas, you might suppose. The fun begins when politicians get hold of them. The appeal of rainforestry is evident to both ends of the spectrum. Its implications are decidedly pro-market, while its emphasis on natural forces and interconnectedness appeals to many voters on the left.

Both Republicans and Democrats are now claiming the language of bionomics as their own. Newt Gingrich included it on his reading list. And when the Bionomics Institute of San Francisco held a forum in Washington on May 18th, both the Progressive Policy Institute (the New Democrats' think-tank) and the

Progress & Freedom Foundation (Mr Gingrich's) turned out to sponsor it.

Yet when it comes to the rainforest itself, the two camps hold very different views. Is the marketplace a happy habitat that has been invaded by a parasitic government virus? Or is it a Darwinian jungle, full of dangerous predators that must be hunted? Bill Archer, the Republican chairman of the House Ways and Means Committee, wants to "create an entrepreneurial society in the rainforest", whereas Will Marshall, president of the PPI, stresses that "we still need rules in the rainforest."

Who says that politicians are unable to adapt to exploit niches in the market? Already, 1996 promises to be full of steaming undergrowth and Tarzan-style ululations.

Chairman ARCHER. I thank each of you gentlemen for your input. I think you have all given us a lot to think about, and we certainly want to stay in contact with you as we move forward with this process.

Mr. Collins.

Mr. COLLINS. Thank you, Mr. Chairman. I will be brief because I know it is getting late in the day.

Mr. Rahn, you mentioned the term "cash flow." You don't hear cash flow around here very often, but truthfully that is what this whole system is about, is cash flow. That is the reason we have $5 trillion in debt is because of shortage of cash flow and the overexpenditure or writing of bad checks. I am pleased to hear someone other than me and the Chairman mention cash flow.

Mr. Roberts, you seemed adamant about not having to report anything to the IRS, but as I hear others talk about national sales tax and rebates, would that not require some type of reporting?

Mr. ROBERTS. If the sales tax is, for example, applied to professionals who sell services, then they become collection agents for the government, but still it is not their income that they have to report, and for the majority of the people there would be no reporting requirements. As long as the government collects revenues from any source, there will be an IRS.

It is sometimes suggested——

Mr. COLLINS. But on the lower income level, though, it has been mentioned a rebate to those who are lower income. Would that not require some type of reporting to some Federal agency so they know who to send a rebate to and how much?

Mr. ROBERTS. Yes, you would have to send your postcard to the Treasury. I think these proposals of rebates are excessively defensive. They are letting Socialists define the issue, which is we can't have a regressive form of taxation.

I don't think it matters because, as I pointed out, you can redistribute all the income you want to the poor, regardless of the form of taxation. It can be a very regressive form of taxation, and you can still achieve redistribution as we do, and most of it is in kind, you know, housing subsidies, food stamps, Medicaid. And therefore I am not defensive the way two of the witnesses are about a value-added tax or a retail sales tax. So I would myself just dispense with the rebates, but if you are going to have them, yes, someone has to get the postcard and write the check.

Mr. COLLINS. Mr. Moore.

Mr. MOORE. First of all, if you wanted to deal with the regressivity issue, you could do it the way Craig is suggesting. You could just deal with all income redistribution efforts that the Federal Government undertakes on the spending side. That would be one way to do it.

What I am suggesting, though, is a $5,000 per person rebate that goes to everyone, regardless of their income, because under this system we don't know what anyone's income—you know, we are going to put the whole income distribution argument out of business because nobody in Washington is going to know how much money anyone is making anymore, so what is going to happen under this system is that every American gets a rebate every quarter as long as they—and it doesn't require any information except

for a Social Security card. So it does put the IRS out of business to that extent.

Mr. COLLINS. That would not require a reporting of income to do what you are talking about.

Mr. MOORE. Right.

Mr. COLLINS. How would you handle Social Security?

Mr. MOORE. Well, under our plan—we should have another whole hearing about Social Security. We want to privatize Social Security and deal with that icon later, but under our plan we would not make any changes to Social Security.

Mr. COLLINS. You would still have the FICA tax?

Mr. MOORE. That is right. I don't know, maybe someone else has some ideas about that. There are some plans that have been developed, Mr. Collins, that would actually fold in a Social Security payroll tax into the payroll, into the national sales tax, and that would require you to go from about an 18 percent national sales tax up to about, what, a 25 percent or so.

Mr. COLLINS. We are back to the reporting thing then, with the FICA tax.

Mr. MOORE. Yes.

Mr. COLLINS. That is all.

Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Christensen.

Mr. CHRISTENSEN. Two quick points. One, I want to thank you, Mr. Roberts, for your testimony. It definitely was something that I will want to get the transcript on because I appreciated your rhetoric.

My question would be for Mr. Moore and Mr. Roberts, though. What do you tell the National Federation of Retailers and those Main Street shopowners when they start hollering about the fact that the price of their goods has now been increased 18 to 20 percent?

I see a potential problem there. I generally favor what I have heard today from your testimony. I truly believe that we are heading in the right direction, but I see that as a potential problem, and I also see possibly the simplicity of getting there, the transitional problem that we have talked about earlier today rather than going cold turkey, as Mr. Gibbons said, which I am in favor of, that there might be a transitional problem. I would like your comments on those two issues.

Mr. ROBERTS. I think the retailers, like everyone else, will see the advantage of not having to report their incomes to the IRS, and the fact that the prices of the goods will be higher by the amount of the tax is offset by the fact that everyone's take-home pay will be higher by the absence of withholding. So I don't think it puts them at any unique disadvantage or somehow alters the rules against them in any way.

The transition problems could be varied, but we should never let a transition problem keep us off the path of progress, and we should never get bogged down into whether or not it is convenient for the tax collection agency. The convenience for the IRS should be the last thing that this House considers.

The House is endowed by the Founding Fathers with the initiative power of government. It is the House that is closest to the peo-

ple, and it is supposed to be an expression of the popular will. Therefore, you don't want to be tools of the IRS and permit the IRS to tell you how difficult it will be for them to do this or that or the other thing. That is not our problem. It is not a problem for the House.

Mr. MOORE. Mr. Christensen, you are quite right that the retailers are going to put up a bit of a fight on this. In fact, we have been hearing from the retailers a bit already. We have to find a way of compensating them for the cost of collecting the tax because as a matter of fairness, we have to find a way, if only a small portion of the business is charged with collecting the tax, then I think in all fairness they should be reimbursed for some of that cost of collecting that tax.

But I would agree with Craig on one thing, that when you look at small business generally, I have heard the argument made that, well, small businesses wouldn't like to have to collect a sales tax, if you ask small businesses, if you had small businesses before this Committee, if you ask them to compare about the compliance costs of sales tax versus an income tax, I mean, there is no comparison. They think the sales tax is much easier.

Do you have something to add to that?

Mr. HAYES. We have a number of Members that have small businesses. I think a lot of it is just education. Whenever you tax something, you take something away from someone, and he has less money to spend. So we have under the income tax. By withholding, we already have a tax on consumption. We have reduced the amount you can consume by whatever the tax rate is, period.

Under the retail sales tax we are giving, Mr. Roberts said, we are giving all of the money to you, and we are letting you make the choice, how do you want to consume. I think when you look at that, when the retailers start to see that, that a lot of those objections are going to go away, particularly when you tie it in with the fact that most of them are collecting the State sales tax now and all of our proposals contemplate having the State collect the Federal sales tax, and therefore not have to have an IRS and not have to have an enforcement agency at the Federal level.

Mr. ROBERTS. May I just make one point about that. You see, under the kind of income tax system we currently have, you can't save by being frugal because you are taxed on your income and not your expenditures. So being frugal doesn't permit one to build up a nest egg, but under a retail sales tax or a VAT a person can be careful in his expenditures and therefore rapidly accumulate capital.

Mr. CHRISTENSEN. Thank you very much.

Thank you, Mr. Chairman.

Chairman ARCHER. Gentlemen, thank you to each and every one of you. I again apologize for how long you had to wait, but we are very grateful for your input.

Mr. HAYES. Thank you very much.

Chairman ARCHER. The Committee will be adjourned.

[Whereupon, at 5:45 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

6-7-95

Mr P. De Mossely "Hello from Eriberto, Jacob & Crystal Acedo."

As a conserved tax payer and formerly self employed car painter, the first year of work I was penalized for being self sufficient? My taxes were very strict on me, and my family at that time where prospering in all areas. I put people to work sanding, masking, preparing surfaces for color. Not that this is for the betterment of people who want to be self employed the thing that bugs me is the method of the IRS tactics! I would like to see a tax program dedicated to people like myself (trying to make it for the better interest of my children & Grandchildren). A flat tax program & users tax? Could work well for people like myself? Now that I'm 45 years old two children, single parent. I would try my venture once-more but time isn't on my side. Mr De Mossely Please consider people like myself in dealing with a "new tax program" for our children's sake! Also (Please completly do away with the IRS completly.) Small Government is in order. (Keep in mind the poor people)

Respectfully

Mr E.C. Acedo & Family

6566 Lanston St Apt B

San Diego, Ca 92111

(619) 565-7527.

P.S. Help us, help them by small taxs. to government.

Raymond C. Adamczyk
10315 W. Greenfield, #530
West Allis, Wisc. 53214

June 11, 1995

Dear House Ways and Means Committee,

I wish to go on record in expressing my views on the tax debate. The Flat Tax seems the simplest and fairest tax idea out there. What could be fairer than every American paying the same percentage or rate? But I think it is extremely important to include in the language of any flat tax bill a ceiling percentage, above which taxes could not be raised. Please consider a maximum percentage in the wording of a flat tax proposal, say 20%, or something reasonable in that neighborhood. Otherwise, what is there to stop a future legislator from increasing a flat tax of today to say, 75%?

Thank you for allowing me to express my views on this matter.

Raymond C. Adamczyk
Raymond C. Adamczyk

STATEMENT OF THE AMERICAN ACADEMY OF FAMILY PHYSICIANS

The American Academy of Family Physicians is pleased to present to the Ways and Means Committee this statement for the record of the hearings held June 6-8, 1995, on replacing the federal income tax. The Academy's purpose in presenting this statement is to support two of the Chairman's stated goals for the hearing:

- to encourage greater savings and investment and
- to improve the international competiveness of American workers and business.

The Academy, which represents over 80,000 practicing family physicians, family practice residents, and medical students with an interest in family medicine, has a longstanding interest in the impact of health care costs on the American economy. Health care costs in the U.S. are extraordinarily high and are escalating rapidly. For these reasons, they not only compromise access to necessary health care services and lower the quality of available care, but they also siphon badly needed resources away from other sectors of the economy, particularly those involving international trade.

This statement will address the following issues: (1) U.S. health care costs are the highest in the world and the gap between U.S. health care costs and those of other developed nations is growing wider; (2) high health care costs have a negative impact on savings and investment, the federal budget deficit, and the competitive position of U.S. business in international markets, (3) the major factor explaining the high health care costs in the U.S. relative to its international competitors is the extent of development of its primary care system; (4) reforms of the Medicare and Medicaid programs and in the private sector will have little impact on costs until the primary care infrastructure is substantially enhanced; (5) Congress can facilitate the shift toward primary care without increasing government involvement in the health care market mostly through modifications in existing federal programs: and (6) because of chronic and severe shortages of primary care physicians in rural communities, these enhancements in the primary care infrastructure are of crucial importance to the most internationally competitive sector of the U.S. economy, agriculture.

1. U.S. health care costs are the highest in the world.

As a percentage of gross domestic product, total health care expenditures in the U.S. are two-thirds higher than the average for countries belonging to the Organization for Economic Cooperation and Development (OECD) and more than 30 percent higher than expenditures in Canada, the second-highest country. In terms of per capita health care spending, spending in the U.S. is 2.2 times higher than the OECD average and more than 50 percent higher than spending in Canada.[1]

Not only is U.S. health care spending considerably above average, the rate of spending growth continues to outpace that in the other major OECD countries (Canada, France, Germany, Japan, and the United Kingdom). From 1980 to 1992, the percentage by which the U.S. health care spending-to-GDP ratio exceeded the average for the other five major OECD countries doubled from 30 percent to more than 60 percent. Over this same period, the percentage by which U.S. per capita health care spending exceeded the other five countries grew from 60 percent to more than 90 percent.

Changes in the health care spending-to-GDP ratio over time provide a measure of the a nation's total resources devoted to the health care sector of the economy. By adjusting health care spending by changes in overall prices it is possible to

assess the investment opportunities forgone in other sectors of the economy. Compared to the other major OECD countries, the opportunity costs of U.S. health care expenditure growth are substantially higher. This finding reflects that fact that between 1980 and 1992, health care spending in the U.S. increased 3.5 percentage points faster than per capita GDP, compared to 3 percent points in Canada and 2 percentage points or less in the other major OECD countries.

In summary, the U.S. health care system remains the most expensive in the world, and the gap between the U.S. and the other OECD countries is widening. Compared to the other major OECD countries, the U.S. faces the highest rates of increase in health care spending relative to GDP, the highest health care inflation relative to overall prices, and the highest opportunity costs of forgone consumption and investment in other sectors of the economy.

2. High health care costs hinder the international competitiveness of U.S. business.

Businesses in the tradable goods sector face particularly high health care costs. Fifty-eight percent of America's internationally traded goods and services are manufactured goods. In 1992, employer costs of employee health benefits per hour were 76 percent higher in the manufacturing sector than in the non-manufacturing sector.[2]

Faced with steadily higher health care costs, American businesses respond in a number of ways. They hire fewer workers; provide lower wage increases or less generous benefits for existing workers; forgo investment in more plants and equipment, education and training, and research and development; lower dividends to shareholders; or increase prices, thereby leaving consumers with less income to spend on other goods. Each of these outcomes has a negative effect on the economy and on the competitiveness of American business in international markets.

Increases in health insurance costs are either shifted back onto workers in the form of lower take home wages or shifted forward in the form of higher prices. Backward shifting if often inhibited by minimum wage legislation, existing labor contracts, and informal restrictions against wage reductions. In some industries, compensating for rapidly rising health care costs would require real reductions in wages. Wages are not easily lowered, and fully compensating reductions are not possible. Moreover, workers increasingly value their health insurance benefits and are unwilling to give up coverage or accept reduced benefits. Health insurance benefits have become a major issue in collective bargaining.

Due to increased health care costs, total compensation for workers with health insurance may be higher than the value of the workers' production. Higher labor costs thereby result in lower profits or increased profits. However, companies are able to pass higher health insurance costs forward in the form of higher prices with little loss of sales only when competitors experience parallel increases in costs.

There is a wide disparity in the combinations of fringe benefits and wages offered by different companies. Because companies with and without health insurance benefits compete in the same markets there is great pressure on companies that provide insurance to devise methods to eliminate the cross-subsidies. This is reflected in shifting of production overseas, outsourcing to small companies without health insurance and the increased use of part-time labor.

A country's international trade balance will reflect the equilibrium between domestic savings and domestic investment. Interest rates will be higher in countries with low savings relative to investment than in countries with surplus savings. Higher interest rates will attract foreign capital, raising the exchange rate, and, thereby, reduce exports and increase imports. Furthermore, increases in public outlays for health care translate into larger budget deficits and reductions in national saving.

3. The under-developed primary care system is a major factor in higher U.S. health care costs.

There is a substantial body of evidence indicating that the lack of a well-developed primary care system is a major factor in explaining the higher U.S. health care costs. This evidence stems from a variety of sources including cross-national comparisons, studies of the variation in per beneficiary Medicare expenditures, comparisons of the cost of care provided by primary care physicians and subspecialists, and examinations of the impact of lack of access to primary care services. The following section reviews briefly this evidence.

- The lower health care costs, better health status (i.e., higher quality), and greater satisfaction ratings in other developed nations are, to a large extent, due to their reliance on primary care.

The most extensive work in the area of international comparisons has been done by Barbara Stafield, M.D.[3] She compared ten Western industrialized nations on the basis of three characteristics: the extent of their primary health service, their levels of 12 health indicators (e.g., infant mortality, life expectancy, and age-adjusted death rates), and the satisfaction of their populations in relation to overall costs of the systems. In nine out of ten countries, she found that nations with better developed primary care systems have lower health care costs, better health status indicators, and higher levels of satisfaction with their health care systems. Specifically, when the proportion of primary care physicians is greater, health care costs are lower. This is because primary care physicians have a more cost-effective style of practice and do not substitute unnecessary medical tests for good clinical judgement. Furthermore, nations with greater access to and reliance upon primary care services show lower infant mortality rates, longer life-expectancy, better immunization rates, lower age-adjusted mortality, and greater overall satisfaction with health care services than the U.S. The better developed a nation's primary care system, the better the population's health status and the higher the level of popular satisfaction. Ratings for the United States were low on all three measures.

It is important to note that higher health care costs in the United States are not due to greater use of hospital beds, the aggregate supply of physicians, or a greater number of physician contacts. Inpatient beds, admissions, average length-of stay, and occupancy rates in the U.S. are among the lowest in the OECD countries. Physician contacts per person per year in the U.S. are below the OECD average, and the U.S. physician-to-population ratio is slightly below average. However, the U.S. has a far higher percentage of specialists than in most other OECD countries.

- In the Medicare program, the lack of primary care is directly related to high per capita health care costs.

The most compelling evidence demonstrating the impact of primary care on overall health care costs comes from several studies examining the variation in per beneficiary costs under the Medicare program. For example, Dor and Holahan

examined differences in expenditures between beneficiaries living in urban and rural communities.[4] After adjusting for differences in prevailing fees, there is a 15 percent difference in per-beneficiary volume of physician services between urban and rural areas. This study used multivariate techniques to examine a broad range of factors that might explain the variation in expenditures including beneficiary demographic characteristics, health status, consumer out-of-pocket costs, income, physician availability, hospital utilization, and health market characteristics.

The results of this study indicate that the most important factor in controlling Medicare expenditures for physician services is the mix of physician specialties. Specifically,

- a ten percent increase in the per capita supply of general practitioners and family physicians results in a two percent decrease in expenditures, and

- a ten percent increase in the per capita supply of "specialists" results in a 1.4 percent increase in expenditures.

The supply of general practitioners and family physicians has a relatively large impact on expenditures for inpatient care, surgical care, and consultations. The supply of specialists has a large impact on expenditures for office-based services, medical and consultations.

The results of the Dor-Holahan study can be used to estimate the impact on expenditures of shifting the current specialty mix to one in which 50 percent of physicians are general practitioners and family physicians and 50 percent are specialists. Holding the aggregate physician supply constant,

- shifting to a 50-50 specialty mix would result in a 39 percent decrease in expenditures for physician services.

Specialty mix is the only policy relevant variable that explains the large variation in Medicare expenditures for physician services, and its impact on expenditures is large. The results of the Dor-Holahan study have been replicated in two more recent studies.[5]

- Primary care physicians have a more parsimonious practice style than their subspecialty colleagues.

There has been a large body of research performed over the last several decades that compare the practice patterns of primary care physicians with their subspecialty colleagues.[6] The most comprehensive of these studies is the Medical Outcomes Study, which showed that given an equivalent patient population, primary care physicians provide more cost-effective care than their subspecialty colleagues. For example, cardiologists hospitalize patients with similar levels of illness at more than twice the rate of family physicians and ordered more tests. Even after adjusting for differences in the types of patients seen by different specialties, cardiologists and endocrinologists had utilization rates that were considerably higher than those of primary care physicians for all health care resources.

- The improved availability of primary care services reduces the inappropriate use of expensive health care services.

The increased availability of primary care services for low-income populations reduces the inappropriate and expensive use of emergency departments. In one study, nearly half (45 percent) of patients waiting for emergency department care

cited unavailability of primary care services as their reason for using the emergency department.[7] Only 13 percent of those waiting had conditions clinically appropriate for the emergency room; 38 percent were willing to trade the emergency room visit for assurances of an appointment at a primary care clinic within 3-days.

- Real world examples of the cost-effectiveness of primary care are provided by HMOs and the State of Hawaii.

Policy makers seeking to constrain the growth in health care expenditures are turning increasingly to HMOs and managed care as an important solution. HMOs have been shown to have far lower rates of utilization of hospital and other intensive technological services with no decrement in quality or patient satisfaction. One of the ways HMOs are able to achieve these results is by dramatically altering the mix of specialties within their provider ranks. Fully 70 percent of U.S. physicians are subspecialists, and only 30 percent are in the primary care specialties. However, within HMOs, the ratio is nearly reversed; 60 percent of physicians are in primary care, and 40 percent are in the subspecialties.[8]

Traditionally, Hawaii's doctors have emphasized primary care instead of specialized services.[9] Utilization rates for high cost treatments are well below the national average. The result of this practice is reflected in Hawaii's low infant mortality rate and low rates of premature death due to chronic disease such as heart disease and cancer. Early detection of potentially life threatening conditions results in low mortality and low hospitalization. Contrary to some popularly held beliefs, Hawaiians are healthier not because of unique genetics, healthy climate, or highly technological medicine, but because they have access to primary care. Moreover, Hawaii's readily available primary care makes its system less expensive. Hawaii's health care costs as a share of gross domestic product are closer to those of Canada, Germany, France, and Japan then that of the rest of the United States. Despite Hawaii's high cost of living, health care is less expensive.

4. Medicare and Medicaid reforms will have little impact on costs until the U.S. primary care infrastructure is substantially enhanced.

Congress is considering a wide range of proposals designed to reduce the rate of increase in Medicare expenditures, including higher beneficiary cost sharing, enrolling a higher proportion of Medicare beneficiaries in managed care plans, Medicare vouchers, and medical savings accounts. While each of these reform proposals holds some theoretical possibility of reducing expenditures, there is only one proven factor that consistently holds down per capita Medicare expenditures, the availability of primary care. Congress' success in controlling Medicare outlays will be directly related to its success in improving beneficiary access to primary care services.

As evidenced by the managed care industry and other nations, primary care is the backbone of high-quality, cost-effective health care systems. In addition to the diagnosis and treatment of acute and chronic illness, primary care physicians routinely provide health promotion, disease prevention, counseling, and patient education services. Historically, primary care physicians have been the providers for America's poor, underserved, and uninsured. For example, nearly 30 percent of all visits by uninsured individuals are provided by family physicians.

In general, primary care physicians can manage 85-95 percent of all patient complaints with the same success, and at less cost, than their subspecialist colleagues. For those cases that require more subspecialized care, primary care

physicians maintain a wide variety of specialty and institutional consultative and referral relationships. It is part of the primary care physician's role to guide patients through the specialty care maze and to advocate for those who otherwise have difficulty obtaining access to subspecialty services.

It is the primary care physician's responsibility to coordinate all resources and services of the health care system for the benefit of his or her patients. Because of the depth and breadth of their training, primary care physicians manage those medical conditions that cause most of the morbidity and mortality in this country (heart disease, high blood pressure, etc.).

Unfortunately, the trends in physician supply are running in the opposite direction. The proportion of practicing physicians engaged in primary care has declined from nearly 90 percent of physicians in 1930 to less than 30 percent today. The distribution of physicians in graduate medical education programs indicates that proportion is likely to decrease still further.

Under the current system, there is no connection between the number and type of physicians needed by the public for its health care and the number and type of physicians that are trained. The choices that medical students and medical educators make are heavily influenced by the fact that teaching institutions get paid much more to train subspecialists in hospital settings and physicians get paid much more to provide subspecialty services.

Medicare, which is the major source of graduate medical education (GME) funding, provides a powerful financial incentive for hospitals to train residents in the procedurally-oriented specialties rather than in the generalist specialties. For example, by limiting funding to hospitals, Medicare funding of graduate medical education targets inpatient training -- training that is relevant to an ever-narrower spectrum of medical care. Family physicians are largely trained in ambulatory settings where more and more health care services are delivered. Yet, these sites are ineligible for Medicare training funds.

Leaders of individual academic medical institutions decide how many residencies and fellowship positions they need to serve as inexpensive house staff for their various departments. Upon completion of their training, these physicians are turned loose on the community whether or not there is any need for any more physicians in their particular specialty.

Federal spending on Medicare GME currently totals over $6 billion annually, which averages nearly $70,000 per resident.[10] In some teaching hospitals, the per resident payment is over $100,000 per year (in some rural states the per resident amount is only about $10,000 per year). Congress has placed absolutely no control on the flow of this money in regard to the total number and specialty type of residency positions that are funded. Any hospital that is able to get a residency slot accredited can receive Medicare GME dollars. Given the mismatch between the physician supply and the public's health care needs, this in an irresponsible expenditure of federal funds.

5. Congress can facilitate the shift toward primary care without increasing government involvement in the health care market mostly through modifications in existing federal programs.

Congress can substantially enhance the availability of primary care by modifications in existing federal programs. The changes recommended below will improve payment for primary care services and redirect training dollars toward

programs that produce primary care physicians. None of these recommendations creates new federal bureaucracies.

Given the potential for widespread Medicare savings when primary care services are maximized, the Academy recommends that the following Medicare reforms.

A. Modify Medicare graduate medical education (GME) funding so that it better supports primary care training.

- Limit the number of funded first-year residency positions to 110 percent the number of U.S. medical school graduates.
- Limit the period of funding eligibility to the first three years of residency training.
- Eliminate the penalty that teaching hospitals incur for the time that residents spend training in non-hospital owned ambulatory facilities.
- Extend eligibility for direct GME payments to non-hospital entities that operate approved residency programs.
- Up-weight direct and indirect GME payments for residents in the primary care specialties.

B. Remove disincentives to primary care practice by restoring equity to Medicare payment for visit services, which are the type of service that primary care physicians most commonly provide.

- Implement a single fee schedule conversion factor rather than the three conversion factors currently in use.
- Revise the Medicare Volume Performance Standard (MVPS) formula by replacing the current factor for the growth in the volume and intensity of services with one based on projected growth in gross domestic product plus two percentage points.

C. Reverse the anti-rural bias in Medicare physician payment.

- Eliminate the Geographic Adjustment Factor (GAF).
- Provide 20 percent bonuses to physicians providing services in health professions shortage areas (HPSAs) and eliminating bonuses for specialty services in urban areas.

Although Medicare GME provides some support for primary care physician training, Title VII of the Public Health Service Act is the only federal program that provides targeted funding for primary care training. Many family practice residency programs would not exist today if it were not for the availability of the Title VII funds. Until Medicare GME funding changes occur, primary care training programs will remain highly dependent on grants from Title VII.

The American Academy of Family Physicians strongly supports the reauthorization of Title VII of the Public Health Service Act. In particular, the Academy urges Congress to pass S. 555, the "Health Professions Education Consolidation and Reauthorization Act of 1995," which was introduced by Senator Nancy Kassebaum and adopted by the Senate Labor and Human Resources Committee. S. 555 would achieve the combined goals of supporting primary care physician training, consolidating a number of different federal health professions training programs, and achieving budget savings.

6. <u>Enhancements in the primary care infrastructure are of crucial importance to rural agricultural communities</u>.

Despite the fact that agriculture is the most competitive sector of the U.S. economy, nowhere is the shortage of primary services felt more severely in rural agricultural communities. The supply of physicians in rural communities is only one-third to one-half that in urban areas.[11] Moreover, in counties with fewer than 50,000 residents the ratio of primary care physicians to population has actually decreased since 1990.[12] The impact of the rural physician shortage is reflected in higher rates of chronic disease, higher death rates from occupational trauma, and lower health service utilization rates.

Although generally in short supply, family physicians are three or four times more likely than other specialties to practice in rural areas. They are the *only* physicians among all the specialties who are as likely to settle in nonmetropolitan areas as the general population. Subspecialist physicians tend to locate their practices in urban and affluent communities, not in rural and other underserved areas.

Family physicians are the principle providers in community health centers, rural health clinics, federally qualified health centers, and the emergency rooms of local hospitals. Virtually all of the providers in frontier communities are family physicians.

Rural and agricultural advocates have recognized the need for more primary care in their communities. Specifically, the American Farm Bureau Federation has recommended enhancements in:

- Efforts of medical schools to train additional qualified family physicians to practice in rural areas;

- Incentives at state and local levels to encourage doctors to practice in rural areas.[13]

The American Academy of Family Physicians appreciates this opportunity to address health care issues that affect the international competiveness of American business and the savings and investment rate in the U.S. We look forward to working with the Committee and the Congress in crafting proposals to improving the accessibility and quality of health care services as well as bringing health care costs under control.

Notes

1. The information on comparative health care costs is derived from: Schieber, G.J., Poullier, J. and Greenwald, L.M., Health System Performance in OECD Countries, 1980-1992, Health Affairs, Fall 1994.

2. Data from the Bureau of Labor Statistics cited in the testimony of Edith Rasell, M.D. before the Subcommittee on Health for Families and the Uninsured of the Senate Finance Committee hearings on the impact of health care reform and U.S. business competitiveness, January 12, 1994.

3. Starfield, B., Primary Care and Health: A Cross-national Comparison, Journal of the American Medical Association, 266(16), October 23/30, 1991.

4. Dor, A. and Holahan, J., Urban-Rural Differences in Medicare Physician Expenditures, Inquiry, 27, Winter 1990.

5. see Welch, W.P. et al., Geographic Variation in Expenditures for Physicians' Services in the United States, Journal of the American Medical Association, 328(9), March 4, 1993, and Chetty, V.K. et al., Medicare Reimbursement and Physician Specialty Distribution, publication pending.

6. Greenfield, S. et al., Variations in Resource Utilization Among Medical Specialties and Systems of Care, Journal of the American Medical Association, 267(12), March 25, 1992.

7. Grumbach, K., Keane, D., and Bindman, A., Primary Care and Public Emergency Department Overcrowding, American Journal of Public Health, 83(3), March 1993.

8. Group Health Association of America, HMO Industry Profile, 1993 Edition.

9. Testimony of John C. Lewin, M.D., Director of Health, Hawaii State Department of Health, before the Senate Committee on Labor and Human Resources, October 19,1993.

10. Council on Graduate Medical Education, COGME 1995 Physician Workforce Funding Recommendations for Department of Health and Human Services' Programs, June 1995.

11. Kindig, D. and Movassaghi, H., Physician Supply in Small Rural Counties, Health Affairs, Summer 1989.

12. Council on Graduate Medical Education, COGME 1995 Physician Workforce Funding Recommendations for Department of Health and Human Services' Programs, June 1995.

13. Letter from Dean R. Kleckner, President, American Farm Bureau, to Mrs. Hillary Rodham Clinton, February 11, 1993.

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Statement Of John William Kurowski
Founder Of The
American Constitutional Research Service
Before the
Committee On Ways And Means
United States House Of Representatives

June 1995

Mr. Chairman and Members of this Committee:

The subject of tax reform was extensively debated by the Founders of our country. I do not know if other participants in these Hearings have taken the time to research the accounts of these historical debates when formulating the suggestions they will present to this Committee, but, having researched the Founders' original tax reform package, I am inclined to believe its fundamental principals are as valid today as when they were put into practice over two hundred years ago.

Our nation's first revenue raising Act was "...in a certain sense a second Declaration of Independence; and by a coincidence which could not have been more striking or more significant, it was approved by President Washington on the fourth day of July, 1789." [See, Twenty Years of Congress, James G. Blaine, 1884, Vol. 1, page 185]

James Madison, in discussing this Act before Congress identified a fundamental principal concerning the power delegated to Congress to lay and collect taxes:

> "...a national revenue must be obtained; but the system must be such a one, that, while it secures the object of revenue it shall not be oppressive to our constituents."

The Act went on to imposed taxes, not on Congress' constituents, but on specific "goods, wares, and merchandise, imported into the United States", and not one dime was raised under the Act by internal taxation! Internal taxes were frowned upon by the Founders, especially when a national revenue could be had by requiring foreigners to pay for the privilege of doing business on American soil!

Jefferson, in his Second Annual Message (December 15, 1802) states:

> "In the department of finance it is with pleasure I inform you that the receipts of ***external duties*** for the last twelve months have exceeded those of any former year, and that the ratio of increase has been also greater than usual. This has enabled us to answer all the regular exigencies of government, to pay from the treasury in one year upward of eight millions of dollars, principal and interest, of the public debt, exclusive of upward of one million paid by the sale of bank stock, and making in the whole a reduction of nearly five millions and a half of principal; and to have now in the treasury four millions and a half of dollars, which are in a course of application to a further discharge of debt and current demands." [emphasis added]

Imagine...all this in consequence of "external duties"!

In Jefferson's Second Inaugural Address (March 4, 1805), he points out:

> "At home, fellow citizens, you best know whether we have done well or ill. The suppression of unnecessary offices, of useless establishments and expenses, enabled us to ***discontinue our internal taxes.*** These covering our land with officers, and opening our doors to their intrusions, had already begun that process of domiciliary vexation which, once entered, is scarcely to be restrained from reaching successively every article of produce and property...
>
> "The remaining revenue on the consumption of foreign articles, is paid cheerfully by those who can afford to add foreign luxuries to domestic comforts, being collected on our seaboards and frontiers only, and incorporated with the transactions of our mercantile citizens, it may be the pleasure and pride of an American to ask, what farmer, what mechanic, what laborer, ever sees a tax-gatherer of the United States?"[emphasis added]

Although a national sales tax appears to be somewhat fairer than existing taxation, such a tax would do ill to our nation as the various proposals are all based upon an internal consumption tax plan which ultimately increases the cost of goods manufactured on American soil; burdens the American Citizen in its collection; and, are to be paid by the "farmer, mechanic, laborer", etc., who will continue to see the intrusion of the "tax-gatherer of the United States" if such a system is adopted!

In view of the undesirable effects of an internal national sales tax, perhaps it is wise to follow the Founder's plan and study how imposts and duties (external taxation) were successfully used to fill the national treasury, encourage domestic manufacturing and assist in building a strong industrial base.

In addition to imposing a specific amount of tax on specific articles of consumption imported, the first revenue raising Act also imposed an across-the-board tax on imports which was higher for imports shipped in foreign owned foreign built vessels, and discounted the tax for imports arriving in American owned American built ships:

> "...a discount of ten percent on all duties imposed by this Act shall be allowed on such goods, wares, and merchandise as shall be imported in vessels built in the United States, and wholly the property of a citizen or citizens thereof."

This patriotic and skillful use of external taxation gave American ship builders a hometown advantage and predictably resulted in America's merchant marine becoming the most powerful on the face of the planet. Unfortunately, today when I visit the docks in New York's Hell's Kitchen area, I am saddened that I can no longer read the names on the docked ships as they all seem to now be foreign owned foreign built vessels displaying flags and languages I am unfamiliar with....an irrefutable sign of America's decline brought about by the obvious acceptance of thirty pieces of silver.

Yes, there was a day when our national treasury was gladly filled by foreigners paying for the opportunity to do business on American soil. But this was when members of Congress, and those running for Office, put American interests first and would have considered the NAFTA, GATT and the WTO as acts of sedition, and would have tarred and feathered those participating in the surrender of America's sovereignty.

A national sales tax plan which omits external taxation as a principal source to fill our national treasury, is in fact a surrender of national sovereignty to the advantage of foreign interests!

A Second Source To Fill The Treasury

Having identified imposts and duties (external taxes) as being the Founder's intended primary source to fill our national treasury, I will now turn to their intended internal consumption tax plan.

An across the board national sales tax would unquestionably increase the cost of production on American soil, as previously pointed out. To avoid this, and other unwanted effects of an across the board national sales tax, common sense dictates we must exclude from the list of taxable items, tools of production, supplies necessary to conduct business, services needed to sustain business, and the necessities of life (food, shelter, clothing, medical expenses) i.e. all those items which makes labor possible must be excluded.

In simple language, a consumption tax plan ought to be limited to articles of luxury, and each article must be individually selected by Congress and the appropriate amount of tax must be determined for each specific item chosen, just as was done in the first revenue raising Act of our country!

By limiting the tax to articles of luxury, and requiring each article to be specifically chosen and the appropriate amount of tax determined by Congress, a self regulating check and balance is imposed upon Congress. If Congress does its job properly and the nation as a whole is productive and prosperous, the sale of articles of luxury will undoubtedly increase, and with it, the flow of revenue into the common treasury! But, if Congress' policies become burdensome and its regulatory requirements upon business, industry and our nation's labor force inhibit a hearty economy, or any particular article is excessively taxed, the first sign would be is a decline in the flow of revenue into the national treasury! Thus, the free market place determines the limit of taxation under the Founder's internal consumption tax plan, and it establishes a self regulating gauge beyond the reach of Congress' manipulation!

As Hamilton said, in regard to taxes on consumption, they:

> " . . . may be compared to a fluid, which will in time find its level with the means of paying them. The amount to be contributed by each citizen will in a degree be by his own option, and can be regulated by an attention to his own resources. The rich may be extravagant, the poor can be frugal; ***and private oppression may always be avoided by a judicious selection of objects proper for such impositions*** . . . It is a signal advantage of taxes on articles of consumption that they contain in their own nature a security against excess. ***They prescribe their own limit, which can not be exceeded without defeating the end proposed__that is, an extension of the revenue.***" [No. 21 of the Federalist, emphasis added.]

Balancing The Budget

Still one more question remains to be answered: what is to be done if insufficient revenue is raised from external and internal taxes on consumption?

Once again the Founder's plan shines bright above all contemporary suggestions. Careful research into our Nation's early legislative history reveals the Framers did in fact provide Congress with an emergency power to be used if deficits should arise. And the wisdom of the Framer's method, unlike the proposed balanced budget amendment (S.J. RES.1), contains a brilliant mechanism which would abruptly end Congress' current profligate spending habits!

Under the Framer's plan, whenever the monies arising from Congress' normal taxing powers (imposts duties and excises) are found insufficient to fund federal expenditures during a fiscal year, and a deficit is produced by Congress borrowing to finance expenditures, Congress must then use its direct taxing power at the beginning of the next fiscal year to raise an amount sufficient to retire this deficit.

Congress is required to follow the rules of apportionment when imposing this tax, and bills each state for a share of the deficit. Each State must contribute a share of the total deficit in proportion to its allotted number of Representatives as set forth in Article 1, Section 2, clause 3, of the United States Constitution. The more votes a State exercises in the House, the larger is its share toward extinguishing a deficit . . . ***representation with proportional obligation!***

The chart below is based on a total House membership of 435:

STATE	NO.OF REPRESENTATIVES	SHARE OF DEFICIT
NEW YORK	31	31/435's
MARYLAND	8	8/435's
CALIFORNIA	52	52/435's
IDAHO	2	2/435's
FLORIDA	23	23/435's
etc		

FOUNDING FATHERS' FAIR SHARE FORMULA

The states are left free to raise their share of the tax in their own way, within a time period set by Congress. But if any state shall neglect to pay its share, then Congress must send forth its officers to assess and levy that state's apportioned share, together with interest thereon.

Legislative History

This method of extinguishing deficits appears in seven of the ratification documents which gave life to the United States Constitution. The first emergency *direct tax* was imposed in 1798, to extinguish part of the Revolutionary War debt. It was later used during the War of 1812, and also to extinguish deficits during the Civil War.

The Sixteenth Amendment to the United States Constitution did not repeal or alter Congress' power, or *obligation,* to impose the emergency direct tax should a deficit arise. The power of Congress to impose a direct tax still exists, and direct taxes are still required to be apportioned among the states, as pointed out by the United States Supreme Court [see Stanton v. Baltic Mining Co., 240 U.S. 103, (1916); Eisner v. Macomber, 252 U.S. 189 (1920); and, Bromely v. McCaughn, 280 U.S. 124 (1929). Also see Congressional Research Service Report No. 84-168 A 784/275, which was updated September 26, 1984].

Big Advantages

There is no smoke and mirrors with the `FAIR-SHARE' method of balancing the budget. The emergency direct tax is required to be imposed whenever Congress closes a fiscal year with a deficit. The structural mechanism which would immediately bring fiscal sanity to Congress is the requirement of having Congress send a bill to the governor of each state, notifying him to remit his state's *apportioned share* toward extinguishing the deficit created during the year by Congress; the governors and state legislators being left with the burden of having to raise this money, and to send it off to Washington, D.C.

Picture, for a moment, the expression on the faces of the Governor of New York and the New York State Legislature, if New York should receive a bill for its apportioned share [31/435] of the 1995 federal deficit. This threat would create a compelling incentive for the Governor of each state, and the various state legislatures, to keep a jealous eye on the spending habits of their Congressional Delegation . . . it would require the fiscal accountability which the state governments once *demanded* from their Senate and House Members!

In addition, because each state's share of the tax burden is determined by a fixed rule, similar to that which determines the House membership size of each state, a barrier is erected preventing the kind of mischief which Congress now practices, i.e., discriminatory tax legislation; pork-barrel favoritism; special interest lobbying, etc.

Bottom Line

The Framers of our Constitution provided a specific method to extinguish anticipated deficits through an emergency direct tax. Hamilton, in No. 36 of The Federalist Papers, reminds us:

> "Let it be recollected that the proportion of these taxes ***is not to be left to the discretion of the national legislature, but is to be determined by the numbers of each State, as described in the second section of the first article*** [United States Constitution]. An actual census or enumeration of the people must furnish the rule, a circumstance which effectually shuts the door to partiality or oppression. The abuse of this power of taxation seems to have been provided against with guarded circumspection." (EMPHASIS ADDED)

The rule of apportionment was written into our constitution to remedy a major defect associated with "democracies", which Madison points out in No. 10 of The Federalist Papers:

> ". . . have ever been spectacles of turbulence and contention; have ever been found incompatible with personal security or the rights of property; and have in general been as short in their lives as they have been violent in their deaths."

And so, the Founding Fathers formed a Constitutional Republic to avoid the predictable disastrous consequences of democracy.

The intended use of the emergency direct taxing power to extinguish deficits is not only far superior to any of the proposed balanced budget amendments being offered . . . it is already part of our Constitution. The method in text form is as follows:

The Fair Share Balanced Budget Method

"A R T I C L E__

"SECTION 1. Congress ought not raise money by borrowing, but when the money arising from imposts duties and excise taxes are insufficient to meet the public exigencies, and Congress has raised money by borrowing during the course of a fiscal year, Congress shall then lay a direct tax at the beginning of the next fiscal year for an amount sufficient to extinguish the preceding fiscal year's deficit, and apply the revenue so raised to extinguishing said deficit.

"SECTION 2. When Congress is required to lay a direct tax in accordance with Section 1 of this Article, Congress shall immediately calculate each State's apportioned share of the tax based upon its number of Representatives as allotted by the Constitution, and then notify the Executive of each State of its apportioned share of the total tax being collected and a final date by which said tax shall be paid into the United States Treasury.

"SECTION 3. Each State shall be free to assume and pay its quota of the direct tax into the United States Treasury by the final date set by Congress, but if any State shall refuse or neglect to pay its quota, then Congress shall send forth its officers to assess and levy such State's proportion against the real property within the State with interest thereon at the rate of___ per cent per annum, and against the individual owners of such property. Provision shall be made for a 15% discount for those States paying their share by___ of the fiscal year in which the tax is laid, and a 10% discount for States paying by the final date set by Congress, such discount being to defray the States' cost of collection.

Conclusion

There are participants at this Hearing, and many political pundits appearing on talk shows across our country, who are far more articulate than I in identifying the glaring defects and dishonest nature of income taxation, whether flat or progressive. Likewise, there is also an abundant supply of those presenting well rehearsed arguments against an across the board national sales tax, and have displayed their rhetorical skills quite admirably. But who, I ask, has made a substantial argument against the Founding Father's original tax reform package?

Perhaps our only problem in regard to tax reform is that we, as a nation, have lost touch with the original intent and wisdom of those who framed and ratified our Constitution...such negligence culminating in our current dilemma.

In closing Mr. Chairman, I would like to take this time to thank you and your staff for allowing me this opportunity to present my humble opinion on a subject of such great importance.

STATEMENT OF THE AMERICAN FARM BUREAU FEDERATION TO THE HOUSE WAYS AND MEANS COMMITTEE ON AN ALTERNATIVE FEDERAL TAX SYSTEM

June 6, 1995

Farm Bureau is the nation's largest general farm organization with a membership of 4.4 million member families in 50 states and Puerto Rico. Farm Bureau members produce virtually every commodity grown commercially in this country. Our policy is developed by producer members at the county, state and national levels of our organization. We appreciate the opportunity to comment on tax issues important to our member families.

Farm Bureau applauds the efforts of this committee to hold hearings and move forward with the tax debate in the 104th Congress. Making tax policy more farmer-friendly has been on the top of Farm Bureau's agenda for many years. The current debate contains many good tax reform proposals which are important to farmers and supported by Farm Bureau including; a lower capital gains tax, a higher estate tax exemption, deductibility of health insurance premiums by the self-employed and expanded use of individual retirement accounts (IRAs). We urge the committee to view these proposals as the start of a series of tax changes that will improve the economic well-being of our nation and its farmers and ranchers.

Federal tax policy must give all citizens, including farm and ranch families, more opportunity to keep their own money and create their own personal financial safety net rather than rely on government. For farm families to be financially secure, tax policy must create a business climate where well managed farms can produce profits. Then, tax policy must allow farmers to keep more of their income so they can save for future financial security.

Over time, the U.S. tax code has become more complex and harder to manage. Thus, U.S. tax policy has a tougher time accomplishing its intended agenda of encouraging private initiative, economic growth, equity, simplicity and collecting the needed revenue with a minimum amount of economic distortions. All of this has come at a cost to the private sector in terms of lost output and efficiency in our economy. It is now estimated to cost $192 billion annually to comply with the current tax system and its 480 forms.

Current Farm Bureau Policy

Farm Bureau policy states that tax policy should be designed to encourage private initiative,

economic growth, equity and simplicity. Farm Bureau supports the consideration of a single rate net income tax system. Farm Bureau policy currently opposes a value-added tax and believes that sales tax should be reserved to state and local governments. Farm Bureau also supports the repeal of federal estate taxes as well as cutting the tax rate on capital gains to a maximum of 15 percent and indexing capital gains for inflation. Farm Bureau supports changes in IRAs to expand their use for saving for education, for the purchase and upgrade of primary residences and for medical illness. Tax changes to reinstate IRAs, to allow non-employed spouses to participate, and to expand the uses for saved funds will be good for farm and ranch families of all ages.

Farming and ranching are extremely capital intensive businesses. Even a part-time, beginning farmer who owns little or no land can easily have over $100,000 of capital investments. When land is added to an operation's assets, capital needs can quickly reach a minimum of $200,000 to $300,000. Capital gains tax relief is needed to facilitate the movement of agricultural capital assets to the next generation of America's farmers and ranchers and to improve the economic viability of existing farm operations. It is preferable for this transfer to occur while both generations are alive, rather than be subject to estate taxes at the time of death.

Farmers and ranchers have a vital interest in estate taxes because production agriculture remains a family enterprise-based industry. According to the 1992 Census of Agriculture, 85.9 percent of farms and ranches are individual or family proprietorships and 9.7 percent are partnerships. Of the 3.8 percent of operations that are incorporated, only 0.4 percent are not family held. Without estate law changes, the next generation will find it more difficult to continue farming.

Farm Bureau also supports increasing the annual gift exemption per donee from the current $10,000 to $20,000. This would provide another tool to ease the estate tax burden and help keep farms and ranches in the family.

The 25 percent tax deduction for health insurance premiums of self-employed sole proprietors has been made permanent in recent legislation and will move in the near future to 30 percent. This is a move that Farm Bureau has supported. We commend Congress for passing this legislation. In addition, Farm Bureau supports a permanent 100 percent deduction for health insurance premiums paid by self-employed individuals. Providing self-employed persons the ability to deduct 100 percent of the cost of their health insurance is a matter of fairness. Corporations, including farms that are incorporated, are able to deduct the entire costs of their employees' health insurance. It is only fair that all farmers, regardless of how their businesses are organized, be able to deduct their entire health insurance costs.

Farm and ranch income can vary greatly from year to year. When farmers and ranchers have good income years, the amount of savings they can shield from taxes is limited and their incomes are heavily taxed. During tough financial years, farmers and ranchers may have no money to save. Changes in IRA rules will allow farmers to save more money and allow them to retain more of their income from savings. In addition, increasing the variety of uses for savings will give farmers more control of their financial future.

Farm Bureau supports accelerated depreciation, allowing for annual expensing of preproduction expenses and increasing the amount of capital purchases allowed to be expensed each year. Farm Bureau also supports tax incentives for producers who are forced to make expenditures in order to comply with environmental laws. Farm Bureau supports allowing farmers and ranchers to count income from livestock sales and disaster payments in the year that they would normally have occurred so that taxes paid are fair and a true reflection of normal farm income. Finally, Farm Bureau supports the creation of a per child tax credit, elimination of the marriage penalty and an increase in the personal exemption.

Creating a New Tax System

Current debate is beginning to move beyond tax reform toward a complete overhaul of the entire federal tax system. New tax systems being debated include the flat tax concept, a national sales tax, a value-added tax system and other consumption-based tax systems. Farm Bureau supports consideration of a single rate income tax system, but has not endorsed any specific plan. Farm Bureau believes that the goal is to design a system that is fairer and simpler and will encourage strong economic growth and greater opportunity for all citizens.

The earliest work on a new system was done by Stanford Professor Robert Hall and Alvin Rabushka of the Hoover Institution. Their book, The Flat Tax, was first published 10 years ago, with a second edition this year. According to their analysis, a hypothetical farmer in Iowa would be due a carry-forward against future taxes when gross farm revenues (amount received from crop sales) fall short of the total farm expenses paid (including the purchases of goods, services, materials, wages, salaries, pensions, capital equipment, structures and land). In a profitable year, each farmer would also be able to deduct the costs of doing business (including capital equipment, structures and land) from revenues before calculating and paying taxes owed. The results, based on Hall and Rabushka, could be sent to the government on a 10-line postcard.

This type of flat tax is favorable for farmers and ranchers with families (since personal allowances and dependent exemptions will still be deductible) and farmers and ranchers with business expenses (that can be deducted in the year they were made). Several flat tax plans have recently been proposed in Congress and several more will likely be added in coming months. Under each of these proposals, farmers would still be able to deduct all legal business expenses and transmit the results to the IRS on one simple form. The results should be positive on the macro economy as well.

Earlier this year, House Majority Leader Dick Armey (R-TX) put forth his proposal based on the flat tax idea to simplify the U.S. tax code. This proposal would create one tax rate (20 percent initially and 17 percent after the federal government is downsized) allow Americans to calculate their taxes in just minutes instead of hours. The results could be sent to the IRS on a postcard. The positives that Farm Bureau notes with this type of plan include: eliminating the current double taxation on savings and investment, lowering our already high marginal tax rates, simplifying tax compliance, insuring fairness, producing higher economic growth, and higher taxpayer compliance while restraining the growth in federal spending.

On the Senate side, Sen. Arlen Specter (R-PA) introduced on March 2, 1995 the Flat Tax Act of 1995 (S.488). This bill would also scrap the majority of current deductions and regulations and replace them with a 20 percent flat tax that could be filed on a simple 10-line postcard. While the Armey plan would eliminate all deductions and further cut the size and cost of government, the Specter plan would include limited deductions for home mortgage interest on up to $100,000 in borrowing and charitable contributions up to $2,500. Individuals would not be taxed on any capital gains, interest on savings or dividends. In our opinion, this is a very positive step. Under this plan, farm businesses would be able to expense 100 percent of the cost of capital formation, including purchases of capital equipment, structures and land in the year in which the investment would be made. The major positives about the Specter plan are:; simplicity, less regulations, more economic growth, increased efficiency, lower interest rates, lower costs of compliance and decreased fraud.

On April 25, 1995, Senators Domenici (R-NM) and Nunn (D-GA) added their plan to this mix. Positive features of their include: simplifying the tax code and spurring personal savings and business investment. A new deduction for the 7.65 percent social security/medicare payroll tax would be added as well as a deduction for education/training costs and all personal savings including stock/bond purchases. The marginal tax rate for married couples earning over $24,000 a year would be an effective 32.35 percent (after deducting the social security tax rate). This, in our opinion, is still a relatively high marginal rate. Business would pay a flat rate of 11 percent on income (revenues minus expenses) compared to the current rate of 35 percent, a plan that could be an aid to farm businesses.

House Ways and Means Chairman Bill Archer has recently called for the abolishing of the present income tax system and replacing it with a consumption tax. In his words, the current system is "too broken to be fixed and must be replaced." The Archer replacement tax would be a broad-based tax on individual and business consumption spending with exemptions for medical and housing expenses. Chairman Archer would also repeal the 16th Amendment to the Constitution that authorizes the current income tax. While Farm Bureau policy currently does not support a value-added type tax, we commend the Chairman for his open mind and willingness to help move America closer to a new tax system.

Tax policy and the resulting rules, regulations and systems are critical to our members. Policies and systems that are fair and equitable promote both the economic well-being of farmers and our nation's food supply. Our tax system must provide incentives for citizens to pay their fair share of their respective tax liabilities and encourage all citizens to create personal financial safety nets. We urge the debate to continue as America moves toward such a new system.

STATEMENT OF AMERICAN IRON AND STEEL INSTITUTE (AISI) ON BEHALF OF AISI's U.S. MEMBER COMPANIES

The American Iron and Steel Institute (AISI), on behalf of its U.S. member companies, commends Chairman Archer and the Committee on Ways and Means for holding this hearing to examine the potential benefits of fundamental tax restructuring and alternatives to the current income tax system.

This is a huge undertaking. It is one that holds enormous promise even as it raises major concerns. Our long-held position is that this subject deserves serious national consideration. We therefore applaud all of the tax policy leaders on both sides of the political aisle for having the vision to move this issue into a front-and-center position in the 104th Congress.

Needed: A Careful Look at the Pros and Cons

For the past several years, AISI has been one of the strongest, most public supporters of a careful, in-depth study of the pros and cons of basic tax reform. By letting the Congress know at every opportunity that this is a key issue for U.S. steel producers, AISI has sought to promote a national debate on this matter. We concluded long ago that the study of fundamental tax restructuring is a priority issue for one simple reason -- the existing U.S. business tax system is hurting U.S. investment, productivity, competitiveness, economic growth, jobs creation, and ultimately the standard of living in the United States.

Still, as Chairman Archer has recognized, basic tax reform must be more than just an improvement over the current system. To justify the great effort that such a massive task entails and to ensure that the end result will be a pro-competitive tax system for the 21st century, the Congress must proceed carefully, look at the pros and cons, listen to those in the private sector that will be most affected, and address the significant number of serious concerns, questions and issues related to fundamental tax restructuring.

If the Congress does decide, after an appropriate period of careful study, to take the current income tax system and "tear it out by its roots," the aim on the business side should be to create a simple, revenue-neutral substitute for, not an add-on to, the existing business tax system of the United States (corporate income, including alternative minimum, taxes and payroll taxes). Accordingly, we are pleased that virtually every one of today's major bills or proposals -- from the flat tax to the "USA Tax" -- endorses the concept of a total replacement of the existing business tax system.

The fact that hardly anyone today would suggest enacting a consumption or value-added tax as an add-on to the current income tax system is progress -- it is a first step on the road toward national consensus. What we now need to do is start defining the kind of tax system and tax policy results that we would like to see well into the next century. As Chairman Archer has said, consideration of basic tax reform must be measured against certain well-defined goals. We would urge that the Congress begin by developing a list of guiding principles.

Guiding Principles

If we as a nation are to move toward fundamental tax restructuring, it must be done right. Basic tax reform must conform to key principles. Any new business tax system should:

1. **replace current taxes on U.S. companies and avoid net increases in taxes on U.S. businesses** -- we will not improve U.S. competitiveness, if there are net increases in taxes on U.S. firms;

2. **provide for immediate expensing of new plant and equipment purchases** -- any new system should encourage U.S. investment,

discourage disincentives to investment, and promote rather than hinder the competitiveness of U.S. manufacturing;

3. **be border-adjustable** (exempt exports, apply to imports the same as U.S.-produced goods) -- this is an essential element of leveling the playing field and developing a pro-competitive U.S. tax system for the 21st century;

4. **be simple, less burdensome, and relatively easy to administer** -- steel and other U.S. industries share these goals with the individual taxpayer; and

5. **include appropriate transition rules** -- it is absolutely critical that Congress recognize that issues of fairness and equity affect both businesses and individuals and, if we are to make the new system fair, U.S. firms must be allowed to carry with them into this substitute system the net operating losses (NOLs) or tax credits that they have accumulated under the current system.

Potential Benefits

If properly constructed along the lines discussed above, basic tax reform could yield many benefits. It could lower the U.S. cost of capital, simplify the U.S. business tax code, promote U.S. exports, and provide additional revenue (from imports) for federal deficit reduction and other important national goals. In addition, many economists now believe that this could all be done without raising taxes for U.S. businesses or causing significant price hikes for U.S. consumers.

Accordingly, there are good reasons for the Congress, U.S. industry and U.S. citizens to spend a substantial amount of time over the next year or two trying to craft a new, replacement tax system.

Inadequate Capital Cost Recovery -- The Present System is Broken

There is no doubt that the existing anti-competitive U.S. business tax system is retarding U.S. investment flows and harming U.S. competitiveness. Thus, in January, at Committee hearings on the tax provisions of the "Contract with America," we testified that, as Alternative Minimum Tax (AMT) payers, AISI's U.S. member companies agree totally with Chairman Archer that "the present system is broken...".

On June 6, 1995, the American Council for Capital Formation (ACCF) testified about some of the problems related to the current system. It noted that net business investment in the U.S. has fallen to only half the level of the 1960s and 1970s; that the stock of equipment needed for strong productivity growth has increased all too slowly since 1980; that tax policy does affect capital costs, and that tax rates on investment do affect the level of investment. It also noted in particular that (1) the marginal tax rate on domestic U.S. corporate investment is 37.5 percent -- higher than most other countries -- and (2) U.S. taxes on machinery and equipment investment are especially high (e.g., 18.5 percent on new investment in machinery, versus only 8.8 percent in Japan).

Compared to other countries, the capital cost recovery system in the United States today is grossly inadequate. Based on recent research by Arthur Andersen, the ACCF estimates that, under the AMT, the "present value" of the entire stream of cost allowances for U.S. investments in modern continuous casting equipment is only 59 percent, compared to 81 percent in Japan, 82 percent in Germany, 78 percent in Korea, and 88 percent in Brazil. Viewed another way, after 5 years, a U.S. steelmaker under the AMT recovers only 37 percent on its investment in new plant and equipment, versus 58 percent in Japan, 81 percent in Germany, 90 percent in Korea, and 100 percent in Brazil. It was not always this way. Between 1981 and 1985, when a strongly pro-

investment tax regime was in effect in the United States, the present value for a similar investment made in the U.S. was close to 100 percent.

A Recipe for Capital Formation –
No More AMT and Full Expensing: The Example of Steel

When AISI testified in January, it stressed that "capital costs and capital formation remain critical concerns to our industry....{and that} the last thing we need is an anti-competitive tax that raises the cost of capital and impairs capital formation." Improving the U.S. capital cost recovery system, therefore, would be one of the most important potential benefits of fundamental tax restructuring for the American steel industry. Taking steel as an example, here is why.

U.S. steelmakers must continuously invest in new plant and equipment in good times and bad in order to modernize, remain competitive, and comply with environmental laws and regulations. The AMT treats depreciation as an increase in income. As a result of this adverse treatment of depreciation, many capital-intensive, marginally profitable U.S. steelmakers remain permanently stuck in the AMT – the world's worst capital cost recovery system, with a 150 percent depreciation method and a 15-year cost period for most steelmaking assets (compared to 200 percent and 7 years under the regular tax).

We estimate that the AMT raises our industry's cost of capital by as much as 20 percent. This is why, until basic tax reform is finally in place, steel and other U.S. manufacturing industries will continue to give strong support to the kind of significant "incremental change" contained in H.R. 1215. The House-passed bill and the AMT provision sponsored by the Chairman would remove a major disincentive to U.S. investment by phasing out the AMT by the year 2001.

The bottom line: if the United States were to adopt a truly pro-competitive tax system -- with no AMT to penalize investment and with full and immediate expensing of new plant and equipment purchases in Year One -- it would be a major boon to capital formation in steel and other U.S. manufacturing industries, including our major customers in steel-using industries.

Border-Adjustability -- A Way to Promote U.S. International Competitiveness

A second important reason to consider basic tax reform is the opportunity to include a border-adjustability feature, which could provide significant benefits for U.S. international competitiveness in addition to yielding a substantial amount of revenue from imports.

The United States today is virtually the only major economy in the world that does not use some form of GATT-legal border-adjustable tax (BAT) on business activities in its territory. In Western Europe, Japan and other markets, U.S. exporters and the products that they sell face a BAT upon entry. In the U.S. market, however, we do not require foreign companies to pay a BAT on the goods they sell here – and our foreign competitors also get a rebate of their own government's BAT when their products leave as exports. As a result, the international playing field is not level when it comes to fiscal policy.

Perhaps the best example is the one closest to home. Everyone knows that the North American Free Trade Agreement (NAFTA) will eventually eliminate duties on intra-NAFTA exports of steel and other products. What has not received enough attention is the fact that U.S. exports will continue to be charged a 7 percent goods and services tax upon entry into Canada and a 15 percent VAT upon entry into Mexico -- and that these taxes will continue to be rebated for Canadian and Mexican exports to the United States.

Border-adjustability must be part of any basic tax reform. When combined with full expensing, a substitute BAT could have a powerful pro-competitive effect on manufacturing and the U.S. economy.

Tax Code Simplification

A third main reason to consider fundamental tax restructuring is tax code simplification. As AMT payers, steel companies know all too well the problems associated with tax code complexity. AISI's U.S. members have to keep two sets of books -- one for the AMT and one for the regular tax -- and pay the higher of the two (nearly always the AMT). In addition to this requirement, there are the numerous depreciation and inventory calculations, the all-too-frequent changes in the Code, and the extremely technical language that only an army of accountants and IRS officials can understand.

Looked at from a national perspective, the existing tax system is fraught with excessive administrative costs, and the total annual U.S. compliance cost for the private sector is estimated to be in the $300 million range. Surely, there are better ways for U.S. firms and individuals to spend their time and money.

While any new tax system must include appropriate transition rules, which would involve some complexity, AISI would encourage the Congress to keep the goal of tax code simplification at or near the top of its aims for basic tax reform.

Major Concerns, Questions and Issues

With so much in the way of potential benefits from fundamental tax restructuring, why are we and other U.S. industries holding back somewhat and not rushing to endorse without qualification basic tax reform? The answer is this: perhaps the only thing more complicated than the current U.S. tax code is trying to figure out what a total replacement of the existing system would mean for one's own company, one's industry and the U.S. economy at large. As noted previously, there are a number of critical concerns, questions, and issues that must be addressed before Congress takes the historic step of actually moving to enact fundamental tax restructuring.

Net Tax Burden -- Will It Be Higher?

The potential benefits to U.S. businesses from basic tax reform will be clearly diminished if a new tax regime results in net tax increases. Unfortunately, even assuming that any new tax will be a replacement for, and not an add-on to, existing taxes on U.S. businesses, it is possible that tax burdens on U.S. industry (both in the aggregate and on individual industries and firms) could go up. In this regard, three central questions are:

- What will the tax rate be?
- How broad will the tax base be?
- And will there be net tax increases on U.S. businesses?

U.S. manufacturers have reasons to be concerned. Looking at just one proposal, Price Waterhouse has estimated that, whereas aggregate U.S. corporate tax liability in 1991 -- under the current system -- stood at about $68 billion, it would rise to $78 billion under a 17 percent flat tax, to $88 billion under a 19 percent flat tax, and to $106 billion under a 23 percent flat tax.

Moreover, there are concerns not only about the rate that will be chosen but about the issue of how the tax base will be computed. Our U.S. member companies wonder, for example, if they will be given full credit for social security taxes paid in whatever fundamental tax restructuring proposal is finally adopted. In addition, they are very concerned that some of the proposals add labor

compensation items (e.g., health and pension legacy costs) back into the tax base mix. The effect of this could be to create a "super payroll tax," and that could be especially damaging to some U.S. steel producers.

Effects on Financial Statements -- Both Winners and Losers

Yet another serious concern is the possibility that basic tax reform could eliminate deferred tax assets (e.g., NOLs, minimum tax credits, and health care costs that have value as future tax deductions). This loss of such future deductions and credits could have a devastating effect on some steel companies' financial statements. Accordingly, our U.S. member companies worry about this accounting treatment of fundamental tax restructuring.

The concern is real because the Financial Accounting Standards Board issued "Statement 109, Accounting for Income Taxes," in February 1992, which mandates a liability method for computing deferred income taxes. The adoption of a tax other than on income could have a significant impact on the financial statements of companies. For example, companies with large deferred assets due to NOLs or minimum tax credits could suffer substantial losses from the reversal of such assets, as well as a weakened balance sheet.

The impact of basic tax reform on financial statements is a major concern for some steel companies, because it could possibly wipe the equity of some companies off the books. The main point we would like to make, however, is that there could well be both major windfalls and big losers from the accounting impact of fundamental tax restructuring and, at least so far, this issue has not received the required attention. If the Congress does move forward to enact a new tax system, we urge it to take action to preserve these tax assets.

Accumulated Tax Assets and Credits -- The Paramount Need for Appropriate Transition Rules

AISI has always recognized that basic tax reform could not ensure that every U.S. steel company would pay no more under a new tax system in any given year than they do currently. At the same time, the more we have studied this issue, the more obvious it has become that, even under a well-constructed, revenue-neutral, border-adjustable, substitute tax regime, there must be clear and fair transition rules to ensure that key industries and firms are not unduly disadvantaged, even temporarily.

Many steel companies, for example, have built up significant accumulated tax assets under the existing corporate income tax system -- including NOL carryforwards and AMT credits -- that total hundreds of millions of dollars. Our U.S. member companies naturally want to know: what will happen to these NOLs and other accumulated tax assets under various basic tax reform plans? Unfortunately, appropriate transition rules are a key missing ingredient from many of the proposals for fundamental tax restructuring. This is an issue of basic equity. It remains an absolutely critical issue for AISI's U.S. members.

Some have suggested that, for "GATTability" reasons, the choice is between (1) a tax that is border-adjustable and (2) a transition rule that provides U.S. companies access to their NOLs and accumulated tax credits. If correct, this would obviously make the concept of basic tax reform much less attractive to steel and other industries. We do not agree, however, that this is the choice. First, as one means of solving the problem, the Congress could allow U.S. firms to cash out their NOLs and accumulated tax credits. Second, as Gary Hufbauer (Institute for International Economics) recently noted, "the {GATT-}permitted range of adjustments is not static. Instead, it has gradually expanded over time....{In addition,} the introduction of a new tax has sometimes served as the occasion for enlarging the range of permitted adjustments."

If the Congress does move ultimately to enact fundamental tax restructuring, it should ensure both that the new tax is border-adjustable and that there are appropriate transition rules in place so that U.S. companies and industries are not unfairly disadvantaged. The issue of what may or may not be allowed by the new World Trade Organization will perhaps be a factor in the coming national debate. At this time, it is just one more concern that needs to be addressed.

The Effects on Prices and Consumption – Two Important "Wild Cards"

The American steel industry, like a number of other key manufacturing industries, is inextricably tied to the performance of the U.S. economy as a whole. While AISI and just about everyone else would like basic tax reform to promote U.S. savings and investment, we do not wish to see a new tax system dampen U.S. consumption of steel-intensive products that contribute to the standard of living of our citizens and improve the competitiveness of our businesses. Fundamental tax reform should make the economic pie bigger -- it should grow both U.S. savings and consumption. The question is: will it?

The concern here is whether price increases could result from a new replacement tax system and whether these could possibly push down U.S. consumption of steel-containing manufactures. At the end of our national debate on tax policy, if the Congress does enact basic tax reform, it will inevitably involve some "leap of faith." Two things, however, are obvious right now: we will need to be very clear about our main goals as a national economy, and we will need to improve the way we analyze this issue.

Analytical Constraints

The problem for us and every other U.S. industry is that, while we can all probably agree that, for example, not taxing capital expenditures will have tremendous impacts in all kinds of ways, there is no way to understand these effects fully by using a static analysis.

The fact is that, while a static analysis assumes that certain macro-economic numbers (e.g., consumption levels) will not change, one of the primary aims of fundamental tax restructuring is to effect a society-wide change in tax payer behavior (e.g., to increase savings). At the same time, the "science" of trying to estimate both the micro and macro-economic effects of basic tax reform through use of a more dynamic model has a long way to go.

In sum, there are simply too many moving parts to estimate with any degree of certainty the potential impacts on (1) economic growth, (2) federal revenue, (3) the cost, price and demand of products, (4) the cost of capital, (5) exchange rates, and (6) securities' prices. In addition, some of the dynamic effects from basic tax reform could take decades to work themselves through the economy. Thus, all we can do is try to make an intelligent guess as to how fundamental tax restructuring might affect our particular industry and/or company.

Conclusion

This Committee is embarking on something -- a possible complete overhaul of tax policy in the United States -- that has not been done in this country in over 60 years. AISI applauds you for initiating the process. For our part, we have been looking at the issue of fundamental tax restructuring for a long time, and intend to contribute what we can to the national discussion on basic tax reform that the Committee, Senate Finance, and the "Kemp Commission" will be leading.

In part because of the aforementioned analytical constraints, we have not sought in this testimony to come out for or against any of the major proposals for basic

tax reform. While the economic consequences of each could vary widely, they all have their good points and something to commend them when compared to the existing U.S. business tax system. Our intention here is to suggest guidelines, benchmarks, and principles that we would appreciate the Congress considering as it delves deeper into this important public policy matter.

AISI's U.S. member companies are grateful for this opportunity to provide written comments on fundamental tax restructuring for the record, and look forward to participating actively in the coming debate.

AMERICANS FOR TAX REFORM

Grover G. Norquist
President

May 25, 1995

Hon. Bill Archer, M.C.
Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

Dear Chairman Archer:

We at Americans for Tax Reform salute you for your steadfast efforts in passing the Contract with America tax reductions through the House of Representatives and we urge you to stand firm in your negotiations with the Senate.

We also look forward to your scheduled hearings June 6-8 on proposals to revise or replace the income tax.

Americans for Tax Reform strongly supports reform proposals that will make federal taxes and tax rates fairer, simpler, flatter, and lower. We enthusiastically support the Armey Flat Tax proposal soon to be reintroduced in this Congress.

Americans for Tax Reform strongly opposes any national sales tax or value-added tax. Such taxes have consistently proven in practice to be "add-ons," not replacements for existing levies.

Americans for Tax Reform sponsors the Taxpayer Protection Pledge, which was recently signed by Senator Bob Dole. Other Presidential contenders who have signed the Pledge include Senator Phil Gramm and Pat Buchanan. In the last election cycle, over 400 candidates from both parties were Pledge signers.

Our president, Grover G. Norquist, would welcome an invitation to testify at the June hearings. Norquist is nationally recognized as a leader of the grassroots taxpayers' movement. We would additionally welcome any future opportunity to comment or testify as you find useful.

Sincerely,

James P. Lucier, Jr.
Director of Research

cc: Rep. Phil Crane

1320 18TH STREET NW, SUITE 200, WASHINGTON DC 20036
PHONE: 202/785-0266 FAX: 202/785-0261

STATEMENT OF
JOHN H. PERRY, JR.
FORMER CHAIRMAN,
AMERICANS FOR THE NATIONAL DIVIDEND ACT,
TO THE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
June 7, 1995

Mr. Chairman and Members of the Committee, my name is John H. Perry, Jr. and it is my pleasure to have the opportunity to address a concept I originated nearly fifty years ago and which is before this Committee as one proposal for reforming our Federal tax system. My idea is the basis for H.R. 430, the National Dividend Act, introduced by Congressman Billy Tauzin in the 104th Congress. I am grateful for the confidence that Congressman Tauzin has invested in the National Dividend Act, and for keeping the legislation, which received support from Members across the political spectrum during the past decade, before the Congress.

Members of the Committee, one month shy of ten years ago, I appeared before this Committee championing the National Dividend Act as the Committee conducted hearings which led to the Tax Reform Act of 1986. At that time the gross Federal debt of the United States was $1,816,974,000,000 and the deficit that year, 1985, was $212,334,000,000. As you consider changes to our tax structure in 1995 our Federal debt approaches $5 trillion, and the Budget of the

United States, submitted by the President a few months ago, projects deficits in the $200 billion range for the rest of the century.

There are two changes to our Federal tax structure which will change those numbers, one is good for the short term -- the tried and true method of ***raising*** taxes to meet the demand for revenue, a method not even remotely appropriate today; the other is a permanent, long-term solution, the National Dividend Plan, the subject of H.R. 430, a concept which changes tax structure in such a way as to address not only tax "supply," but tax "demand."

A full decade before my appearance at the 1985 hearings, and before his election to the Presidency, Ronald Reagan noted that the National Dividend Plan "is not a half-baked utopian dream. It is a well thought out, fully documented program. . ." It is, moreover, a program to which I have devoted not only fifty years of my life, but a considerable portion of my assets. A tax bill with the National Dividend Plan as a central feature would be assured of passage and it would be veto-proof -- no legislator could vote to deny voters a dividend and no President would fail to sign the bill.

In the decade between 1985 and 1995 the Congress has considered, and even passed by majority vote, such ideas as budget control acts, and balanced budget amendments to the Constitution, and, more recently, the line item veto, to provide tools for restraining the demand for Federal spending. These ideas, worthy though they may be, and appealing in the abstract, fail for want of addressing demand where it begins: with the people of the United States. It is the voters and taxpayers who insist they want less government, and lower taxes, yet they remain solicitous of programs from which they have, for years, derived

some benefit or which they see to be addressing perceived needs without regard to the depth of those needs or alternatives to meet them.

Even the flat tax, and alternative tax systems being discussed today do not touch spending. And although different ways of developing revenue may be attractive, no systematic program that I have seen puts a cap on revenue -- down the road even a flat tax could be increased to meet more spending. Of course the revenue from any tax scheme could be ignored in favor of continued deficits. And while spending limits and reductions are a priority today, there is no "built-in" limiting mechanism, nor any assurance that the special interests will not derail even the best-intentioned deficit reducing efforts.

The National Dividend Act sets in motion the National Dividend Plan (NDP), a comprehensive program to eliminate Federal deficits, create a "profit sharing" trust fund for America's voter-taxpayers, and create an incentive to support our national business and industrial enterprise.

If the National Dividend Act had been implemented as a part of the Tax Reform Act of 1986 our budget would be in balance for 1996, and America's voter-taxpayers would be sharing in the distribution of National Dividend Trust Funds amounting to some $140 billion -- the portion of Federal tax receipts represented by corporate taxes.

H.R. 430, the National Dividend Act, contains five basic provisions. The first, and the central innovation of the Plan is the creation of the National Dividend Trust Fund in which all Federal corporate income tax receipts would be placed instead of being spent as part of the government budget. The Fund would be distributed to all registered voters so long as the Federal budet was in balance.

Dividend payments would increase as corporate profit increased -- the incentive to support business and industry paying Federal taxes.

The second provision gives voters a vested self-interest in resisting Federal deficits. Deficits would be discouraged by using the Trust Fund to meet excess spending thus reducing dividends. In other words, voters will insist that their legislators live within our government's means, and since all voters have an equal interest in the result, all Americans, rich and poor, "big" and "small," have an equal voice. All voters have an incentive to weigh each program for its value both to them as individuals and to the national interest.

The third provision is the elimination of the double taxation of dividends. This would end Federal personal income taxes on corporate dividends -- and on the Trust Fund distributions. It would serve to attract investment dollars into the private sector creating new jobs and stimulating business and industrial growth, benefitting the American economic machine. The growth would, as it provided jobs and income, increase regular Federal revenues for necessary government operations as well as increasing corporate tax revenue for the Trust Fund.

The fourth provision is a cap on the Federal corporate tax rate. It would be up to the Congress to determine what the percentage would be -- H.R. 430 uses the current rate -- but it assures business of parameters so that business decisions and future plans can be made.

Finally, the fifth provision is a freeze on Federal expenditures to phase-in the program. Every econometric model that we have seen indicates that Federal revenues would meet Federal spending in as little as three years if spending were frozen. The legislation provides a five-year phase-in period, or balance, after

which percentages of corporate tax beginning with 20 percent and increasing by 20 percent each year, are dedicated to the Trust Fund.

Using the decade of the eighties as an example, the following table illustrates the effect of implementing the National Dividend Plan:

A DECADE UNDER THE NATIONAL DIVIDEND PLAN

(In $ Billions)

	RECEIPTS	OUTLAYS	TRUST FUND	DEFICIT*	DEBT
1982	617.8	745.7	—	127.9	1136.8
1983	600.0	745.7	—	207.8	1371.2
1984	666.5	745.7	—	185.3	1564.1
1985	734.1	745.7	—	212.3	1817.0
1986	769.1	756.5	12.6	+ 23.4	1996.7
1987	854.1	815.5	38.6	+108.4	1996.7
1988	909.0	852.0	57.0	+163.3	1996.7
1989	990.7	907.9	82.8	+245.0	1996.7
1990	1073.3	961.3	112.0	+327.6	1996.7

* *+ figures indicate surplus*

The National Dividend Plan (NDP) gives each voter a stake in making sure that government addresses real needs, and in seeing that his or her legislator responds accordingly. Giving citizens a stake in measuring their demands against true budgetary impacts, and the prospect of a return on the success of American business may be a "radical" concept, but it is one with which we each live in our household every day: we must balance our budget -- especially on our long term commitments, and the better we work, the more successful we are.

But, you say, this would just encourage greater divisions among people -- exacerbate the tension between the haves and the have-nots. Never has America denied its most needy citizens. Indeed, poll after poll shows that America's voters want to address legitimate social needs -- but that they also want to keep more of their own money to spend as they find appropriate. They would rather give their church, or local government, or some charitable entity money to meet perceived needs than to have a massive government program. They would rather use their own resources to pay school or college costs than to have to beg from and qualify for some faceless government program.

But the practice of responding to special interests, "oiling" the hundreds of squeaky wheels that now make up not only our Federal programs but the way that we legislate, will have to pass the "means" test: Is it worth it if it means that my dividend is reduced? Some demands will meet that test: certainly challenges to our national sovereignty or national interests around the world which may demand defense expenditures, unusual events such as the disasters which have occasionally resulted in our people demonstrating that we are the most compassionate nation on earth, and other events which may call on our

enlightened self-interest to meet our national interest. The National Dividend Plan gives America's voters not only the opportunity to continue to generously meet national needs, but the self-interest to demand that those needs meet the test of being measured by the light of day.

America is, even with its inequities and its problems, the greatest nation on earth -- a successful and ever-growing experiment in democracy. For decades politicians and economists have debated the role of government and the use of revenues as a tool of policy. The National Dividend Plan is the logical conclusion of that debate: it uses revenue as a social tool to define and limit the role of government. The NDP can once again give life and meaning to the words of Alexander Hamilton -- incidentally the first U.S. Secretary of the Treasury -- that "Here (in Congress), sir, the people govern."

Mr. Chairman and Members of the Committee, thank you for this opportunity to present the National Dividend Plan as contained in H.R. 430. I truly believe that the NDP not only provides a unique way to give the American voter-taxpayer a new sense of both public and private economics, but that it is the only concept which addresses both the need to limit spending and the requirement that spending decisions involve the American people. The National Dividend Plan encourages voters to make judgements, to weigh alternatives, and it even provides for the opportunity to not only forego a dividend but, in special circumstances, to deficit spend against future dividends -- because America is as good and generous and great as it is.

Instead of bemoaning the task of 535 Members of Congress trying to restrain themselves from doing what 260 million Americans appear to want them

to do. it's time that we create an environment in which the millions of American voter-taxpayers demand that the 535 do what needs to be done -- and give them the tool, the incentive, to make it happen. Rather than damn us all to continuing mediocrity, let us seek to develop our greatness, to make us all rich.

John H. Perry, Jr., former Chairman of the Americans for the National Dividend Act and the originator of the National Dividend Plan concept, was Chairman of two Florida corporations headquartered in West Palm Beach, Florida: Perry Oceanographics, Inc., and Perry Offshore, Inc. The latter was the largest commercial builder of robot and manned submarines in the U.S. Mr. Perry is Chairman Emeritus of the Perry Foundation, Inc., a not-for-profit corporation dedicated to marine science.

From 1966 to 1968 he was a member of the U.S. Commission on Marine Sciences, Engineering and Resources which, after two years of study, submitted its report entitled, "Our Nation and the Sea." He served as Chairman of the Commission's technology panel. Mr. Perry facilitates marine research at the Caribbean Marine Research Center. Through the Perry Energy Systems Division of Perry Oceanographics, he has developed an energy process for making methanol from sea water. His current energy project is to have his Energy Partners Company build fuel cells which will make combustion engines obsolete.

Mr. Perry is the former President and Chairman of Perry Publications, Inc. which until 1969, operated 26 newspapers in Florida; **All Florida Magazine**, a Sunday supplement; **Palm Beach Life** magazine; the statewide All-Florida News Service, and numerous commercial printing plants in Florida. Perry Publications pioneered the development of computerized printing of newspapers in the early 1960s. He is a director of the Nassau Guardian (1844) Limited, Nassau, Bahamas. He is the author of The Ultimate Self Interest: A Strategy for National Solvency (1984, 1987), a detailed explanation of the history and operation of the National Dividend Plan.

Mr. Perry was born in Seattle, Washington, January 2, 1917; graduated from Hotchkiss in 1935, Yale in 1939, and attended Harvard School of Business Administration. He makes his home in West Palm Beach, Florida.

June 9, 1995

Phillip D. Mosely, Chief of Staff
House Ways and Means Committee
1102 Longworth Bldg.
Washington DC 20515

Dear Mr. Mosely:

I understand that the House Ways and Means Committee has scheduled "Open"!! hearings on the oppressive US Tax situation.

Please register my "vote" for a total US tax-system overhaul and strongly in favor of a reasonable "Flat Tax".

Thank You.

Sincerely,

James L. Anderson MD
E330 Gerbing View Drive
Union, WA 98592

Encl: (6)

cc: Norman Dicks, US House of Rep.
Slade Gorton, US Senate
Patty Murray, US Senate
Newt Gingrich, Speaker, US House of Rep.
Richard Armey, Majority Leader, US House of Rep.

ROBERT H. ASHWORTH
16300 198TH avenue NE
Woodinville, WA 98070
(206) 788-7895

RE: Flat Tax

Phillip Mosley
Chief of Staff
U.S. House of Representatives
Longworth Office Building
Washington, DC 20515

Dear Congress person,

The time has come for a flat tax of some kind. It must be one where there is no judgment made on what is a legitimate deduction by the IRS. There should be **no deductions.**

It would not have to exceed 10% as all money that changes hands will be taxed adding additional black market monies that are currently not being taxed.

Also, the economy will have a boom like never before. The problem with our economy now is a lack of jobs caused by too high of taxes and the increasing risk to start businesses.

Do it now!

Sincerely,

Robert H. Ashworth

Auto Source
Auction Sales & Broker
Lic. # D12842

June 16, 1995

Mr. Phillip Mosley, Chief of Staff
Committee on Ways & Means
US House of Representatives
1102 Longworth
Washington DC 20515

Dear Mr. Mosley,

I am in complete support with eradicating our current tax system which as you know penalizes the productive people of this country.

I think the National Sales Tax would be the best system to replace our current system for these reasons:

1. It is the form of taxation our Constitution allows.
2. It would require everyone to pay. Drug dealers, prostitutes, and other illegal money makers would finally contribute to our system.
3. It would not allow the Congress to eliminate the deductions and then raise the tax, like they could if we had a flat tax.

A flat tax would still allow for cheating and wasted time preparing forms for the IRS. We must eliminate the IRS and all the wasteful acts associated with preparing our tax returns.

My wife spends too much time with accounting for this business, in addition to our other joint business and our rental properties.

Lastly, we're sick of paying 15.3% of our income in Social Security taxes in addition to income taxes because we're self employed. If the employees of this country had to come out of their savings like we do, this debate would have taken place many years ago.

Please push towards the National Sales Tax.

Thank You,

Rick Jabour

800 "D" Davis St. • Vacaville, CA 95688 • (707) 447-5757 • (800) 441-5657

848 Jackman St. #317
El Cajon, Ca 92020
June 2, 1995

Dear Mr. Mosely,

It is exciting to have input into the issue of changing the tax laws. We must preface our ideas, however, with the statement that it is not the tax laws per se that are the problem, but the overspending. The overspending, and the apparent attitude of our Congressmen that there is an open checkbook available from the American people is what has caused the taxes to be so onerous.

Therefore the first change we would make would be that spending must always be based on the PREVIOUS year's available money, not the estimated amount. That way, unless there is a major recession or depression, the budget ought to always be balanced.

We would most like to see the income tax eliminated. However we do not trust Congress with a "phase in phase out". When Reagon allowed a tax increase with a "future" spending cut, the spending cut was never realized. Therefore we no longer trust "future" promises. If a national sales tax is started, it should be started simultaneously with the income tax being eliminated, and not gradually.

If we instead go to a income flat tax, there should be no national sales tax, and there should be flat tax of perhaps 10-12% with a mandated ceiling (forever) of under 20%. Without a ceiling, I could see the Congress once again consider taxpayers "rich" and we would be even more heavily taxed than now. If there is a flat tax, there should be no tax for incomes of $10,000 or below for single people and $20,000 or below for married people. Other than that there should be no "earned income" credit, and noone should be exempt from the tax, including welfare recipients or other holders of government handouts. A deduction for children including a deduction for child support for whoever pays it,and for interest paid (not just mortgage interest but any interest), and a deduction for taxes paid (including not just state or city taxes but sales tax as well) should be included so we are not paying tax on tax. Also, there should be a deduction for money received that is simply return of income, such as the portion of pensions that comes out of salary that had alreay had taxes taken out of it. Social security tax and Medicare tax should also be deductible. Once again, whatever the money this raises, that should decide the spending. Just like my budget, the budget should be based on income, not on what the Congress can extort from the people. Except for the items mentioned, the tax code should be eliminated. It is too complicated and too difficult to understand. The IRS should also have to prove any claims so that the taxpayer is assumed innocent. Apparently the IRS not can assume that a taxpayer earned income and force the taxpayer to pay tax on this income without evidence that the taxpayer earned said income. This practise of the IRS is ridiculous and the agency should have to prove that the taxpayer earned any disputed income.

Should the income tax be eliminated completely, and a sales tax be instituted instead (as I would like to see), state and local income taxes should also be eliminated. The sales tax then should be only on actual sales of goods, not sales of services. There should be no tax on capital gains. The sales tax also has to have a ceiling beyond which it cannot go. A sales tax of 10-12% seems reasonble, with perhaps food being exempt. The tax should not be able to be higher than 15%. The name of the game is CUT SPENDING. If this has to be forced on Congress by reducing revenues and saying "Thats all there is", so be it.

Thank you for asking for our input.

Yours sincerely,
Lynn Badler
Ted Warren

MR MICHAEL BALL
200 RAVEN CT
MODESTO CA 95350

Dear Group,

I would like to site 3 reasons opposing the consumption tax.

I. A consumption tax on expensive luxery items or any large ticket item, would increase the cost of those items, considerably. This would in turn create the desire, to purchase these items, from other countries. I would also like to site a "trickle down affect" in our economy, on U.S. businesses, and the desire to compete, when these expensive items are more attractive to purchase abroad, just to avoid a consumption tax.

II I fore-see a likely infringement upon the individual right to sell. Yard sales and garage sells or even the right to sell a used vehicle (privately), could potentially become illegal. The only way to avoid this, would be to create another bureaucratic mess, by making citizens apply for some type of sales permit and to

describe the item or items and the selling amount. This too, would lead to the non-negotiable sells in the private sector, if an individual must site a sales amount, in advance.

III With a consumption tax, even the poor and poverish would have to pay and I believe they should be exempt from paying any federal tax.

I would like to site 2 reasons in favor of the flat tax.

I It's more fair and easy, and would apply to all Americans who create an income anywhere in the world, and that tax would be paid, regardless where they made their ~~[illegible]~~ incomes.

I would hope that the flat tax would exempt the poor and poverish, and would have little or no deductions.

II A flat tax would always encourage more and more productivity as the more you earn, the more you keep. I can think of many times, that employees did not wish to work any over time, because additional hours would place them in a

higher tax bracket and they'd make less take home pay. This produced negitivity toward more production and pay!

Notation: As much as I, personally, would like to see the elimination of the IRS, I do not believe this should be the goal. It is a far better achievement to do what is right and fair and to do what is good for America!

So much time and effort is currently spent on tax preparation, because it's a mess and a hassell, to sift through codes and laws. This time would be better spent producing and creating a larger income, to pay to flat tax. And I believe it would be better spent for federal revenues, as well.

Sincerely,
[illegible]

Phyllis D. Beamon
2401 Determine Court
Louisville, Kentucky 40216
May 30, 1995

House Ways & Means Committee
ATTN: Phillip Mosley
Longworth House
Washington, DC 20515

Dear Representative,

I am writing this letter and requesting that it be presented and read before the House Ways and Means Committee on Tax Reform which is scheduled for June 6,7, & 8. The situations and problems that I see in the forthcoming tax reform programs must be addressed by us, the concerned public. It saddens me to see the freedoms and country that our ancestors fought and died for being allowed to vanish without our speaking out on behalf of its salvation. To begin with, the Revenue Act of 1862 is very antiquated and desperately in need of review and updating to meet today's needs rather than the war time periods in which it was formed. Tax preparation and filing has become so complicated and confusing that it must be simplified. I have worked as an accounting clerk in a large business, still the tax laws and forms are so complicated it makes many things easy to either over look or miss completely.

Taxes were implemented as a temporary method to help this fine country. All law abiding, hard working Americans do not mind helping our country remain strong and vital, however, enough is enough! I have served my country in foreign lands and seen how the socialist programs work - they do not work. Why do you think the Soviet Union fell, the people were tired of the oppression. Our forefathers fought to remove themselves from the oppression of England and the situation of taxes being levied heavily on them. I do not mind paying "my fair share", but the continuing of the government to increase taxes on it's constituency and not allowing enough for personal exemption (which should be approximately $12,000 or more) is becoming increasingly hard to bear by ourselves. We are not only taxed when we buy items, but we are taxed directly off our income. If a flat tax was made of 7-8% to be paid when things are purchased, everyone would be paying their share of taxes and the earlier mentioned tax forms, etc. could be done away with. This would again simplify taxes and no one (whether legal or illegal income was being made) would be exempt from paying into the support of this countries needs, in fact even monies "stashed" into foreign bank account would not be exempt.

The power that has been given to the IRS needs to be more controlled and monitored. As it presently stands, the IRS has the authority and power to take a persons assets even though no wrong doing has been established. There are numerous examples of properties, people had worked hard and long to acquire, being lost permanently due to an error not on the persons part, but on the part of IRS. I personally have had two mistakes made in my taxes. The first they claimed that my calculations were incorrect and

so they threatened and billed me for the difference plus interest. The error was on their part, not mine - the notification of their error in truth being made and corrected so I owed nothing was far from being as aggressive in apologies as the earlier had been in accusations! This brings up another point, they charged me interest on the amount I was suppose to have owed them, but they do not pay interest when they owe us and delay release of our refund. And to think this whole program started as a voluntary program, seems to me that the attitude of correspondence could have some considerations and politeness, being rude does not help solve problems. The second incident, they claimed I owed some monies, rather than research the difference I sent them a check for the full amount, with all papers attached that were to be returned (signed, dated, and mailed with check). Several months later I was notified that some form was not returned (though I had copies) so I was being penalized $5.00 and threats were express if I did not pay this additional $5.00. Note should be made that the form they wanted signed did not accompany the notice and so if I had sent a check for $5.00, in another several months would I have received another penalty? Possibly? Probably!

Being an only child, another area of concern for myself is the discussed changes in the inheritance taxes. My parents worked many years saving, doing without, hoping that their only child could have a better, easier life than they had. If laws are changed then a lot of what they have sacrificed and saved to help me will instead go to the government, to support or "shore-up" programs that the funds have been being misappropriated and wasted in the past . They even stand a chance (if sickness occurs) of loosing their home, because Medicare and Medicaid can take your home if your health bills are high, but yet we had no choice from the beginning as to whether to pay into these "insurance" programs (which is what they are) or not. Had people been allowed to invest those monies into other areas many of these Federal Programs would be unnecessary. Another example of misuse of Federal Taxes would be prisoners given Pell Grants. I can understand trying to help rehabilitate them to release back into the community, but why not loan them money rather than give them a grant. I (a law abiding, tax paying citizen) did not qualify for a Pell Grant - I made to much money! At the time I was attending college full time and working full time - single making my own way. Had I committed a crime I guess I would have qualified for a grant! Does there seem to be something wrong with this premise? There does to me. What is our incentive to work, save, and strive to better ourselves? This again brings up another point, when I get old enough to draw Social Security it will not be there. The government has already told all of it constituency of this fact. Another Federal Program that I have supported will NOT BE THERE FOR ME! I have had to pay into it, but will never see ANY return. At least with a life insurance policy, or a saving account, I would have a small amount of income.

I love this country and would not wish to live anywhere else. I have lived in other countries! This is my home and I am supportive of its original goals and dreams of our forefathers. It is up to people like myself to voice our opinion, otherwise the leaders of this once great country, may loose sight of the importance of each and every American.

Sincerely,

Phyllis E Beamer

P.O. Box 1750
Fairfield Glade, TN 38558
June 1, 1995

Mr. Philip Mosley
Chief of Staff
Ways and Means Committee
Washington, DC 20515

Dear Mr. Mosely:

Please let it be known that I support a flat tax of 17 to 20% with some built in protection for unreasonable increases on a regular basis.

Let the free market forces work and get government out the way.

The role of government is to protect its citizens from aggressive enemies, if it gets out of the health care business, school lunches and other social programs it can learn to balance its budget.

Man should be entitled to the fruits of his labor, women too. It's not for the government to determine what allowance we should be allowed to have.

It's time this government got its fiscal house in order and learn some restraint.

Sincerely,

Joan R. Bean

DONALD A. BELT, Ph.D.

920 Sunnyslope Road • Hollister, CA 95023 • Tel: (408) 637-1911 • Fax: (408) 637-8200

May 29, 1995

From: Donald A. Belt

To: Committee on Income Tax Reform via Philip D. Mosely.

Subject: A Proposal for Replacing the Current U.S. Income Tax System with one that is fair to everyone, painless to no one, and simple to administer. I call this new System 'The One Percent Transfer and Exchange Tax'.

Under this new program, every time a transfer or exchange of money or property from one person (or business entity) to another occurs, a one percent tax would be immediately due and payable to the US Government. There would be no exceptions or exemptions. For example, if Exxon sells (or transfers) five billion worth of goods or services to another, they would pay a one percent tax at the time the transaction occurred. There would be no deductions or offsets. The tax would be based on the gross value of the goods or services transferred. If a bank loaned $300,000. to someone, a one percent tax would be due at the time the transaction occurred. When the Bank received repayments, a one percent tax would also be due. Again, there would be no exemptions. If an Estate willed property to family members, the one percent tax of the value of the property would be due when the property transferred. If the Ford Foundation donated a million dollars to a cause, a one percent tax would be due. Everything purchased retail or wholesale would be taxed at this rate. This principle would apply to all tranactions of monetary value.

Two Key Provisions of this plan would include:

-The One Percent Transfer and Exchange Tax would apply to <u>every</u> transfer or exchange of money or property <u>without exception.</u> No deductions or offsets would be given to any person or business entity for any reason whatever. This provision would also apply to any money or property leaving or entering the United States.

-The One Percent Transfer and Exchange Tax Act would be fixed at the one percent level and this level could not be increased by Congress, ever.

This proposal would eliminate most of the IRS Code, many of their employees and much of their overhead. There are many other benefits too numerous to mention.

Leni S. Berliner
5406 Connecticut Ave., NW, #401
Washington, D.C. 20015
202-362-0264 (p)
202-237-2155 (f)

June 14, 1995

Phil Moseley
Minority Chief of Staff
House Ways and Means Committee
1106 LHOB
Washington, D.C. 20515

Dear Mr. Moseley,

I wish to lend my support to Mr. Archer's call for replacing the income tax with a consumption tax. Doing so will increase personal and national savings and investment, while the result should be at least growth- and revenue-neutral (if not stimulating), if priced properly and administered efficiently.

You may find it useful in preparing specific proposals to contact those who were involved in the Chilean tax reforms of 1975, 1984 and 1989: I attach a paper on the topic written by Jose Yañez of the Universidad de Chile.

Sincerely,

Leni S. Berliner

enc.: as stated

Oscar Muñoz, editor (1992) Economic Reforms in Chile
Occasional Paper #7, Inter-American Development Bank
Washington, D.C.

II. TAX REFORMS

By José Yáñez[1]

This chapter presents the principal features and the results of the major tax reforms introduced in the Chilean tax system in the 1970s and 1980s.

In the early 70s, the Chilean tax system was beset by serious problems, which were reflected in the generation of inappropriate incentives in the area of resource allocation, such as the vertical integration of companies solely for tax reasons and because of the pyramidal structure of the taxes, which encouraged tax evasion. Moreover, the tax system had become extremely complex due to the numerous exceptions, deductions, loopholes and special cases that were added as time went on.

Along with this, public finances deteriorated gradually until 1973, when the State budget deficit reached the unprecedented figure of 24 percent of the gross geographic product (GGP). The volume of tax receipts, both in absolute and in real terms, fell between 1971 and 1973. In 1971, receipts were 17.6 percent of the GGP and in 1973 they fell to 16 percent. This drop occurred despite the efforts of the authorities to increase tax revenues in order to finance their redistribution policy.

It was in these circumstances that the sweeping tax reform of 1974-1975 was introduced, when, with a view to solving the above mentioned problems, nearly all of the taxes were changed.

The most notable reforms were the replacement of the sales tax with the value added tax (VAT), the improvement of the indexing system, the tariff reform (lower uniform tariffs) and the new tax and audit administration.

The primary short-term objective was to increase tax receipts to help reduce the enormous budget deficit existing at that time. Tax receipts as a percentage of GGP rose to 17.1 percent in 1974 and to 21.7 percent in 1975. Later, this percentage stabilized around 19.5 percent and remained there for several years (Table 2.1).

With regard to the long-term objectives, the most important was eliminating the inefficiencies that existed in the old system in terms of resource allocation. To achieve this, the VAT was established and preferential tax treatments such as sectoral and regional exemptions, which discriminated between public and private enterprises, were abolished. The second objective, which was closely related to the first, was to eliminate the myriad differences established with respect to taxable goods, as well as the countless rates, exemptions, exceptions, deductions and rates established in the form of nominal fixed amounts per unit

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Table 2.1. Tax receipts as a percentage of GGP

Years	Taxes		Total
	Direct	Indirect	
1971-73	5.1	11.2	16.3
1974-80	5.8	13.8	19.6
1981-83	4.9	17.9	22.8
1984-87	4.2	19.3	23.5
1970	4.8	10.6	15.4
1980	6.2	14.3	20.5
1985	4.2	19.4	23.6
1987	3.7	20.2	23.9

Source: Budget Office, Ministry of Finance. *Report of the State of Public Finance*, various issues.

of product (given the inflationary context of the economy, it was constantly necessary to enact laws or decrees to adjust them).

The objective of equity remained on a plane secondary to the two objectives mentioned above. It was pointed out that the distributive objective was achieved by properly focusing the distribution of social spending on the population and that there was no need to worry about the progressivity of the tax system. Nevertheless, despite this, a series of measures was adopted that tended to promote greater vertical and horizontal equity, as a result of the elimination of discriminatory tax treatment and the simplification of the taxes. Certainly, all the measures aimed at the indexing of incomes, the introduction of the "tax unit" concept, and advance monthly payments made the system more equitable.

In the 1980s a second major tax reform was carried out, this time targeting the income tax. The reform was undertaken in 1984, but full implementation took several years. The primary objective was to minimize the factors in the income tax that discouraged savings and investment. To achieve this, rates and bases were reduced and certain provisions of the income tax law were abolished. In this reform, the objective of efficiency in the allocation of resources took precedence over equity. Moreover, the income tax became far more complicated and there was a drop in tax receipts.

The tax reforms of the 1970s and 1980s had a very specific long-term objective: economic efficiency. This will become clear later when we analyze the reforms in detail from the perspective of the tools used to implement tax policy. Along with this, special attention will be given to analyzing those taxes that made the greatest contribution to the objectives of efficiency, simplicity and increased receipts.

The tax system and inflation

Taxes and inflation influence one another. In the context of an inflationary economy, taxes can be used as a tool to help check or slow this process, particularly those that have a direct impact on the consumption component of

aggregate demand. On the other hand, inflation can also affect the real value of taxpayer contributions as well as the real value of the State's tax receipts.

Some of the tax reforms introduced in Chile in recent years have eliminated the effects of inflation on taxpayer contributions and the Public Treasury's tax receipts.

Among the principal measures adopted to benefit taxpayers, special mention should be made of the indexing of assets and liabilities, the reappraisal of real estate and the tax unit. On the other hand, the principal measures to prevent the devaluation of tax receipts by inflation include the collection of *ad valorem* taxes, regularly adjusting real estate appraisals and establishing advance monthly payments (obligatory or voluntary).

Indexing assets and liabilities

Taxpayers in the first category, i.e., those with capital earnings from commercial, industrial, mining, agricultural, financial and other types of enterprises, must annually adjust their shareholders' equity and the amounts or items comprising their taxable assets and liabilities, provided that the taxpayer declares his real income, as shown in a general balance sheet.

The indexing is applied to the shareholders' equity at the beginning of the fiscal year, increases or decreases in the shareholders' equity, the goods comprising the fixed assets, the goods comprising the liquid assets, the value of credits or rights in foreign or adjustable currency, the value of foreign currency and gold holdings, the value of concession locales, mining holdings and concessions, manufacturing rights, trademark and patent rights, organization and start-up expenses, the value of corporate shares, partnership contributions, debts or obligations in foreign or adjustable currency, etc. The objective of the Chilean tax legislation was for taxpayers to pay taxes on the real profits of the company and not the nominal profits. For the purposes of indexing, the Consumer Price Index (CPI) was used as an indicator of inflation in the relevant periods. Although many details of the indexing system are constantly being fine-tuned, in general terms it has provided an adequate solution to the problem of inflation in determining real profits for tax purposes.

Real estate reappraisal

In Chile there is a tax called the "real estate contribution" or "property tax," which is based on the value of real estate. Since the process of appraising a property is costly, the law stipulates that the interval between one appraisal and another can be no longer than 10 years nor shorter than 5 years. Between appraisals, the value of the property is adjusted semiannually in accordance with the variations in the CPI.

The actual value of real estate changes over time due to obsolescence, wear and tear, the value of the land, construction costs, improvements, disasters, relative scarcity, etc. The actual value may be tied to the market value of the property, which varies over time with the economic conditions in the country. The Internal Tax Service appraisal must be close to the actual value of the

property so that the tax payment reflects the taxpayer's true ability to pay.

The use of this system helped to increase tax receipts, in real terms, by almost four times with respect to previous years, when the appraisal was only adjusted at rates lower than the CPI for the period in question, and a distinction was made between agricultural and other types of real estate.

The Tax unit

The tax unit (TU) is a value selected at a given time, which is then adjusted on a monthly basis in accordance with the CPI. This, then, is a unit of account that has maintained its actual value over time or the nominal value of which has been increasing at the rate of monthly inflation, but one month behind.

This TU has been used in various ways in Chilean legislation. One application is in determining the tax liability of the so-called small taxpayers in different economic areas. Another application is in the field of tax penalties, which are also based on this unit of account. In addition, certain tax deductions and exceptions, especially in the income tax system, are based on the TU. Still, its most important use has been in defining brackets for the uniform employment tax and the global supplemental tax. In an inflationary economy, this prevents taxpayers from falling into brackets with higher marginal rates simply because their income is wholly or partially adjusted. In times of inflation, this tool is essential to avoid constantly changing the direct tax burden on taxpayers.

Ad valorem taxes

Almost all of the taxes in the Chilean system have been established on an *ad valorem* basis, i.e., as percentages of the price or value of a transaction. The main reason for this is that *ad valorem* taxes protect the real value of receipts, given that the treasury collects an equivalent amount of the increase in prices due to inflation. Taxes established in unitary form, i.e., as a certain number of monetary units per product unit, necessitate constant adjustment of the rates to avoid the real erosion of tax receipts. The *ad valorem* system avoids this problem.

Advance monthly payments

Taxpayers who must file annual income statements must make advance monthly payments against the taxes they will be required to pay when filing the annual statement. These payments, duly adjusted, are deducted from the total amount owed and, when applicable, the taxpayer must pay the balance not covered by the advance payments, or, in the opposite case, if the total of the advance payments is greater than the amount of taxes owed, the taxpayer receives a refund.[2]

Although the chief objective of the advance payments is to normalize the flow of revenues to the national treasury, it is also a way of spreading taxpayer payments evenly over time. The advance payment enables the taxpayer to pay

[2] Ministry of Finance, calculation of national general revenues for the year 1990.

a portion of his taxes, thereby reducing the amount owed at the end of the year. The use of these tools has greatly increased the fairness of the Chilean tax system as well as its effects on the allocation of resources. The interests of the State, of workers and of employers have been well protected against the negative effects inflation can have both on payments and on tax receipts.

Value added tax

One of the most significant tax reforms of the 1970s was the introduction of the VAT, which replaced the sales tax.

A sales tax of 8 percent was charged each time a good changed hands and taxes were paid on prices that already included other taxes. These characteristics of the sales tax were detrimental to the efficient allocation of resources. Companies, in order to reduce the direct tax obligation, sold vertically, decreasing the number of transactions and avoiding eight tax points for each transaction eliminated. On the other hand, the so-called pyramidal structure of the tax undermined the equity of the tax system. What the pyramidal structure involved was that the price charged at each stage included the taxes paid in the preceding stages, i.e., taxes were charged on other taxes. The pyramidal structure would not have been a problem if the prices of all goods were affected equally the tax. However, the tax obligation differed, depending on the number of transactions in which each unit of a single product was involved.

The VAT has the advantage of being neutral with respect to the organization of the production and distribution of goods. Since the VAT is charged for each of the transactions involving a given good, but only on that part of the price that is added, from a purely tax-oriented viewpoint, it makes no difference to the taxpayer whether he manufactures his own inputs or purchases them from someone else. Because of this, companies now integrate vertically for reasons of economic efficiency, without this having any effect on their taxes. Under the VAT system, the price of the product is not affected by the number of transactions it was involved in, so that a constant relationship is established between the end price of a good and the tax charged on it. Thus, the VAT eliminates the pyramidal effect, since it is not a cost. The VAT is a tax that is paid at purchase and recovered by the seller, through the tax credit arrangement, and the amount of the VAT must not increase the costs of the taxed product.

The constant relationship between the end price of a good and the VAT enormously facilitated the use of the tax exemption when the product is destined for export—which was arbitrary under the sales tax—and also facilitated taxing the goods imported by the country. Thus, in the Chilean tax system, the VAT on exports is refunded and a general VAT is charged on imports, with the same percentage rate being applied in both cases.

The VAT is viewed in Chile as a consumer tax covering capital goods as well as intermediate products, so that the tax paid at purchase entitles the buyer to a credit against the sales tax. This system is an incentive to investment in capital goods. This ended the discrimination of the sales tax system against investment

in national capital goods, due to the fact that imported goods were exempt.

The VAT declaration in Chile must be made on the basis of what is known as the invoice method, which has helped to discourage evasion. In this case, the percentage of the VAT on the final selling price of the product is applied first, and then the VAT paid on the intermediate goods and capital goods used in production are deducted, provided that these payments are supported by the corresponding invoices. This discourages evasion of the VAT by making it contrary to the taxpayer's interests and because it is a tax that is applied in stages. Evasion, if it is to be made difficult for the authorities to detect, must involve the entire production and distribution process, requiring a number of taxpayers to cooperate for this purpose, which is not easy.

To close any loopholes that taxpayers might use to evade the tax, the VAT base has been steadily expanded over the years. In other words, the objective has been to include all goods and sectors of economic activity in the VAT system. This is why the exemptions originally granted to certain basic consumer goods such as services,[3] commodities, fuels, tobacco, cigars, cigarettes, liquor, construction, etc., were eliminated.

To make the VAT progressive, surtaxes were established for certain luxury items or goods that generate negative externalities, which vary according to the item in question. For example, whiskey has a surtax of 70 percent; jewelry, fine furs, carpets, yachts, canned caviar and fireworks, 50 percent; liquor in general, 30 percent; wine, 15 percent.

The general VAT rate was 20 percent from March 1975 to June 1988, when it was reduced to 16 percent. Later, in June 1990, it was raised temporarily to 18 percent. The VAT base is fairly large, despite the fact that some goods and services are still exempt, such as education, State hospital services, passenger transportation services and bank interest. The VAT applies only to consumer goods and not to capital goods, much as it applies to imports (tariffs are included in the base) and not to exports.

The VAT is intended to be a simplified tax system for small taxpayers: small business owners, craftsmen, and providers of services. A gross monthly amount due is determined, from which the taxpayer is entitled to deduct the taxes charged in the month in question on goods purchased and services utilized. If the difference is negative, no refund may be credited or requested. This simplified procedure has proven to be very useful in reducing the indirect tax burden on small taxpayers.

VAT receipts became the largest source of tax revenues in the Chilean tax system in the second year of its application, doubling the absolute level of receipts between 1975 and 1979. Starting in 1978, the VAT accounted for over 40 percent of the total tax receipts, and reached 50 percent between 1981 and 1982. The introduction of the VAT in the tax system coincided with a surge in

[3] Included were all services for which remuneration was not considered a payment for the services of laborers.

development of the domestic capital market and to eliminate certain inefficiencies and inequities in the tax system.

The combining of the personal and corporate tax systems had various objectives. The first was to eliminate the preferential treatment accorded retained earnings, with a view to promoting the growth of internal investment and channeling these savings toward the financing of investment projects with higher returns, thereby contributing to maximization of the economic growth rate. The second objective was to promote tax equity by taxing shareholders and partners in the same manner, thus eliminating the benefit accorded shareholders to defer the payment of taxes on the undistributed portion of the profits of corporations.

In terms of receipts, the reform increased revenues in national currency from 4.6 percent of the GGP in 1973 and 1974 to 5.9 percent in 1975.

The 1984 reform

The objective of this tax reform was to eliminate discriminatory tax treatment based on the various sources of income, the effect of which had been to increase the negative impact of income tax on private savings. The aim was to encourage private savings and to replace the income tax with another that would conceptually approximate the idea of a tax on personal income. The idea is that income taxes should ultimately be paid by individuals and not corporations.

Taxation of labor income

The tax on labor income is the tax in the second category or the single labor tax, which in the previous reform was completely incorporated into the general supplementary tax. The 1984 reform, as it affected this tax, resulted in a reduction of the direct burden of this tax, which had been increasing in recent years. In 1981 the exemption was increased from three to six tax units and the marginal rates of each bracket were reduced by two percentage points. In 1982 the exemption was increased to 10 tax units and the brackets in the schedule were enlarged.

The 1984 reform lowered the marginal rates of the tax by one percentage point in that year, another in 1985, and a third in 1986. In addition, in 1986, consideration was given to lowering the marginal rate further, from 56 to 50 percent, and enlarging the brackets. In 1985, however, it was considered necessary to postpone the last stage for two years, so that the rate was not actually lowered until 1988.

Until 1983 the income of professionals was taxed with a special 7 percent tax. The reform lowered this rate to 3.5 percent in 1985 and eliminated it in 1986. The rate for advance monthly payments was reduced from 15 to 14 percent in 1984, to 13 percent in 1985 and to 10 percent in 1986.

The supplemental general tax, since it is perfectly integrated with the tax mentioned above, experienced the same variations in rates and brackets as the former. Nevertheless, changes were made in its base: included in the base are only those withdrawals of funds made by shareholders from companies which are not reinvested in other companies, and certain investments held for more than a year can be deducted. Clearly, the aim was to encourage investments with a term longer than one year.

Table 2.3. General supplementary tax and uniform employment tax
(Tax units and percentages)

1983		1988	
Brackets[a]	Marginal rate (%)	Brackets[a]	Marginal rate (%)
0 - 10	0	0 - 10	0
10 - 25	8	10 - 30	5
25 - 40	13	30 - 50	10
40 - 55	18	50 - 70	15
55 - 70	28	70 - 90	25
70 - 85	38	90 - 120	35
85 - 100	48	120 - 150	45
100 and over	58	150 and over	50

Source: Ministry of Finance.
[a] The brackets are determined by monthly tax units for the second tax and in annual tax units for the general supplementary tax.

Taxation of capital gains

The reform retained the tax in the first category on capital earnings. The rate of 10 percent still applied to the profits earned by companies. However, in 1984, authorization was given to deduct this tax as a credit from the supplementary general tax. In other words, as a result of this reform, this was considered a payment on account of the taxes owed by partners or shareholders, and not as a tax that the company owed, as was the case prior to 1983. The credit can only be taken when the profits are distributed or withdrawn from the company and not while profits are being retained. For taxpayers with high marginal rates in the supplementary general tax, this is an incentive to reinvest the company's profits.

The "additional tax" established in the 1974 reform, which applied to corporations and joint stock companies, was lowered to 30 percent in 1984, to 15 percent in 1985 and to zero in 1986. The elimination of this tax ended the discrimination that existed between the various legal forms of a company.

The "additional" tax on the capital earnings of foreign companies operating in Chile was modified, so that the base consists of the amount of earnings retained or remitted abroad. A credit of 10 percent was granted against the additional tax on companies in the first category. The rate of the additional tax was held at 40 percent, but it was later lowered to 35 percent, in an attempt to bring it into line with the equivalent rate in countries that invest in Chile.

The 1984 reform entailed a diminution of the progressivity of the income tax and gave it relevant importance as a source of tax revenues. Receipts in national currency, which were 5.2 percent of the GGP in the early 1980s, fell to 2.9 percent from 1984 on. On the other hand, it is undeniable that it permitted a more efficient allocation of resources, because it eliminated or limited the distinctions made between the various types of income. It also encouraged private savings, but by

reducing the current revenues of the treasury, the reform caused a decline in public savings.

The 1989 reform

In early January 1989, the income tax law was again reformed, this time affecting the tax in the first category, i.e., the capital gains tax. The reform consisted of establishing that the base of this tax would consist solely of profits distributed and withdrawn from companies. Thus, retained earnings were eliminated from the tax base and the supplemental general tax credit of 10 percent of the distributed profits still applied. In this way, it is much clearer that the corporation does not pay income tax. The aim of this reform was to get companies to retain and reinvest some or all of their profits, since they would have 10 percent of all retained earnings as additional funds available for (real and financial) investment projects. The benefit to the taxpayer comes from the fact that he is able to defer payment of the tax and has more funds to invest.

It was also established in the 1989 reform that companies could choose a simplified income tax system, thus avoiding the necessity of filing certain accounting statements.

This reform took effect in June 1990, when there was a temporary return to the provisions of the 1984 reform regarding the tax in the first category. Also, the gap between the brackets for the single labor tax and the supplemental general tax was narrowed, starting at the 30 tax unit level and upwards, and the marginal rates were increased. These changes, which will remain in force until 1994, were an effort to increase receipts in order to finance greater social spending.

The 1990 reform ended the system of making tax declarations on the basis of estimated income for certain taxpayers in the agricultural, mining, and transportation sectors, requiring them to declare their incomes on an actual basis.

Effects on tax receipts

As the above suggests, there was a deliberate intention to reduce the direct burden of income tax, as well as to increase the taxes on consumption. To determine the actual effect on receipts and, therefore, the funds transferred to the private sector, income tax receipts will be examined, but not including receipts in foreign currencies. It will be seen below that the latter consist almost entirely of the revenues generated by copper, which is treated differently from receipts in national currency.

Table 2.4 clearly shows the impact of the 1984 and 1989 reforms on tax receipts, which fell on both occasions. There is no doubt that receipts in 1984, when 1983 incomes were declared, were heavily influenced by the effects of the economic crisis that hit Chile and the world in 1982 and 1983; therefore, it is difficult to say what the cost of this reform was to the treasury in terms of receipts. Nevertheless, not even after the economic recovery did total receipts return to the levels indicated for the years prior to the 1984 reform, i.e., 1980-1982.

The receipts lost to the treasury as a result of the 1989 reform can only be appreciated in terms of the so-called income tax payment system, which involved

Table 2.4. Composition of income tax revenues in national currency
(Percentages)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
First category	4.9	5.2	6.4	4.5	2.9	3.6	4.1	5.9	7.8	9.0
Second category	7.7	6.1	8.7	5.5	3.9	3.2	2.8	2.9	3.4	3.8
Total supplemental	4.0	4.8	6.0	5.3	2.3	1.6	2.8	2.0	2.5	2.8
Additional	1.0	1.3	1.7	1.8	1.9	2.0	1.7	1.9	6.2[a]	3.2
Additional rate	6.3	6.5	7.4	4.1	4.5	4.0	4.6	0.0	0.0	0.0
Article 21	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.1	0.1	0.1
40% rate	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.3	1.1	1.4
Payment system	5.0	1.9	(2.3)	(4.1)	(0.9)	0.1	(3.4)	0.4	0.4	(4.4)
Total income	28.9	25.8	27.9	17.1	14.6	14.6	12.7	14.5	21.3	15.9
Total tax revenues in national currency	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Office of the Controller General of the Republic, *Public Sector Financial Management Statements*, various issues.
[a] Includes income from incorrect declarations equal to 2.7 percentage points, which alter the actual yield of the tax.

Table 2.5. Foreign trade tax receipts
(Millions of 1989 pesos and percentages)

Year	Receipts	Average Tariff (%)	GGP Percentage
1974	83,792	75.1	1.9
1975	103,326	51.6	2.9
1976	87,044	33.9	2.3
1977	94,880	21.7	2.4
1978	89,740	13.7	2.0
1979	76,682	10.6	1.5
1980	75,244	10.1	1.4
1981	90,039	10.1	1.7
1982	50,285	10.1	1.1
1983	89,300	15.9	1.9
1984	133,337	25.0	2.8
1985	156,274	25.0	3.2
1986	130,439	20.0	2.5
1987	159,695	20.0	2.9
1988	176,037	15.0	2.8
1989	153,109	15.0	2.2

Source: Office of the Controller General of the Republic, *Public Sector Financial Statements*, various issues.

heavy outflows that year. The other accounts, except the second category, contain information for the year 1988. The reason for this is that income taxes are generally annual and are declared the year following the one in which the income is earned.

Despite the fact that the reforms were successful in terms of a more efficient use of resources, this was achieved at the cost of complicating the tax and doing less to increase the fairness of distribution.

Tariff reform

In the early 1970s, tariffs were generally high and differentiated, resulting in an extremely complex tariff structure. In 1974 a policy of openness to foreign trade was adopted, thus ending the import substitution process, while at the same time an attempt was made to maximize the country's comparative advantages and open a new path to economic growth based on export sector development. To achieve these objectives, among the economic policy measures adopted was the reduction of tariffs to low, parity levels. This type of policy measure proved to be effective, resulting in substantial growth of the external sector and greater economic efficiency within the country, at a time when the nation was faced with the necessity of competing with other countries.

In 1974 the *ad valorem* rates included in the customs tariff were lowered in

stages until a schedule ranging from 140 to 25 percent was reached. The establishment of duty-free zones and bonded warehouses was also authorized. In 1975 the tariff exemption granted to public services, semi-public institutions, autonomous administrations and State enterprises was eliminated. Permission was granted for capital goods imported prior to a certain date to remain subject to the system of deferred payment of duties, taxes, clearance rates and other levies collected through customs.

In 1977 the rates of the customs tariff were lowered, which continued throughout 1978 and on to June 1979, when the tariffs were at parity at 10 percent. Table 2.5 shows the progress of the average tariff from 1974 to the present. Currently, the customs tariff establishes surtaxes of 5, 8, 10, 12, 15 and 20 percent *ad valorem* and compensatory duties for imports of goods whose prices have been artificially reduced in their respective markets and which could cause serious harm to national production.

Finally, the customs tariff has ceased being a tool whose principal use is to promote the proper allocation of resources between exportable goods, import replacements and importable goods.

With respect to receipts, two situations are discernible. The first, in the early 1970s, occurred when the tariffs were so high that they completely deterred imports of certain goods and services. Reducing the tariffs increased the collection thereof. For example, in 1975, despite the fact that the average tariff fell almost a third and the GGP fell 13 percent, receipts rose 23 percent.

The second situation, in the 1980s, was when the tariff was low and at parity. In these circumstances, raising the tariffs also increased receipts. This is what happened between 1983 and 1985, when the tariff was used as a goal to generate revenues for the treasury. There is no doubt that the introduction of this tariff made a significant contribution to the development of the Chilean export sector and the economy in general, and increased the efficiency, fairness and simplicity of the tax system.

Impact of copper on tax receipts

In Chile, tax receipts can be divided into two parts: receipts in national currency and receipts in foreign currencies. The latter, for convention's sake, are expressed in U.S. dollars and are produced almost entirely by taxes on the profits from the large-scale mining of copper.

The tax from copper is almost the only source of treasury revenues received directly in foreign currency, the other significant channel being foreign borrowing. This shows the enormous importance to the treasury of the international price of copper and the volume of exports, as well as the dependence of the public sector's budget on a single exportable product.

Table 2.6 shows that tax revenues from copper fluctuated substantially in the 1980s, to the point that the largest receipts were 17.2 times greater than the smallest. Copper tax payments are basically the same as income tax. By expressing these payments as a proportion of the receipts of income tax in

Table 2.6. Tax receipts from copper
(Thousands of each year's dollars and percentages)

Years	Taxes		
	CODELCO-Chile	% [a]	% [b]
1980	340,858	97.3	1.3
1981	41,939	88.3	0.1
1982	83,593	95.7	0.4
1983	185,275	43.3	2.2
1984	96,907	96.8	0.5
1985	60,074	97.5	0.4
1986	124,239	93.1	0.8
1987	198,596	98.2	1.1
1988	637,181	98.6	2.9
1989	723,360	98.1	2.9 [c]

Sources: Office of the Controller General of the Republic, *Public Sector Financial Statements*; Ministry of Finance, Calculation of the General Revenues of the Nation, and General Treasury of the Republic, Public Treasury Financial Report.
[a] The percentage of CODELCO-Chile taxes in the total income tax receipts in foreign currency.
[b] The percentage of income tax receipts in the GGP.
[c] Estimated.

foreign currency in column (1) of Table 2.6, it is seen that, on average, the latter was 90 percent higher, and if the figures for 1983 are ignored, the percentage increases to 96 percent. In other words, it is possible to state that income tax receipts in foreign currency are generated almost entirely by copper sales.

The tax resources provided by copper represent a very significant portion of the total tax receipts in foreign currency. On average, in the 1980s, they were 86.7 percent.

Income tax receipts in foreign currency vary greatly when expressed as a proportion of total income tax receipts (both currencies). In 1981 they barely represented 2.8 percent, while in 1989 they had climbed to 52.8 percent. The loss of receipts from the reduction of income tax ordered in 1984 and implemented in stages, as well as the 1989 reform, were offset by greater receipts from copper.

Column (2) shows the income tax receipts in foreign currency as a percentage of the GGP. This share has varied from 0.1 percent in 1981 to 2.9 percent in 1988 and 1989. Undoubtedly, these changes are due primarily to the variations in the international price of copper.

The taxes on copper represent a considerable percentage of total public sector expenditures in foreign currency. On average, in the last four years of the 1980s, they financed a little more than 30 percent of said expenditures. If other revenues in foreign currency generated by copper (profit sharing) are added to the taxes on copper, the percentage of financing expenditures in foreign currency doubles (Table 2.6).

An important conclusion to be drawn from this is that when the State budget relies largely on a single source of financing for expenditures, those expenditures necessarily depend on the variations of that source. Therefore, when things are going well, a stabilization fund should be created with some of the additional resources obtained, so that in the future, if things go wrong, expenditures will not have to be excessively restricted.

Tax administration and prevention of evasion

The tax administration is the State agency whose specific function is to impose taxes and ensure their proper receipt, thus establishing the relationship between the State and the taxpayer.

The tax reform of 1974 established three specific objectives for the tax administration, which have produced good results in terms of preventing tax evasion. The three objectives were to:

a) Implement an information program to increase public awareness of tax reform in all sectors of the country, so that every Chilean would have a complete understanding of the obligations imposed by the tax reform and to ensure fulfillment therewith.

b) Develop a training program for the personnel of the Internal Revenue Service *(Servicio de Impuestos Internos - SII)*, the objectives of which were to respond to the questions, doubts and concerns of taxpayers and thus to adapt the provisions of the reform to the existing conceptual and procedural realities.

c) Establish and maintain information processing systems, whether manual, mechanical or electronic, the general objectives of which were to facilitate and expedite the declaration and collection of taxes and assist the SII in fully exercising the tax controls within its authority.

Numerous programs have been instituted to prevent tax evasion. Following is a discussion of the most important.

Individual Tax Account

The taxpayer's Individual Tax Account *(Cuenta Unica Tributaria - CUT)* is a file containing information about such matters as payments, withholdings, cancellations and credit notes. This individual account has the classic debit and credit structure and contains the information necessary for a tax audit.

The Individual Tax Number *(Rol Unico Tributario - RUT)* is an individual number assigned to each natural or juridical person at birth, which provides access to the taxpayer's Individual Tax Account by the users of the information.

Design of audit programs

Because the value added tax is the principal tax in the tax structure, audit efforts are focused on the VAT, which also has effects on the yield of income taxes. A larger tax debit or a smaller tax credit will have an impact on the taxable base of a company's income tax and will ultimately affect the taxable base of the personal income tax of the owners thereof.

Since the reason for evading taxes is usually to have more disposable income, the additional income resulting from tax evasion will show up sooner or later in the form of increased spending, whether for consumption, investment or savings. When the taxpayer spends the income or saves it, it can be detected and in an audit, he must explain the source of the funds. If the income declared or the wealth accumulated is insufficient to explain the expenditure or the purchase of financial assets, he must then pay the unpaid taxes plus adjustments, fines and interest.

Some examples of audit programs with interesting results in terms of preventing tax evasion are:

a) Detection of failure to declare: this procedure provides for notification of the taxpayer that he has not submitted one or more monthly declarations or the annual income declaration, and forces him to do so.

b) The VAT debit/credit ratio: in the medium and long term, sales must be greater than purchases, otherwise the company would fail. The information is provided by the taxpayer in his monthly VAT declaration. Analysis of this ratio is a very reliable method of detecting tax evasion.

c) Cross-checking of invoices and detection of incomplete declarations: in 1982, the authorities began to obtain information concerning invoices from taxpayer suppliers, i.e., information concerning the latter's purchases. The data obtained from the suppliers' invoices are processed with a view to determining possible irregularities in the vendors' declarations. The cross-checking of invoices also makes it possible to detect falsified invoices.

d) Investment reports: to check income tax declarations, information about the purchase of or investment in certain types of securities by taxpayers is used. In this way it is possible to detect possible irregularities or inconsistencies between the income declared and the investments made.

e) Electronic checking of the consistency of tax declarations: the consistency of the figures entered on various declarations is constantly checked in order to detect errors. If any are detected, the declaration is rejected and the taxpayer is required to submit a corrected declaration and pay any differences owed.

Increase of penalties

In addition to the above mentioned programs to detect tax evasion, changes were also made in the existing penalties, which were increased so that they would constitute a real punishment for evasion. Thus, the cost of evading taxes became very high, thus discouraging this illegal and dishonest behavior. Of course, the principle that the punishment should fit the crime is still respected, but the punishment has been raised to its upper limit.

In summary, the significant rise in tax receipts is due in part to the efforts made to detect and discourage tax evasion. In particular, focusing the efforts of tax auditors on the most profitable tax has paid off handsomely, as has the use of advanced technology (computers, individual taxpayer identification, and trained personnel).

Major lessons of the Chilean tax reforms

Many of the aspects observed following the tax reforms cannot be attributed solely and exclusively to them; instead, they are also due in large measure to other economic policy changes. The opening of the economy and the monetary, exchange rate, fiscal and other policies also explain part of what happened or reinforce the effects looked for in the tax changes.

Another important point was the establishment of specific, prioritized objectives, all aspects of the economic policy being oriented toward the attainment of those objectives which, in the opinion of the authorities, were the most relevant. In this way, all the tools of economic policy were mutually reinforced.

Another lesson is that in inflationary economies, for reasons of both efficiency and fairness, the tax system must be indexed. The goal of the indexing must be to protect both the taxpayer and the State from the effects of inflation. In this area, Chile has achieved an adequate level of success by means of the corrective measures taken. Nevertheless, this does not mean that there are still not other actions that need to be taken to improve the indexing system.

Another interesting conclusion is that each tax is better at achieving a certain objective, so that each should be aimed at that particular goal. For example, tariffs should preferably have a role in resource allocation and should not be used to increase receipts; income taxes discourage savings and investment, while consumption taxes are neutral. In any case, it is the prioritization of objectives that will determine which taxes are used and how they are applied.

A final point worth mentioning is that in developing a tax system, the detection of tax evasion must not be overlooked. A policy which, in relative terms, places emphasis on punishments or penalties for tax evasion in connection with the policy of auditing the taxpayer is a tool that will help curb evasion. Of course, the authorities must ensure that tax evaders pay the penalties imposed on them and avoid forgiving and pardoning these offenses. In other words, the will to implement the policy must be present. The use of the latest technology to audit

tax declarations is another tool that has helped to detect and discourage tax evasion. The use of computers, the creation of the CUT (Individual Tax Account), and programs to ensure the proper documentation of business transactions have been particularly useful in this regard.

Many other conclusions are expressed in each section of this document, which address the various taxes individually; therefore, to avoid being repetitive, they will not be included in these conclusions.

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June 16, 1995

Mr. Phillip Mosley, Chief of Staff
Committee on Ways & Means
US House of Representatives
1102 Longworth
Washington DC 20515

Dear Mr. Mosley,

I am in complete support with eradicating our current tax system which as you know penalizes the productive people of this country.

I think the National Sales Tax would be the best system to replace our current system for these reasons:

1. It is the form of taxation our Constitution allows.
2. It would require everyone to pay. Drug dealers, prostitutes, and other illegal money makers would finally contribute to our system.
3. It would not allow the Congress to eliminate the deductions and then raise the tax, like they could if we had a flat tax.

A flat tax would still allow for cheating and wasted time preparing forms for the IRS. We must eliminate the IRS and all the wasteful acts associated with preparing our tax returns.

I spend too much time with accounting for this business, in addition to our other joint business and our rental properties.

Lastly, we're sick of paying 15.3% of our income in Social Security taxes in addition to income taxes because we're self employed. If the employees of this country had to come out of their savings like we do, this debate would have taken place many years ago.

Please push towards the National Sales Tax.

Thank You,

Kathy Jabbour

499C EDISON COURT • CORDELIA, CALIFORNIA 94585
1-800-585-4044 • (707) 864-4044 • FAX (707) 864-4043

Chief of Staff Mosley
Of Ways and Means Committee
Longworth Building
Washington D.C. 20515

PLEASE, NOW IS THE TIME.

DISSOLVE THE I.R.S. AND

GIVE US A NATIONAL SALES TAX

Other:

From:

John Carl
4325 Zaca Pl
Los Angeles, CA 90065
5/27/95

Mr. Mosely
Committee on Ways and Means
Longworth Office Bldg
Washington, DC 20215

Dear Congressmen,

I want to express my desire that you on the Committee on Ways and Means decide to get rid of the income tax in all aspects, even to the extent of repealing the income tax amendent, ridding us of the scourge that has come of it. I would of course prefer a tax on all imports to the U S. Knowing that is unrealistic I wholeheartedly support a National Sales Tax as proposed by Congressman Archer. Please note that I am also vehemently opposed to a value added tax. I fully believe that a person should know the exact contribution that he makes for the right of self government and that cannot be done with hidden taxes of any sort. This also takes care of all those taxes that are not collected by our Internal Revenue Service. The "underground economy" would then pay their fair share due to the fact that they need goods and services just like the rest of us. I wish you all godspeed with the new and improved society in which we all can be free to earn and build without a lot of interference from our employees in government.

Sincerely,
John Carl

6-18-95

Phil Moseley
Majority Chief of Staff
House Ways & Means Committee
Room 1102
Longworth House Office Bldg.
Independence & New Jersey Aves., SE
Washington, D.C. 20515

Mr. Moseley,

We would support a National Consumption tax (not V.A.T.) and the total elimination of the I.R.S.

Our problem is why the delay? We hear talk of 1996 or 1997 and beyond for implementation. This is baiting the public.

Why not get going NOW and get the job done?

Sincerely,
A. A. Carter

5244 Rosewood Dr.
Mission, K.S. 66205

Att: 6 copies

STATEMENT OF
BRADLEY D. BELT*
DIRECTOR, DOMESTIC POLICY ISSUES PROGRAM
THE CENTER FOR STRATEGIC AND INTERNATIONAL STUDIES

CONCERNING REPLACEMENT OF THE FEDERAL INCOME TAX CODE

PRESENTED TO THE
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

June 6, 1995

Mr. Chairman, Congressman Gibbons, members of the Committee, I am delighted to have the opportunity to testify before the Committee on Ways and Means on a matter that has a direct bearing on the future economic prosperity of all Americans. In addition to balancing the federal budget, no more important action can be taken to spur economic growth than replacing the federal tax code with a new tax system that would facilitate, rather than punish, economically productive behavior. Increasing realization of this fact is due in no small part to your vocal support for tax replacement, this series of hearings being the latest example of your exemplary leadership on this vital issue.

The Center for Strategic and International Studies[1] has been a proponent of comprehensive tax reform since 1992, when the CSIS Strengthening of America Commission recommended replacing the current income tax with a new consumption-based tax designed to promote saving and investment. This proposal has evolved into the USA Tax Act of 1995 (S. 722), which was recently introduced by the chairmen of the Strengthening of America Commission, Senators Pete Domenici and Sam Nunn.

While CSIS is proud of its sponsorship of the Commission and its work, the purpose of my testimony is not to advocate any one tax replacement proposal. Rather, I wish to present the economic rationale for tax replacement by examining the current tax code's fundamental deficiencies, outlining basic principles and a framework for a new system of taxation, and providing a brief analysis of the major tax plans that have been advanced by members of Congress.

The simple truth is that the current tax system is hopelessly flawed and must be replaced. The ad hoc tinkering at the margins of the code that has characterized tax "reform" in recent decades has only exacerbated the problem. What is needed is a new tax system--a tax system that will not penalize entrepreneurial activity, that is transparent, fair, and comprehensible, and that will enable American enterprises to compete effectively in the global marketplace.

The new tax system should fully integrate individual and business taxes, and, most importantly, should encourage, or at least remain neutral with respect to, economically productive activity. In this regard, the new tax system should exclude net new savings from the individual tax base and allow businesses to expense new investments in the year they are made. In contrast to the existing tax system, individuals would have an economically rational reason for saving rather than consuming, and businesses would be able to invest in R&D, new plant and equipment, and human resources--the kind of investment necessary to enhance productivity and provide for future prosperity.

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*The views expressed herein are those of Mr. Belt and do not necessarily reflect the views of CSIS, its staff, or its contributors.

[1]CSIS is a non-partisan public policy research institute based in Washington, D.C. that provides policymakers with a strategic perspective on issues relating to domestic and international economics and finance, politics, and global security matters.

The economic arguments for replacing the current tax system are compelling and, with the advent of the 104th Congress, the political prospects for tax reform have never been better. The challenge will be to resist the temptation to tinker with the familiar and instead completely rethink tax policy. Only if we take the bold step of replacing our tax system with a new system that is efficient, comprehensible, and conducive to savings and investment can we ensure that those who pursue the American Dream have any hope of attaining it.

WHY WE NEED TO REPLACE THE INCOME TAX

During its relatively short lifespan, the federal income tax has evolved into a byzantine maze of nearly incomprehensible and often inconsistent rules and regulations that both engenders distrust among taxpayers and taxes the abilities of expert practitioners. Its questionable and superficial equity is undermined by a variety of exemptions, deductions, and credits, and it clearly distorts the relative prices of goods and services, altering behavior in a manner inconsistent with sound economic principles.

The imperative for comprehensive tax reform becomes apparent when one considers that almost one-fifth of America's annual gross domestic product (GDP) is funneled through a federal tax system that wastes billions of dollars, misallocates resources, and impairs U.S. competitiveness. Fiscal profligacy on this scale jeopardizes America's economic future and hampers its ability to meet severe domestic and international economic challenges.

Although they may disagree on specific alternative approaches, proponents of comprehensive tax reform all condemn the existing income tax. As the debate on tax reform has progressed, the litany of the tax code's woes has become very familiar:

- *The tax code is too complex and costly.* By virtually any measure--including the astonishing number and length of IRS forms and instructions--the current U.S. tax code is extraordinarily complex. Most troubling are the economic costs of compliance that complexity imposes on society. Due to excessive complexity, valuable time and resources--which could otherwise be devoted to economically productive activities--are wasted on compliance with and enforcement of unnecessarily complicated rules and regulations. Estimates of total direct and indirect compliance costs range into the hundreds of billions of dollars.

- *The tax code distorts economic activity.* Because the present tax code does not treat all economic transactions in a neutral manner, it distorts the pricing of goods and services and thereby reduces overall economic efficiency. The tax code, for example, encourages current consumption at the expense of saving by taxing individuals on their earnings and again on their returns from their savings. Among the more serious economic decisions that the U.S. tax code distorts is the choice of how businesses finance investment by taxing corporate equity income once when earned and again when returned to shareholders in the form of distributed dividends. This double taxation of dividends reduces the incentive for entrepreneurial activity.

- *The tax code is anti-competitive.* The U.S. tax system impacts directly on the competitiveness of American businesses that operate in an increasingly globalized economy. Businesses are affected both in terms of the amount of taxes they pay and the types of distortions that the code creates. The U.S. corporate tax code increases the cost of capital for American businesses and thus erodes U.S. competitiveness. Moreover, the corporate income tax is, in many respects, inconsistent with the tax regimes of our principal trading partners, with the result that American exports often are relatively more expensive overseas.

Wholesale tax reform is clearly needed to address these deficiencies. Anything

less than a completely new system of taxation will not be sufficient. To ensure that this new system works, Congress must recognize and adhere to certain fundamental principles of tax reform.

PRINCIPLES FOR COMPREHENSIVE TAX REFORM

America's experience with the income tax offers several important lessons that should inform the process of tax replacement. First, the tax code should not favor those who consume resources over those who save. Second, the tax code should be simple enough for Americans to understand. Third, taxpayers must be convinced that everyone pays his or her fair share. Lastly, the tax code must not hamper U.S. businesses operating in the global marketplace. These lessons can be distilled into the following principles for tax reform:

- *Efficiency.* An efficient tax structure does not discourage economically productive activity. Or, more accurately, it treats transactions in a consistent and neutral manner and does not reward or penalize decisions to buy, save, borrow, invest, or produce. As a result, prices are undistorted and accurately reflect the valuations of consumers and producers, allowing them to make decisions that optimize their economic well-being.

- *Comprehensibility.* A comprehensible tax is one that is not needlessly complex and allows taxpayers to understand and comply with their tax obligations without having to expend undue time, effort, and financial resources. This will reduce taxpayer cynicism and minimize compliance and administrative costs. Similarly, a simplified tax system is less costly for government to enforce because there are fewer tax rules and regulations for taxpayers to evade.

- *Fairness.* Reinstilling the high taxpayer morale that once existed in the United States will require a tax system that treats taxpayers fairly, or more accurately, satisfies societal notions of equity, which can be quite subjective. At the very least, the tax system should promote horizontal equity, so that people who are similarly situated economically bear similar tax burdens.

- *Constructive Empowerment.* Taxpayers should have the ability to lower the amount of their earnings that are subject to taxation by saving and investing more of their income, not by working less. In addition to incentivizing economically productive behavior, this will give taxpayers a greater sense of control over their taxes and thus increase support for the new tax system.

- *Competitiveness.* The tax code should work to the advantage of American businesses competing in the global marketplace. This will require an awareness of how domestic taxes are treated by international tax rules and adjusting our tax rules accordingly.

If Congress can remain faithful to these basic principles, and use them as beacons to navigate through the politically tumultuous waters of tax replacement, it can fashion a new tax system that is consistent with America's economic interests. I now turn to what such a tax system would look like.

FRAMEWORK FOR A NEW TAX SYSTEM: KEY FEATURES

To be consistent with the principles described above, the tax system that replaces the current tax code should include the following features:

- *Lower rates and broader base.* High tax rates, especially at the margins, discourage economically productive activity and encourage economically unproductive

activity. Broadening the base by eliminating deductions, preferences, and credits would allow effective and marginal rates to be lowered, thus stimulating economic growth and productivity-enhancing investment.

- *Fully integrated individual and business taxes.* An integrated tax structure would reduce complexity and ensure that income is taxed only once. Integration of the individual and business taxes would produce a number of economic benefits, such as increasing investment in corporations, reducing corporate dependence on debt finance, and lowering the cost of capital.

- *Exclusion of saving from the tax base.* Ideally, what would be taxed is some measure of consumption, rather than simply income. In an income tax framework, individuals would be allowed to deduct from their tax base all income that is saved or exclude from their income the return from savings. This would eliminate the current code's hostility to this economically vital activity.

- *Immediate expensing of business investment.* Businesses should be able to deduct expenses at the time they are incurred. Not only do depreciation and amortization schedules dramatically increase tax complexity, they discourage business from investing in plant and equipment, research and development, and human capital.

- *Harmonization with foreign tax systems.* To compete on a more equal footing in foreign markets, the United States should adopt a system of taxation that is consonant with the tax regimes of our principal trading partners.

In addition, adoption and implementation of a new tax system requires appropriate transition rules. Most tax proposals contemplate a fully phased-in tax system. Unfortunately, while a tax system may be designed from scratch, it would have to be implemented in an environment in which economic decisions and behavior are made in the context of previously enacted laws and regulations. Without appropriate transition rules, large segments of the economy might suffer severe short-term dislocations that could more than offset the longer-term benefits of the new tax system.

Moreover, accounting, political, and social factors affect tax policy. For better or for worse, no tax code is simply an economic document. It will inevitably reflect the value judgments and priorities of the population to which it is applied. In an ideal policy world, the new tax system outlined above would be based exclusively on the principles I have described, and these principles would be consistently applied.

Many policy choices, however, will be based on practical and political realities that would, if adopted, tend to undermine the theoretical purity of the tax replacement models advocated by economists. Congress will face policy options concerning the tax treatment of certain items--such as housing, education, and health care--that may place it at odds with economists. While I do not have time to delve into specific policy options, it is my hope that, to extent possible, policy choices will be assessed on the basis of sound economic principles, and not political expediency.

KEY ISSUES

The tax reform debate has focused on several issues that arise in replacing the current income tax. Two issues that I will focus on have received considerable attention and have generated much disagreement: the effects of tax reform on national saving and tax fairness.

Saving. The principal difference between a tax system based on the principles I have described and the current income tax is that the new system would not include savings in the individual tax base. In part because of the dynamic effects of tax policy

changes, it is difficult to predict the precise extent to which private savings are likely to increase after the current tax code's bias against saving is eliminated. A number of economists have argued that targeted tax incentives do not necessarily increase savings, but simply result in a shift in savings from non-tax preferred investments to those that are tax preferred.[2]

It is useful, however, to examine the performance of the individual retirement account (IRA), which was introduced in the early 1980s and can be used as a reasonable proxy.[3] By excluding savings from the tax base, the new tax system would effectively operate like an unlimited, unrestricted IRA. Such a system, however, will have a stronger effect on saving than IRAs or 401(k)s. IRAs allow a deduction only for retirement saving (assessing a penalty for early withdrawal) for no more than $2,250 annually. In addition, the 1986 Tax Reform Act reduced the maximum annual contribution to IRAs and eliminated eligibility for high-income earners. But the new tax code would apply the deduction to saving for any purpose for all households, and set no limit on the amount of saving that is tax deductible.

Although there is no assurance that excluding savings from taxation will change behavior and result in more private savings, economists have identified three effects that should, over time, significantly improve the prospects for a greater rate of private saving:

- *The Incentive Effect.* This characteristic is perhaps the most obvious of the three. By excluding savings from the taxable base, households can easily and legally reduce their tax burdens by saving more. This creates an obvious financial incentive to save.

- *The Horizontal Redistribution Effect.* This effect describes the redistribution that takes place among persons in the same income class. Conversion to a neutral tax code would reduce the tax of above-average savers and raise that of below-average savers within each income group. The result would be more total saving from each group.[4]

- *The Postponement Effect.* The new tax would reduce the tax burden during the work-stage of life, postponing some burden until the retirement stage and enabling workers to save more.[5] In an economy with growing real wages and an expanding labor force, the higher saving of workers outweighs the higher dissaving of retirees, increasing aggregate net saving.

It should be noted that consumption is not a vice to be punished by the tax code. We must remember that one person's consumption is another person's income. Tax reform should therefore seek to increase aggregate consumption over the long term by

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[2]William D. Andrews and David F. Bradford, "Savings Incentives in a Hybrid Income Tax," in Henry J. Aaron, Harvey Galper, and Joseph A. Pechman, eds., *Uneasy Compromise: Problems of a Hybrid Income-Consumption Tax* (Washington, D.C.: The Brookings Institution, 1988), p. 292.

[3]Concerns that targeted tax incentives such as IRAs merely result in individuals shifting the locus of savings (rather than creating new savings) led Congress to significantly restrict IRAs in 1986. Empirical studies have concluded, however, that even for those who had been significant savers, IRAs appear to have stimulated an increase in their total saving, not a mere shift among savings vehicles [see Steven F. Venti and David A. Wise, "Have IRAs Increased U.S. Saving?: Evidence From Consumer Expenditure Surveys," *The Quarterly Journal of Economics*, August 1990]. The case is further bolstered by the evidence presented in a more recent study that looked at the experience of participation in another tax-preferred savings vehicle, the 401(k) plan, and found that contributions to these accounts did not simply substitute for other forms of saving and that participation in 401(k) plans among those eligible exceeded 60 percent at all income levels [*Business Week*, September 27, 1993, p. 28].

[4]Stephen B. Maurer and Laurence S. Seidman, "The Consumption Tax, Horizontal Redistribution, and Aggregate Saving," *Mathematical Modelling* (Vol. 5, 1994), p. 216.

[5]Laurence S. Seidman, "Boost Saving with a Personal Consumption Tax," *Challenge* (November-December 1989), pp. 48-49.

contributing to economic growth and prosperity. It will do this by encouraging the saving and investment necessary to improve economic productivity. This, in turn, will produce a permanently higher level of future consumption per household--i.e., a higher standard of living.

Fairness and Rate Structure. Most people equate tax fairness--a very subjective notion in and of itself--with progressivity and a steeply graduated rate structure. High marginal tax rates, however, impose economic costs on society by discouraging economically productive activities such as work and by encouraging tax evasion and tax avoidance, whereby taxpayers seek to limit the amount of their income that is subject to the high marginal tax rate.

Moreover, this definition of tax fairness, which has become ingrained in this country's political psyche, confuses the issue of how tax burdens are distributed along the income spectrum. This is because rate structure alone does not determine the degree to which a tax is progressive. Specifically, it does not tell you the percentage of one's income paid in taxes, or the *effective* rate of tax.

Consider the existing income tax code. Somewhat surprisingly, the effective tax rate paid by high income taxpayers under current law is quite similar to that they would pay under a 17 percent flat tax with family and personal deductions large enough to produce a zero effective rate for about half of all families. Although the top five percent income group currently faces a marginal tax rate of 39.6 percent, data compiled by MIT professor Jonathan Gruber indicate that their effective tax rate is just 17.4 percent (low-income taxpayers have effective rates near, or even below, zero).[6] The variance between marginal and effective tax rates occurs because high-income taxpayers are today able to avail themselves of numerous tax avoidance strategies. Consequently, while the rate structure does affect the distribution of tax burden across income groups, it should not be the sole basis for assessing the relative fairness of proposed tax plans utilizing different rate schedules.

Another tax fairness issue concerns the tax code's role in distributing income among various groups in ways deemed politically or socially appropriate. Aside from expressing concerns that use of the tax code for redistribution purposes creates economic distortions, many have argued that the expansion of numerous federal social and economic programs have obviated the need to redistribute income on the revenue side of the federal budget. Former chairman of the president's council of economic advisors Michael Boskin recently noted that the percentage of the federal budget devoted to transfer payments has increased dramatically since the 1950s. If we can achieve social and economic ends through government spending, then relying on the tax code for redistribution becomes unnecessary and counterproductive.

PROPOSED ALTERNATIVES TO THE INCOME TAX

With the advent of the 104th Congress, the prospects for replacing the current tax system have taken on a new urgency. Most of the attention has focused on three approaches to replacing the federal income tax: the Unlimited Savings Allowance (USA) Tax System promoted by Senators Domenici and Nunn, the "flat tax" advocated by House Majority Leader Dick Armey and Senator Arlen Specter, and Senator Richard Lugar's national sales tax.

The USA Tax System

The USA Tax Act of 1995 (S. 722) was recently introduced by Senators Domenici

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[6]Jonathan Gruber, "Payroll Taxation in the United States: Assessing the Alternatives," in Robert J. Shapiro, ed., *Enterprise Economics and Tax Reform: Promoting U.S. Growth in the Global Economy*, Working Papers, Vol. III (Washington, D.C.: Progressive Foundation, 1994), p. 22.

and Nunn. The USA Tax is based on the recommendation of the CSIS Strengthening of America Commission, which was organized under the auspices of the Center for Strategic and International Studies and chaired by Domenici and Nunn.

The USA Tax is an integrated tax system comprised of an individual tax and a business tax. The individual tax would operate like a "super" IRA, with taxpayers subtracting their net new savings from their gross income--which includes wages, salaries, fringe benefits, and capital income--and paying tax on the difference. The USA Tax employs a graduated rate structure and allows taxpayers to continue to file annual tax returns that will look like the forms they are already familiar with. The USA Tax also maintains the home mortgage interest and charitable deductions, and adds one for post-secondary tuition expenditures.

The business tax would asses a flat 11 percent tax rate on "gross profit," or the difference between the revenue from the sales of goods and services and the amount paid to other businesses for goods and services such as plant, equipment, rent, and supplies. All forms of business enterprises (not just corporations) would pay this tax. Businesses could immediately expense all of their investments and the tax would be border adjustable and territorial.

The USA Tax directly addresses the current tax code's most glaring flaw: the double taxation of savings and investments, and Senators Nunn and Domenici claim that the USA Tax would be much simpler than the income tax, with about 80 percent of the Internal Revenue Code eliminated after enactment. While it is not clear that the USA Tax would lead to increased saving, this would be the most ambitious effort to incentivize saving. In as much as a graduated rate structure may be necessary to satisfy societal notions of fairness, the USA Tax does so to maintain progressivity. Moreover, the USA Tax is the only proposal which has thus far garnered strong bipartisan support.

It has been noted, however, that calculating net new savings could be a new and time-consuming chore for many taxpayers. For those filers who use the relatively simple 1040EZ form, for example, the USA Tax could be far more complicated. Moreover, because businesses are not permitted a deduction for either wages and salaries or dividends and interest, it appears that labor and capital income is taxed twice--at both the business and individual levels. In addition, it has been argued that the USA Tax would relatively benefit capital intensive exporters at the expense of labor intensive service industries.

The Flat Tax

Two versions of the flat tax have been proposed: Senator Specter's Flat Tax Act of 1995 (S. 488) and House Majority Leader Armey's flat tax, which was part of his Freedom and Fairness Restoration Act, a bill that he introduced in the 103rd Congress. Both plans are based on the work of Robert Hall and Alvin Rabushka of Stanford University. Essentially, all wage and business income would be taxed at a single tax rate of 20 percent under the Specter plan and 17 percent under the Armey plan. Except for personal allowances, all deductions would be eliminated (Specter would permit deductions for home mortgage interest on home loans of up to $100,000 and charitable contributions up to $2,500). In addition, while the USA Tax System would tax capital income at the individual level if it is not saved, capital income is taxed at the business level under the flat tax and is not part of the individual tax base. Businesses would be allowed to immediately expense their investments.

The most compelling feature of the flat tax is its simplicity. Individuals and businesses would spend significantly less time and money paying taxes and the IRS's enforcement costs would decline dramatically. The flat tax would tax all income once and only once, thereby eliminating the double taxation of saving and investment. It would also integrate business and individual taxation and continue annual tax returns.

The flat tax suffers principally from the perception that it will reduce vertical and horizontal equity. First, many believe that the rich will benefit disproportionately from a flat tax at the expense of the middle class. For the very rich, this is probably true, although the generous personal and family allowances make the flat tax progressive. Second, because capital income is not taxed at the individual level, one person with exclusively labor income will be taxed at the individual level while someone with an equal income from returns from capital will not be taxed at the individual level. This capital income is taxed at the business level, but this tax burden is shared by consumers and workers in the form of higher prices and lower wages. Another political liability is the elimination of deductions for charitable contributions and home mortgage interest or, as Specter proposes, capping the deductions below current law. The mortgage interest deduction, in particular, will be defended by homeowners and the real estate industry.

The National Sales Tax

Senator Lugar has suggested replacing the federal personal and corporate income tax with a 17 percent national sales tax on goods and services--with an exemption for food and medical services--that would be assessed at the point of retail sale. Low-income taxpayers could be given a tax rebate. Unlike the USA and flat taxes, which tax consumption but function as income taxes, the sales tax is a pure consumption tax.

First, as with the flat and USA taxes, the sales tax would eliminate the current tax code's anti-savings bias and, according to some economists, significantly stimulate economic growth. Second, a sales tax would virtually eliminate the need for a tax code, which would reduce taxpayer paperwork and lower compliance and enforcement costs. In fact, Lugar would eliminate the IRS, a prospect that appeals to many Americans. Lastly, proponents of the sales tax note that it would tax the underground economy, because criminals could not avoid taxation when they purchase goods and services.

The sales tax, however, has serious drawbacks. Being a consumption tax, it is potentially quite regressive: low-income taxpayers would pay a larger portion of their income in taxes than wealthier taxpayers. A sales tax could be made progressive by providing a waiver or refundable tax credit for low-income taxpayers, but doing so would compromise the objective of administrative simplification. Another problem is that, because the sales tax would be obscured in the selling prices of consumption items, the taxpaying public would be less sensitive to its tax burden. The sales tax would also face political opposition from retailers who would have to play the role of tax collector and from state and local governments that wish to retain their own sales taxes. Moreover, unless the 16th Amendment (authorizing the income tax) is repealed, many believe that the sales tax would add to existing levies rather than replace them.

CONCLUSION

While the tax reform plans I have just described differ on specifics, they share common elements that make them all far preferable to the existing tax system; in fact, the similarities are much more important than the differences. In short, they shift the tax base from income to consumption, thereby eliminating the current code's bias against saving and investing; they make taxation less complex; and they better integrate business and individual taxation (the sales tax would do away with both). Most importantly, tax reform proponents are unanimous on the issue of greatest significance--the need to replace the tax code. There is complete agreement that the tax code imperils our ability to achieve real productivity and wage gains and improve our standard of living.

While comprehensive tax reform is economically desirable and should receive the support of a majority of Americans, certain interest groups will inevitably resist any significant change in the tax code. Because the current tax system is distortionary, it changes the relative prices of commodities and thereby creates winners and losers. To the extent that a new tax system eliminates these price distortions, it will make losers out

of the old winners, and vice versa. For example, completely neutral treatment of savings would result in state and local governments losing their present tax-based funding advantage and the housing industry could suffer if the tax benefits accorded homeownership were eliminated. While these may be desirable outcomes on efficiency grounds, the reality is that the new losers will have every incentive to resist change, and many have powerful lobbies that could put considerable pressure on members of Congress. A proposed tax structure which is not sensitive to these potential minefields will fail.

The American people, moreover, tend to view radical change with healthy skepticism. Part of the problem is that the public perceives many tax reform proposals as attempts to increase their aggregate tax burden. Of course, the tax proposals now under consideration could be made revenue neutral, and since any new tax system based on the principles outlined above would be a more efficient way to collect taxes and would enhance future productivity, it would be, over the long run, less burdensome. The federal government would therefore require fewer tax revenues than under the existing income tax.

The fact that taxpayers will be able to lower their tax burden by consuming less and saving more, in a manner of their choosing, is perhaps the best political marketing tool for comprehensive tax reform. Granting individuals greater control over their money and the way in which it is taxed would give them a sense of empowerment and enable proponents of tax reform to garner the grassroots support that it both needs and deserves.

Not since 1954 has the outlook for comprehensive tax reform been so promising. This opportunity must not be wasted on complex and incremental manipulations of the income tax. The United States needs instead to implement a new tax system that reflects today's economic realities and raises public revenues in the most fair and least complex and distortionary manner possible. In doing so, we would take an important step in safeguarding the American Dream.

COMPARISON OF INCOME TAX WITH MAJOR TAX REPLACEMENT PROPOSALS

Proposal	Tax Rates for Married Couples	Individual Tax Base	Major Exemptions, Deductions, and Credits	Business Tax Rates	Key Business Tax Features
Current Income Tax	$0-$39,000 15% $39,001-$94,250 28% $94,251-$143,600 31% $143,601-$256,500 36% Over $256,500 39.6%	▸Wages ▸Salaries ▸Pensions ▸Interest ▸Dividends ▸Annuities	▸Personal and family ▸Charitable contributions ▸Mortgage interest ▸Fringe benefits ▸Municipal bond interest ▸State and local taxes ▸Earned income	▸Corporate income tax rates: $0-$50,000 15% $50,001-$75,000 25% $75,001-$10,000,000 34% Over $10,000,000 35%	▸Immediate expensing: no ▸Wages/salaries/pensions: deducted ▸Fringe benefits: deducted ▸Interest: deducted ▸Dividends: not deducted ▸Alternative minimum tax
Armey Flat Tax	All wage income: 17%	▸Wages ▸Salaries ▸Pensions	▸Personal and family	▸All business income: 17% rate	▸Immediate expensing: yes ▸Wages/salaries/pensions: deducted ▸Fringe benefits: not deducted ▸Dividends/interest: not deducted
Specter Flat Tax - S. 488	All wage income: 20%	▸Wages ▸Salaries ▸Pensions	▸Personal and family ▸Charitable contributions ▸Mortgage interest	▸All business income: 20% rate	▸Immediate expensing: yes ▸Wages/salaries/pensions: deducted ▸Fringe benefits: not deducted ▸Dividends/interest: not deducted
National Sales Tax - Lugar version	All taxable sales: 17%	▸Retail purchases	▸Food ▸Medicine	▸All businesses pay 17% tax on retail purchases	▸Border adjustable
USA Tax - Domenici-Nunn - S. 722	$0-$5,400 8% $5,401-$24,000 19% Over $24,000 40%	▸Wages ▸Salaries ▸Fringe benefits ▸Pensions ▸Interest ▸Dividends ▸Annuities	▸Net new savings ▸Personal and family ▸Charitable contributions ▸Mortgage interest ▸Municipal bond interest ▸7.65% payroll tax credit ▸Post-secondary tuition ▸Earned income	▸Gross profits: 11% rate - defined under USA Tax as revenue from the domestic sale of goods and services (excluding financial receipts) minus the amount paid to other businesses for goods and services	▸Immediate expensing: yes ▸Wages/salaries/pensions: not deducted ▸Fringe benefits: not deducted ▸Dividends/interest: not deducted ▸Border adjustable ▸7.65% payroll tax credit

STEVEN B. CORD, President ALBERT S. HARTHEIMER, Vice President EDWARD H. SCHOYER, Treasurer HANNO T. BECK, Secretary

Center for the Study of Economics

2000 Center Plaza, #238
Columbia, MD 21044
Tel. (410) 740-1177
Fax (410) 740-3279

Testimony - Dr. Steven Cord

for the FUNDAMENTAL TAX REFORM HEARING

June 1995

PROPOSAL - Tax land ownership, not producer income. This can be done by giving federal grant preferences to those cities which tax land assessments more than building assessments, or more directly by levying a federal tax on income from land ownership. For further details on this, contact us as we have been doing research and actual implementation of this for many years and with many governments.

BENEFITS - If this were done, land sites would have to be used efficiently (it would be uneconomical to hold sites out of full use and yet pay a tax on its rental value), and this by itself would create jobs and promote economic development. Surely, this is better than raising prices via a national sales tax.

Also, taxes on labor and capital could be substantially reduced, thereby once again creating jobs and economic development. Most voters would receive tax reductions (i.e., they would pay more with labor-and-capital taxes than with land taxes).

ENDORSERS - Seven recent American Nobel Prize winners in economics have endorsed this idea (see enclosure) as well as hundreds of prominent urban experts (see enclosure). The proposal has worked well wherever tried.

We are a non-profit research corporation and we offer to put our experience at your disposal for expenses only; please feel free to contact us.

H. L. Chambers
6225 Salt Cedar Road, NE
Rio Rancho, NM 87124

Wed, June 7, 1995 11:15 PM

Mr. Philip Mosley, Chief of Staff
House Ways & Means Committee
1102 Longworth House Office Bldg.
Washington, D C 20515

Dear Sir:

Enclosed please find six (6) copies of a statement regarding revision of the personal income tax for submission to the Ways & Means Committee.

I wish - in this statement - to express my views and address the topic of the personal income tax.

Most of us would agree that our system of taxation is too complex, too expensive to administer, and subject to "attempts to defraud" on the part of both taxpayer and government.. Instead of a cooperative symbiotic relationship, we seem to have an inefficient, antagonistic, contentious and adversarial relationship. This is generally unproductive on all counts.

Some in government, as well as private citizens and lobbying organizations, seem to favor a so called "flat tax" as a replacement for the personal income tax . **I don't favor the flat tax as a replacement for the personal income tax for the following reasons:**

1. It requires individuals to "report" their income. This leads to fraudulent underreporting on the part of the so called "underground" economy and others. The underground economy has been estimated by IRS survey to generate from 3 to 4 billion dollars annually. Individual businessmen (proprietors) have - for generations - been "skimming" their own gross to avoid income taxes. Requiring individuals to "report" income generates unnecessary bureaucracy - in the IRS and elsewhere. In short, it generates extensive costs for both government and taxpayer. It allows much "income" to go "unreported and so untaxed".
2. What criminal mobster, prostitute, drug dealer, marijuana grower, money launderer, etc., will report their income honestly on a "flat tax" postal card form?
3. Do *you* really believe that individual privately practicing professionals honestly report *all* of their *cash* income? I speak of such as doctors, dentists, optometrists, private duty nurses, lawyers, photographers, tailors, etc., etc. I'm sure you 'get' the thrust of my thinking
4. I believe that we need to rid ourselves of much of the IRS - our most **despised** bureaucracy! A flat tax would not effectively achieve this goal.

I don't support a "flat tax", nor do I support a "value added tax" (for many of the reasons cited above, as well as because of the tremendous bureaucracy such a tax would require for administration). **I do strongly support a national sales tax, imposed and collected at the point of final sale, as a replacement for the personal income tax for the following reasons.**

1. Money is relatively worthless until spent to acquire desired goods and services. Even the persons cited above for probable tax evasion spend money to obtain goods and services they need or desire. Conspicuous consumers will pay taxes commensurate with their conspicuous consumption. Nothing but prescription drugs, foodstuffs, and directly paid defined medical expenses would be exempt from sales tax. Restaurant meals would NOT be so excluded. Nor would school-lunch charges. Such would ensure that welfare recipients and the impoverished "poor" thus would have their tax liability reduced, but would still pay some taxes.

2. The sales tax "rate" could be periodically adjusted to meet the real needs of government without altering any other part of the system.

3. Existing 'loopholes' could be eliminated, and no opportunity to create future 'loopholes' would be supported by such a system.

4. The resulting expansion of the tax "base" would reduce rates while promoting fairness.

5. Printing, distributing, and auditing of tax forms and instructions, refunding, and general record keeping on the part of IRS would be very substantially reduced. Such savings could be applied in a fashion deemed proper by The Congress.

6. Individual ordinary taxpayers would no longer be required to retain - at considerable expense - tax preparers to sort out the obfuscating tax laws and IRS regulations, deliberately made so by The Congress and the IRS. This would accrue to the individual's benefit.

7. Cost of collection and forwarding such sales tax should result in a payment by the government of a very small percentage to the collector based upon the amount of tax collected.

8. This collection method could be standardized and inserted in the cash register automatic computer driven system extant at nearly all business outlets.

Other reasons could be cited, but the thrust of my comments should be quite clear to you.

I cannot believe that The Congress - having allowed the initiating of a complex procedure to use the House Post Office for fraudulent purposes and having discovered a means for writing and cashing personal checks for which there were no funds on deposit in the House Bank - would find construction of the general system proposed to be beyond their competence!!!!!

I strongly urge you to seriously consider making changes to our personal income tax structure in keeping with the comments above.

I request that you inform me of House Ways and Means Committee activities in these regards.

Very truly yours,

Harold L. Chambers
copy to computer file

Mr Phillip D Mosley, for the 1 202 225 3121
House Ways & Means Committee
Longsworth Building
Washington, DC 20515

Honorable Sirs:

I am indebted to Mike Reagan, 1 800 468 MIKE, the son of our former President, for calling my attention to your hearings on reforming federal taxation. As 1996 candidate for United States Representative in California Congressional District 12, I take the Oath of Office to heart: I will to the best of my Ability, preserve, protect and defend the Constitution of the United States.

Please forgive my few simple minded questions:

Is our Government Constitutional in Order to form a more perfect Union, establish Justice, insure domestic Tranquility, provide for the common defence, promote the general Welfare, and secure the Blessings of Liberty to ourselves and our Posterity?

Does Article I Section 2 of our Constitution state that Representatives and direct Taxes shall be apportioned among the several States which may be included within this Union, according to their respective Numbers... ?

Did the Supreme Court of the United States find the Civil War Income Tax unconstitutional? When the 16th Amendment was passed in 1913, was the promise made by Congress that the rate would not exceed 7% on incomes over $500,000?

With regard to the Constitution and taxation, have we lost our way, wandering for some years in the wilderness? Did Judge Learned Hand remind us that the power to tax is the power to destroy?

US Treasury and Census statements indicate that since 1913, government spending has increased 824 times faster than our population. Are we really that much better off? Has human nature remained constant enough for 82, 207 or 3400 years, that we can avoid an endless sea of high compliance costs, deficits, debts and poverty under the yoke of tax tyranny?

I pray yes. Therefore I support the Biblical and Constitutional 20% flat tax proposal of Chairman Bill Archer, exempting savings, capital gains, state taxes, churches and poor people from taxation. Experiences in Britain versus Hong Kong confirm the wisdom of Joseph in limiting taxation and government. We love our liberty.

Yours most truly,

Richard Charles 1 415 347 9382 Home Office
POB 322
Burlingame, CAlifornia 94011

Honorable Philip Mosely
Chief of Staff, Ways and Means Committee
Longworth Building
Washington D.C.

June 3.1995

Dear Sir:

I understand you will our letters included into the record our during the Tax hearings. The following is my thoughts on taxes and our burdensome tax system:

As a small business owner I can assure you there is absolutely nothing that can be more disruptive, time consuming, and costly than dealing with the Internal Revenue Service. Every income earning individual must deal with a large, clumsy, indifferent and often inept bureaucracy that makes inconsistent and often arbitrary determinations that can cost you everything you own and more. Although the extreme examples of bureaucratic ineptitude wiping out innocent taxpayers are probably relatively rare, the fact that it happens at all, and that the IRS appears to publicly flaunt these "triumphs", creates a chilling tyranny over every hard working individual in this country. A type of "taxpayer terrorism" engaged in by our own government for the purpose of keeping taxpayers appropriately submissive.

Furthermore, I resent the amount of resources I must devote to research, planning and record keeping , to try and preserve as much of my hard earned income as I can. These are resources I can scarcely afford but that I must expend if I want to merely exist, let alone prosper in this country.

I also resent the social engineering our elected officials are always engaged in. It should *not* be the role of government to punish or reward individuals for earning, investing, or spending their hard earned income the way they want.

Liberty from this entirely unnecessary burden on the individual can only come with elimination of all the complex and often indecipherable tax laws and replace it with a simple flat rate. No exceptions, no deductions-- not even one; lest future law makers use it as a reason to add new and more complex rules later.

Even better would be the total elimination of the income tax altogether. I realize other forms of revenue generation could be socially unpopular and perhaps politically impossible but please consider that when our government is entitled to know anything about our income, true privacy as our Constitution requires can not be achieved. Currently we are required to report where we earn our money, where we invest it, our marital status, the number of children we have, where we get our health insurance, were we go to church, what charities we give to and so forth. (Incidentally, most of these items are things I am barred by law from asking any potential employees! Is the government so much more privileged?) And if you are self employed you even have to report, among other things, how many stamps you buy!

Only you have the power create a United States where law abiding citizens can truly be free from this unnecessary, and unreasonable burden. I implore you to eliminate this intrusion into the most personal and intimate details of our lives. I can only hope and pray that you choose total liberty for your country. Thank you for this opportunity.

Peter Chopelas
15105-317th St. NE
Arlington, WA 98223

CITIZENS FOR SOUND TAX REFORM

OFFICE OF THE PRESIDENT

Thursday, 8 June 1995

Dear Representative Mosely,

Thank you for addressing the issue of tax reform. It is long overdue, and a sound solution should pass your committee and the House without any trouble. Of course, a sound solution involves replacing the current system with the 17 percent flat tax, as proposed by Rep. Dick Armey. I hope you will support the flat rate tax, and will be watching Congress to see what you do. Thank you.

Cordially,

Tim Ruel

1276B Kamahele St
Kailua, HI 96734-3339
Phone/Fax: 808/261-7212

TO: OUR SERVANTS,
All elected/appointed officials
In the State of Washington and in Washington D.C.

FOR THE RECORD:

FROM: WE, THE PEOPLE, THE GOVERNMENT

Many lives have been sacrificed for this Flag, and for the FREEDOMS it stands for. Our State and Nation are on the brink of bankruptcy, because too many of our elected officials have submitted to the control of Our Prime Enemy: THE MONEY POWER. WE, The People, are losing our individual rights to LIFE, LIBERTY, and the PURSUIT OF HAPPINESS, because of the unconstitutional laws and regulations that have been passed, and forced upon us! Under the black and white illustration of Our Flag below, is the Pledge of Allegiance to our Flag and to our Country. Do YOU know this Pledge by heart? Do the words YOU say when you make this Pledge come from YOUR Heart? and bring a 'lump to YOUR throat'? Have YOU read and understand, the Constitution of the United States of America, and the Constitution of the State of Washington? If Your answers to these questions is 'YES', welcome aboard! Join the effort to RESCUE OUR STATE AND OUR NATION FROM BANKRUPTCY AND ANNIHILATION, by supporting THE 1% FLAT-RATE TRANSACTION TAX REFORM PROPOSAL, with NO DEDUCTIONS, NO EXEMPTIONS, and NO LOOPHOLES!

"I pledge allegiance to the flag of the United States of America, and to the Republic for which it stands, one nation, under GOD, indivisible, with liberty and justice for all."

Shortly before his assassination in 1865, ABRAHAM LINCOLN was quoted as saying: "I fear for the safety of my country. Corporations have been enthroned, an era of corruption in HIGH PLACES will follow, and the MONEY POWER, of the Country will endeavor to prolong its reign by working on the prejudices of the people, until the wealth is aggregated in a few hands and the REPUBLIC IS DESTROYED."

Don't let Lincoln's prophesy happen! If everyone who truely loves AMERICA, will JOIN THIS BATTLE TO RETURN OUR GOVERNMENT TO THE PEOPLE; and if the POWER TO CREATE MONEY and ISSUE U.S. TREASURY NOTES were once again IN THE HANDS OF CONGRESS; and if the unjust, complicated, and inadequate FEDERAL INCOME TAX were to be replaced with A LOW FLAT-RATE TRANSACTION TAX, America would be 'OUR AMERICA' again! YOU, who are members of the Committee On Ways And Means, have THE WAYS AND THE MEANS TO RESCUE OUR NATION... We pray that GOD will guide you, and that this mission will be accomplished, before you adjourn.

THE COALITION FOR A 1% TAX
Chairman, Clarence P. Keating, Jr.
2669 36th Avenue S.W.
Seattle, WA 98126; 1 (206) 937-1092

(Over)

THE 1% FLAT RATE TRANSACTION TAX

TWENTY FULL YEARS have been devoted to the research necessary to draft this TAX REFORM ACT: it is Constitutional, simple to administer, provides adequate revenue, and is worthy of YOUR support!

UNDER THIS ACT:

1. ALL STATE and LOCAL TAXES in conflict with our Constitution will be REPEALED! NO sales tax, property tax, B&O taxes, Hotel-Motel tax, excise taxes, tolls, and fees for licenses & permits.
2. Everyone, from the largest corporation to the individual citizen will be taxed at the same low rate (not to exceed the Constitutional limit of 1%).
3. The Tax will be paid by the SELLER OF GOODS OR SERVICES.
4. Checking or Saving Accounts will not be taxed; when you write a check, the person receiving the check will pay the tax.
5. At the present time, approximately 22% of your income is paid out in State and Local Taxes. That's $5500.00 on a salary of $25,000.00 a year. Under the 1% TRANSACTION TAX, YOU WOULD BE PAYING ONLY $250.00, to your State and Local Governments.

HIGHLIGHTS OF THE 1% FLAT RATE TAX:

Our research indicates that there are over 3 TRILLION dollars transacted annually, within the Washington State banking system alone. Taxing these dollars at 1% would produce a revenue of at least 30 BILLION dollars. Our present combined State, County, and Municipal budgets have been around 25 Billion. Under the 1% TRANSACTION TAX, the way would be cleared to wipe out our acquired bonded indebtedness and regain our sovereignty as a free state, since we will no longer suffer the indignities of having to submit to Federal blackmail control.

A DEBT-FREE WASHINGTON COULD BE THE BEACON TO GUIDE ALL THE STATES OUT OF CHAOS!

THIS TAX-REFORM PLAN WILL WORK!

There are literally TRILLIONS OF DOLLARS in electronic money transfers in our Country annually; these are untaxed dollars. Add to these the SPECIAL EXEMPTIONS granted the large Corporations and the LOOPHOLES they all find to use; and, finally, all of the OTHER TRANSACTIONS in the Market place, our verified figures show that a Tax of a fraction of 1% on the total of these transactions, would be sufficient to provide ALL of the revenue needed by every level of government in our Country! The 'Money Power' knows this too, as is evidenced by the 'CONSPIRACY OF SILENCE' on this TAX-REFORM PROPOSAL, by ALL the news-media under their control.

It has been proven over the years, the most recent was during President Kennedy's administration, that when taxes are lowered the revenue is increased because the economy is improved. The 1% TRANSACTION TAX will leave more money in the pockets of the people for them to spend or invest, and the economy will be stimulated again!

May 29, 1995

The Honorable William Archer, Chairman
Committee on Ways and Means
Longworth Office Building
Washington, DC 21565

ATTN: Phillip Mosley, Chief of Staff

Dear Congressman:

Attached are six (6) copies of "Income Tax Conclusions" which I would like entered into the record of the forthcoming hearings on Tax Reform. I understand your hearings are scheduled for June 6, 7, 8, 1995 in the Ways and Means Committee.

Congressman Archer, you are to be commended for the courageous public stand you have taken regarding the current income tax situation and the monstrous consequences perpetrated by the Internal Revenue Service bureaucracy. Millions of us agree with you and hope you prevail over any proposal that supports taxing the fruits of anyone's labor.

The Founding Fathers knew it, you know it and millions of us out here know it. That is, we know that a properly designed government's sole function is to protect the unalienable rights of every individual from foreign and domestic enemies, to ensure that justice is carried out in the courts and to provide an honest money system. THAT'S IT! We can do the rest. A proper government would only have limited powers to raise taxes, and thus, would be restricted to its 'necessary' size. The income tax was deliberately imposed so as to give government an unlimited source of funds to involve itself in an unlimited number of unnecessary activities, restricted only by the endurance of the people.

The attached "Income Tax Conclusions" were taken, with permission, from Lynne Meredith's "Vultures in Eagles Clothing", Prosperity Pubiishers, 17011 Beach Blvd., Suite 900, Huntington Beach, CA 92647. Her book is the culmination of seven years of research into the history of income taxes in America. Congressman Archer, if you are serious about getting all the facts out on the table, I urge you to have Lynne Meredith to testify before your committee.

Bob Corke

Bob Corke
(196) 441-8025
(916) 456-8902

INCOME TAX CONCLUSIONS

"[T]he Constitution recognizes the two great classes of **direct** and **indirect** taxes, and lays down two rules by which their imposition must be governed, namely the rule of **apportionment** as to direct taxes and the rule of **uniformity** as to duties, imposts and excises. "**Pollock v. Farmers' Loan & Trust Co.** 158, U.S. 601 at 637.

"**Direct taxes** bear immediately upon person, upon possessions and enjoyment of rights. **Indirect taxes** are levied upon the happening of an event." **Knowlton v. Moore**, 178 U.S. 41

Constitution Article I, §2, Cl. 3 "...**Direct** taxes shall he **apportioned*** among the several states, according to their respective numbers..." **Article I, §9, Cl. 4** "No capitation** or other **direct** tax shall he laid unless **in proportion to the census** of enumeration... "

***Apportionment** means to equally divide among the population (census) regardless of income. ****Capitation tax:** "a tax imposed upon a person at a fixed rate, regardless of taxpayer's ability to pay, occupation, assets or income."

1895	**Direct, unapportioned taxes on income ruled unconstitutional**	**Pollock v. Farmers Loan & Trust Co.** 157 U.S. 420 "...We are of the opinion that taxes on personal property, being a **direct tax**...the income of personal property, are likewise direct taxes. The tax...so far as it falls on the income of real estate or personal property, being a direct tax within the meaning of the Constitution, and therefore, unconstitutional and void because **not apportioned** according to representation..."
1909	**President Taft proposes Tarriff Amendment**	Congressional Record June 16, 1909, pg 3344: "It is now proposed to make up the deficit by the imposition of a general income tax, in the form, substance and almost the same character as that which, in the case of Pollock v. Farmers' Loan and Trust Co. (157 U.S. 420) was held to be a direct tax, and therefore **NOT** within the power of the federal government to impose unless apportioned among the several states according to population...I, therefore, recommend an amendment...imposing on all corporations...an excise tax measured by 2% on the net income of such corporations. This is an excise on the **privilege** of doing business as an artificial entity...This course is much to be preferred to the one proposal of reenacting a law once judicially declared to be unconstitutional."
1909	**Corporate Tariff Act of 1909**	
1913	**The 16th Amendment is declared to be ratified**	This was an unsuccessful attempt to override the Pollock Case ruling.
1916	**SUPREME COURT RULES: The 16th Amendment did not overturn the Pollock Case.**	"The 16th Amendment contains nothing repudiating or challenging to the rule of the Pollock Case..." **Brushaber v. Union Pacific RR Co.** 240 U.S. 1 at 12

1916	**The 16th Amendment did not give congress the power to collect an unapportioned direct income tax.** **The 16th Amendment is Constitutional because it is only applicable to indirect taxes.** **The income tax is an excise.**	"..[T]he confusion ... arises from the [erroneous] conclusion that the 16th Amendment provides... a power to levy an income tax which, <u>although direct</u>, should not be subject to the regulation of apportionment... [T]he far reaching effect of this erroneous assumption... if acceded to, would cause one provision of the Constitution to destroy another; ... bringing the Amendment into irreconcilable conflict with the **general requirement that all direct taxes be apportioned**... This result would create radical and destructive changes in our constitutional system....The 16th Amendment, as correctly interpreted, is limited to indirect taxes and for that reason is constitutional....The conclusion reached in the Pollock case...recognized the fact that taxation on income was in its nature an excise..." **Brushaber v. Union Pacific RR Co.** 240 U.S. 1 at 10, 11, 12,18,19

"Excises are taxes laid upon the manufacture, sale or consumption of commodities within the country, upon licenses to pursue certain [regulated] occupations and upon corporate privileges; the requirement to pay such taxes involves the exercise of privilege." **Flint vs Stone Tracy Co.** 220 US 107.

"The 16th Amendment does not extend the power of taxation to new or excepted subjects..."
<u>Peck v. Lowe,</u> 247 U.S. 165

1920	**The 16th Amendment did not eliminate the regulation of apportionment for all direct taxes.**	"The 16th Amendment must be construed in connection with the taxing clauses of the original Constitution " <u>Eisner v. Macomber</u>, 252 U.S. 189 at 205

26 CFR (1939) §9.22(b)-l "<u>Exclusions from gross income</u>.–The following items <u>shall not</u> be included in gross income and shall be exempt from taxation under this title:

> (b)-1 **Exemptions; exclusions from gross income.** Certain items of income...are exempt from tax and may be excluded from gross income...<u>those items of income which are, under the Constitution, not taxable by the Federal Government.</u>"

FINAL CONCLUSION: The 16th Amendment is constitutional because it is limited to **only** <u>indirect taxes</u>. **Compensation for Labor** and **the exercise of the Right to Labor are property** and, as such, are <u>items of income, under the Constitution</u> (Art. 1, §2, Cl.3, Art. 1, §9, Cl. 4), <u>not taxable by the Federal Government</u>. Compensation earned, exercising the Right to Labor is excluded from "Gross Income" and <u>**is exempt from taxation under Title 26**</u>, under the authority of Title 26, Code of Federal Regulations (CFR) ('39) §9.22(b)-1.

c:\..\conc3

303 WEST BROAD
TEXARKANA, TX 75503-2822
JUNE 18, 1995

CHIEF OF STAFF
PHILIP MOGELL
COMMITTEE OF WAYS AND MEANS
LONGWORTH H.O.B.
WASHINGTON, DC 20515

DEAR SIR:

RE HEARINGS FOR ALTERNATE FEDERAL TAXATION.

WE WOULD LIKE TO MAKE THE CASE FOR A 5% NATIONAL SALES TAX, WITH ABOLITION OF THE FEDERAL INCOME TAX AND INTERNAL REVANUE SERVICE, SINCE THE I.R.S. WOULD NO LONGER BE NECESSARY.

IN 1985, A FORMER I.R.S. EMPLOYEE, MIKE LOVE OF WACO, TEXAS, DREW UP A WANG COMPUTER MODEL FOR SUCH A TAX. WITH THE DEFICIT AT THAT TIME, A 5% NATIONAL SALES TAX WITH NO CREDITS, DEDUCTIONS, EXEMPTIONS OR EXCEPTIONS WOULD HAVE BALANCED THE BUDGET IN 2.62 YEARS. IN HIS MODEL, 2% WOULD GO TO THE GENERAL ACCOUNTING OFFICE AND 3% TO SOCIAL SECURITY. IN SUBSEQUENT YEARS, THE REVANUES NOT USED FOR THE CURRENT YEAR'S BUDGET COULD BE USED TO REDUCE THE NATIONAL DEBT. FIVE PER CENT IS PLENTY TO TAKE CARE OF OUR NEEDS AS THE TAX BASE (U.S. POPULATIUON) HAS INCREASED IN THE LAST DECADE.

ABOUT 40 STATES, INCLUDING TEXAS, COLLECT SALES TAXES. TEXAS COLLECTS HERS THROUGH THE STATE COMPTROLLER'S OFFICE. A SIMILAR OFFICE WITH CONSTITUTIONAL SAFEGUARDS COULD BE SET UP AT THE FEDERAL LEVEL TO COLLECT THE TAX FROM BUSINESSES OF ALL KINDS.

ADVANTAGES OF A NATIONAL SALES TAX INCLUDE EASE OF COLLECTION, NO PAYROLL DEDUCTIONS, THE SHRINKING OF THE UNDERGROUND ECONOMY, A BOOMING NATIONAL ECONOMY, WITH BUILT-IN INCENTIVES TO BUY HOMES AND OTHER BIG TICKET ITEMS AND LESS FEDERAL BUREAUCRACY.

OTHER ADVANTAGES: NO CUMBERSOME FEDERAL TAX RETURNS FROM INDIVIDUALS, NO RECORDKEEPING FOR TAX DEDUCTIONS BY INDIVIDUALS AND LESS WORK FOR ACCOUNTANTS.

THE ECONOMY WOULD BOOM AS A RESULT OF AMERICANS' GETTING MORE MONEY TO SPEND, THANKS TO LOWER TAXES. THIS WOULD RESULT IN MORE TAX COLLECTIONS, DUE TO THE INCREASED CONSUMER SPENDING. MORE JOBS WOULD BE CREATED AND PRODUCTIV1TY WOULD INCREASE. THIS IS ILLUSTRATED IN AN ADAM SMITH ECONOMIC MODEL IN BOTH PERFECT COMPETITION AND IMPERFCT COMPETITION.

THIS SIMPLE MODEL IS FOREIGN TO THE CURRENT ADMINISTRATON THAT INSISTS TAXES MUST BE RAISED TO FINANCE THE DEFICIT.

ONE DISADVANTAGE: A NATIONAL SALES TAX WOULD BE REGRESSIVE IN THAT LOW-INCOME PERSONS WOULD PAY PROPORTIONATELY MORE THAN MIDDLE AND HIGH-IMCOME PERSONS. HOWEVER, WE DOM'T SEE THIS AS A BIG PROBLEM, SINCE PEOPLE ARE USED TO PAYING SALES TAXES IN MOST STATES. IN TERMS OF DOLLARS, HIGH-INCOME PERSONS WOULD PAY THE MOST.

ONE LAST ISSUE. THE PROPOSED 17% FLAT TAX PROPOSED BY CONGRESSMAN DICK ARMEY (R-TX) IS, IN OUR OPINION, AN INSULT. FOR SOME PERSONS IN THE 15% TAX BRACKET, ESPECIALLY THOSE JUST STARTING SMALL BUSINESSES, IT COULD MEAN A TAX INCREASE. THIS TAX COULD BE RAISED AT ANY TIME, OR INDEXED. THE CURRENT I.R.S. BUREAUCRACY WOULD STAY IN PLACE. (THE FEDERAL GOVERNMENT IS LOOKING TO CUT JOBS. HERE'S A GREAT PLACE TO START.) UNDER OUR PROPOSAL, IT WOULD TAKE A 2/3RD'S MAJORITY IN THE HOUSE OF REPRESENTATIVES TO RAISE THE SALES TAX, OR, BETTER YET, WHY NOT PUT IT TO A VOTE OF THE PEOPLE? .

WE BELIEVE A NATIONAL SALES TAX WOULD BE ADVANTAGEUS FOR OUR ECONOMY AND FOR TAXPAYERS AND WOULD CUT THE BUREAUCRACY. EVERYONE WE'VE MENTIONED THIS TO LOVES IT; IT WOULD HAVE BROAD-BASED SUPPORT. PLEASE CONSIDER A NATIONAL SALES TAX.

PLEASE REPLY. THANKS.

SINCERELY,

Hazel Cotton

HAZEL COTTON

6/19/95

PHILLIP MOSLEY, Chief of Staff
1102 House Office Building
Washington, DC 20515

Dear Sir:

I am for a 13.5% Consumer Tax which will omit tax on housing, food and medical care.

Get rid of IRS!

Thanks.

B. Denney
3221 Louisville
El Paso, TX 79930

COMMITTEE ON WAYS AND MEANS

HEARING ON TAX REFORM

JUNE 6-8, 1995

STATEMENT OF THE DISTILLED SPIRITS COUNCIL
OF THE UNITED STATES

The following statement is submitted on behalf of the Distilled Spirits Council of the United States, Inc. (DISCUS), for inclusion in the printed record of the joint hearing on fast track issues. DISCUS is the national trade association which represents U.S. producers and marketers of distilled spirits. We welcome the opportunity to contribute to the Committee's investigation into reform of the current Federal tax system.

DISCUS concurs with Chairman Archer that any reform of the federal tax system should be directed towards simplicity, increased savings and investment, economic efficiency and international competitiveness. In addition, DISCUS believes that the various tax reform proposals should be evaluated in terms of the incidence of taxation on each sector of the economy as well as on competing lines of business, the impact on state revenues, and the short-term (first 4-5 years) macroeconomic impact.

Among the several tax reform proposals now before the Ways and Means Committee, four types are particularly noteworthy: (a) flat tax proposals by Rep. Richard Armey (R-TX), Sen. Richard Shelby (R-AL), and Sen. Arlen Specter (R-PA); (b) the national sales tax proposals by Rep. Bill Archer (R-TX) and Sen. Richard Lugar (R-IN); the Unlimited Savings Allowance (USA) Tax proposal by Sens. Pete Domenici (R-NM) and Sam Nunn (D-GA); and the subtraction-method VAT proposal by Rep. Sam Gibbons (D-FL). DISCUS makes the following recommendations to the Committee, and would welcome the opportunity to elaborate upon these points if called upon by Congress:

- **The federal government should reduce its dependence on narrowly-based excise taxes.**

  - High rated taxes on specific products – such as on distilled spirits for which 44% of the price of a typical bottle is taxes – are fiscally inefficient. Further tax increases have little revenue-generating potential, and further distort the allocation of resources in the market.

  - Liquor excise taxes are hidden from consumers who therefore do not realize how much tax they have to pay. The tax is imposed on the supplier who passes it on as a part of the cost of goods to the wholesaler.

  - The government collects much less money from the excise tax than consumers have to pay. Excise taxes cascade into higher prices since – as a cost of goods – it is marked up by the trade just like other costs of goods.

  - Federal tax reform focused on a broad tax base at a uniform marginal rate on all tax payers would be more fair, and cause less price-induced distortion of resource allocation.

- **The federal government should not tax products twice, nor should there be taxes imposed on taxes paid. Presently, distilled spirits is taxed several times.**

  - It pays an excise tax as it leaves the distillery or customs.

  - It pays another excise or "monopoly" tax as it enters state jurisdiction.

  - It pays sales tax(es) as it is sold to the consumer. Not only is the product

taxed, but also taxes are paid on taxes collected earlier by federal and state governments.

- A national sales tax would compound this cascading of taxes because that high-rated tax would constitute another (a) tax on the product, (b) tax on the federal excise tax, and (c) tax on the state excise taxes.

o **Existing specific taxes such as the FET on distilled spirits should be repealed if a new layer of tax, such as a national sales tax, is enacted.**

- Imposing a new tax in addition to, or on top of, the existing FET (Federal Excise Tax) burden would be disastrous for the industry.

- A national sales tax would be particularly heavy on high-priced, premium products. It would move away from the principle that the volume of alcohol (not the value of alcohol) in all alcohol beverages should be taxed.

- Tax fairness demands elimination of double taxation. It would be unfair tax policy to impose a national sales tax or VAT without repealing other indirect taxes on distilled spirits.

- The United States would want to avoid the disastrous experience of Canada, where a "tax revolt" resulted from superimposing a high-rated value-added "Goods & Services Tax" in addition to an existing federal excise tax and provincial sales taxes.

o **The tax burden should be equitably distributed, among both tax payers and products taxed.**

- Regressive federal excise taxes conflict with the principle of tax fairness. Like sales and VAT taxes, excise taxes -- even at lower consumption per capita among lower-income families -- consume a greater portion of income from low- and middle-income families than from the rich.

- Increases in these taxes also cause a greater proportion of jobs lost among the poor than among the wealthy.

- If alcohol content remains the basis on which beverage alcohol will be taxed, government should give serious consideration to a revenue-neutral adjustment of all alcohol taxes in order to apply a uniform tax to all alcohol.

o **Any new broad-based tax should be applied at a uniform rate to all purchases, thereby avoiding the costly complexity of multiple rates.**

- Simplicity and administrative efficiency would be lost in an attempt to make a national sales tax or VAT more equitable by imposing multiple rates.

- The United States would wish to avoid the experience of Belgium, France, Ireland and Italy which have multiple rated taxes.

- There are other, more efficient ways to address equity concerns than by multiple rates.

o **The federal tax system should not undermine state-level taxation systems, or have the unintended effect of diverting revenue from states to the federal government.**

- Following the FET increases in 1985 and 1991, state and local governments

lost more than $140 million in excise tax revenues, and saw unemployment compensation increase by $70 million.

In summary, DISCUS agrees that in the interest of economic efficiency and international competitiveness, federal revenues should be raised through broadly-based income or consumption taxes rather than narrowly-based taxes such as the federal excise tax. The tax system should not waste time and resources of taxpayers and the government. The tax system should encourage businesses and individuals to increase savings and investment. The tax should be far simpler to calculate and administer than the present system. The tax should have a uniform rate with an absolute minimum of exceptions (loopholes, exemptions). Tax reform and all taxes should be fair -- to competing products (e.g., spirits, wine and beer), to those less able to pay, to workers and business, and to the states.

Americans should be as aware of the taxes they have to pay as well as of the benefits they receive so they can evaluate the trade-off when a tax increase is proposed. For this reason, taxes should not be hidden as are federal excise taxes. Most importantly, it also means that a double tax should not be imposed, i.e., the imposition of any type of new consumption tax must include the repeal of already existing and highly regressive excise taxes.

June 22, 1995

DISPELLING THE REVENUE TAX CONFUSION

Dear Chairman Archer:

To avoid the unnecessary confusion regarding the Income Tax, it is imperative that a review of the United States Supreme Court ruling should once and for all settle any questions as to whether the Income Tax is a Direct Tax or an Indirect Tax. In its unanimous ruling, the Supreme Court in Brushaber v. Union Pacific Railroad Company, 240 U.S. 1 (1916) held that the 16th Amendment and the Income Tax enacted thereafter is constitutional because it is restricted to that class of taxes known as Indirect Taxes, which include excises, imposts and duties, all of which are privilege taxes.

The jurisdictional question for purposes of enforcing the Income Tax depends entirely upon the question as to who or which persons are "subject to" the tax, and why and/or how do those persons become subject to an indirect tax. The question is jurisdictional because the term "taxpayer" is strictly a legal term narrowly defined by law as being only such a person who is subject to such a tax. For example, see Title 26, Section 1313(b):

> ". . . the term 'taxpayer' means any person subject to a tax under the applicable revenue law."

This does not include any direct tax. The Supreme Court's rulings in Veazie Bank v. Fenno, 75 U.S. 533, Springer v. United States, 102 U.S. 586 and Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429 clearly show that direct taxes are only those laid upon the several States, and that Congress, under Article 1, Section 2, Clause 3, and Article 1, Section 9, Clause 4, may tax the States, provided that such tax shall be apportioned according to the respective populations of the several states, as Congress has done in 1798, 1813, 1815, 1816, and 1861. Such a tax on the States is the only direct tax that Congress may lay and collect.

The Constitution's rule of apportionment as to direct taxes is based upon and controlled by land values strictly in terms of people or population instead of any monetary "market value". Congress must first determine how much money it will raise by such a tax, thus the total amount of the tax is set by Congress and each state pays its share of that amount based upon and according to their respective or individual populations. For example, Congress needs 50 billion dollars and California's population is approximately 10% of the nation's population, and therefore, California's share of that 50 billion dollar tax would be approximately 5 billion dollars. The enforceability of Congress' power of direct taxation is that each state may raise its share from its own real estate tax rolls of each state.

But land speculators, which include banks, insurance companies, individuals and corporate America generally, have historically prevailed through their real estate lobby in preventing Congress from exercising this revenue power, which would tend to discourage and reduce the parasitic enterprise of land speculating. As a result, Congress has not used this power since the Civil War and has been forced by the real estate lobby to eke out the nation's revenue only by its power of indirect taxation.

WRITTEN COMMENTS OF THE EDISON ELECTRIC INSTITUTE

REGARDING REPLACING THE FEDERAL INCOME TAX

BEFORE THE COMMITTEE ON WAYS AND MEANS U.S. HOUSE OF REPRESENTATIVES

JUNE 22, 1995

The Edison Electric Institute (EEI) is the association representing the nation's investor-owned electric utility companies. Its members serve 99 percent of all customers served by the investor-owned segment of the electric utility industry. EEI's members generate approximately 79 percent of all the electricity produced in the United States and serve 76 percent of the nation's customers. EEI and its member companies appreciate the opportunity to present our written comments on this important issue, and look forward to working with the Committee in its search for an alternative tax system to replace the federal income tax.

EEI believes that a broad-based consumption tax is a better way to raise federal revenue than the current corporate income tax. Our current tax system is extremely complicated and burdened with a tangled multitude of exemptions and loopholes. It punishes success and rewards consumption at the expense of savings and investments, and is extremely difficult and expensive to administer. EEI supports the Committee on Ways and Means' efforts to develop an alternative tax system that is fairer and encourages savings. Our testimony will predominately discuss a value-added tax (VAT), which EEI favors as an alternative to our current income tax. If the Committee wishes, EEI will provide additional comments on either the flat tax proposed by Representative Armey or S. 722, the Unlimited Savings Account (USA) tax proposal, at a later date.

BROAD-BASED CONSUMPTION TAX

A VAT is the best alternative to fund the federal government into the 21st century. Although consumption taxes can take many forms, a VAT has become the international consumption tax of choice, and with good reason. A VAT is far superior to our current federal income tax system because it does not rely heavily on income, but promotes a balance between income and consumption. Additionally, it would provide stability and neutrality to our tax system. Since its base is large, encompassing most economic activity, the VAT is nowhere near as vulnerable to economic fluctuations as an income tax, nor dependent on particular industries. Moreover, it taxes all financial factors of production equally, not discriminating between debt and equity, nor penalizing a particular form of business organization. Compared to the income tax, it encourages capital investment and is favorable to international trade. In short, a VAT meets Chairman Archer's goals of administrative simplicity, stimulation of savings and investment, improvement of our international competitiveness, as well as collection of tax revenue from the "underground economy" and from others who currently do not comply with the tax laws. Set forth below is a discussion of how a VAT meets each of these objectives as well as some utility-specific concerns that need to be addressed.

ADMINISTRATION AND COMPLIANCE

The administrative and compliance burdens of a VAT vary greatly, depending on the type adopted. As a rule, the more complicated the tax, the more costly it will be for the government to administer and more difficult for taxpayers to comply. Ideally, a VAT would tax the consumption of all goods and services. A broad-based VAT has two advantages. First, it discriminates less among taxpayers based on their preferences for particular goods and services. Second, a low tax rate on a broad base changes the relative prices of consumer goods and services less than a high tax rate on a narrow base. Excluding goods and services from the VAT base increases the tax rate needed to raise a given

An Indirect Tax is a tax upon the exercise or exploitation of an intangible privilege, which is typically created and granted by a state government permitting certain people to engage in or pursue a certain business, profession, occupation, or trade that is otherwise unlawful. Said privilege so granted is evidenced by a license, which, in and of itself, is a taxable gain. And the use or exploitation thereof is also taxable, with the amount of the tax typically being measured by the income, which is procured under said license. Therefore, an indirect tax could be called a privilege tax. Of course, a God-given, constitutionally protected fundamental human right cannot to be taxed for revenue purposes.

Due to some people's lack of knowledge and understanding of the difference between direct taxes as property taxes and indirect taxes (excises, imposts, and duties) as privilege taxes, their ignorance is often exploited by their employers, who happen to be subject to a privilege tax which includes the income tax and the Social Security tax.

The problem is not only misconduct by the IRS, but even more, it is misconduct by thousands of employers who are unlawfully and fraudulently taking monies from the paychecks of their employees who are not subject to any income tax or any Social Security Tax, or any other revenue tax, and, therefore, no money may lawfully be withheld from their paychecks under the guise of "withholding and collecting" a tax.

Ignoring all of this, the employer, as a condition of employment, unlawfully demands a Social Security number from a prospective employee, who usually submits the number or obtains one in order to "get a job". If the employee is merely exercising a God-given, constitutionally protected, fundamental human right to work, for which no license is needed, then he is not subject to a tax, and, therefore, is not a "taxpayer" within the meaning of the law and cannot lawfully be identified as such, either by number or any other means. Nevertheless, in most instances, his Social Security Number is unlawfully treated by the employer as if it were a "taxpayer" identification number (TIN) so that the employer who is otherwise subject to the full amount of the Social Security Tax, will unlawfully shift half of this Social Security Tax on to the employee.

Not only must Congress overcome the land speculators' real estate lobby and return to using its constitutional power of direct taxation of the states, which is payable from their own real estate tax base, Congress must by appropriate legislation, send a message to all employers to cease and desist from unlawfully attempting to apply the revenue law to employees who are not subject to a tax.

Yours truly,

Sheridan B. Duncan

amount of revenue. A single rate, broad-based VAT would promote economic neutrality and minimize compliance and administrative costs.

If the structure of a VAT includes exemptions and multiple rates, the GAO estimated that the administrative costs could be as much as $700 million higher than a VAT without exemptions. Various factors determine compliance costs; most importantly the design of the consumption tax, the frequency of the reporting period, and the threshold level of taxation. While we understand that the structure of a VAT may need to contain tradeoffs to meet different social, political and economic objectives, such tradeoffs reduce total revenue generated and complicate tax administration.

EFFECT ON SAVINGS AND INVESTMENT

The United States economy suffers from an imbalance between savings and consumption. The national savings rate has declined steadily through most of the 1980s and 1990s, and is now lower than that of most of its trading partners. Between 1983 and 1992, the net national savings rate of the United States averaged 3.6 percent. Over the same period, compared to the United States, Japan's net national savings rate was five times as high, Germany's rate was three times as high, and the European Union countries' savings rates were, on average, twice as high. The U.S. net national savings rate dropped below 2 percent in 1992.

Net domestic investments in those countries noted above during the 10-year period were 1.5 to three times those in the United States. Due in large part to our low savings rate, compensation and real wages have declined in relation to historic trends. The current federal income tax system contributes to this deterioration because it creates biases that distort economic decisions and penalize savings. A low savings rate leads to reduced investment, lower economic growth, fewer jobs, and a lower standard of living. The result of these biases is to make the United States dependent on foreign savings for capital formation and to sustain its trade deficit.

A VAT can stimulate savings if it replaces other taxes that discourage savings. The savings rate measures a society's desire to sacrifice consumption today for increased consumption tomorrow. We need to encourage increased savings in the United States. Without savings, funds are not available for capital formation and financing of the national debt cannot occur without borrowing from abroad.

EFFECT ON INTERNATIONAL COMPETITIVENESS

Since its inception in the 1950s, both developed and developing countries have widely adopted the VAT. According to the International Monetary Fund, about 90 countries have adopted VATs. This includes all fifteen of the countries that make up the European Union and twenty-three of the twenty-five industrial nations that make up the Organization for Economic Cooperation and Development. The United States remains one of two Western industrialized countries without a national consumption tax. As a result, the United States relies more heavily on income and payroll taxes than most of its major trading partners. This puts United States companies and workers at a disadvantage as they attempt to compete in the ever expanding global marketplace.

The competitiveness of the United States would improve if a VAT replaced our corporate income tax. A VAT is "border adjusted," i.e., imposed on foreign imports while exempting United States exports. The principle is to impose the tax in the country where consumption of the goods or services takes place. Border tax adjustments are indirect taxes that are refundable under the General Agreement on Tariffs and Trade (GATT). A destination-based VAT with border tax adjustments provides a trade advantage over an origin-based VAT without a border tax adjustment.

Enacting a VAT in addition to our current income tax system would not create a trade advantage. However, if a VAT replaced the corporate income tax, the price of United States products could fall compared with foreign goods to the extent that the price le\ reflects the corporate income tax. If replacing the corporate income tax with a VAT low

the prices of American goods, then the United States trade balance would improve.

UNDERGROUND ECONOMY

Various estimates indicate that under our income tax system, lost revenue from the "underground economy" is as high as $200 billion annually. This is a significant revenue loss almost equal to the current federal budget deficit. An invoice-method VAT would go a long way toward taxing the underground economy as it would be more difficult to escape taxation. The invoice-method requirements of a VAT are necessary to ensure a high level of compliance, and thereby to address Chairman Archer's concern with the underground economy.

UTILITY ISSUES

The interaction of a VAT with state ratemaking raises issues for the electric utility industry. The "revenue requirement" of an electric utility includes its tax liability and is in principle recovered through the ratemaking process. State gross receipts taxes, state franchise taxes, and federal income taxes are all liabilities included in a utility's revenue requirements. A sales tax is not part of the revenue requirement. Utilities cannot automatically adjust rates to reflect changes in such taxes since these changes require approval of regulatory authorities. By contrast, a sales tax is generally a liability of the consumer with utilities serving solely as collection agents for the government. Consequently, utility bills automatically reflect a sales tax.

Treatment of a VAT for ratemaking purposes should ensure that the ultimate consumer of electricity bears the cost. However, the design of a VAT raises several issues. The design of a VAT could be such that utilities are simply collection agents. This is how the House drafted the proposed BTU tax in its version of the Omnibus Budget Reconciliation Act of 1993. An invoice-method VAT is a liability of the ultimate customer and would be collected and remitted by the utility. It would not be part of the utility's revenue requirements. Instead, the VAT would be a separate calculation outside the ratemaking process.

Alternatively, the design of a VAT could designate the seller as the taxpayer. Such a design would create regulatory problems for the utility. For example, under a subtraction method VAT, such as the USA business tax, utilities likely would be required to obtain regulatory approval in order to include VAT amounts in rates.

TRANSITIONAL RULES

EEI realizes that the implementation of any alternative tax system will require complicated transitional rules. Our current income tax system requires the depreciation of capital expenditures over varying lives and provides for limits on the use of credits and losses. Any alternative tax system should provide corporations with an ability to amortize their remaining tax bases in capital assets, use any tax credits qualified under existing law, and utilize any unused net operating losses.

CONCLUSION

EEI recommends that this Committee adopt a position supporting an invoice-method VAT as a replacement for our current federal income tax system and establish as its number one priority, its implementation. **EEI believes that implementation of a VAT should only be adopted as a replacement for our current income tax system and not as a means to generate additional revenue.** Additionally, EEI believes that a VAT should tax all business consistently. We thank the Committee for the opportunity to present our views, and we look forward to working with you in the future on this proposal and other important matters.

Comments for the Record
In Connection with Hearings on Replacement of the Federal Income Tax
June 6 through June 8, 1995

By R. Randall Capps
Federal Tax Director and Assistant Treasurer
EDS

On behalf of EDS, I would like to compliment Chairman Archer and the Committee on Ways and Means on the committee's effort to find ways to make the federal tax system more simple and to reduce negative effects of the current system on the economy. EDS believes that it is good to review possible alternatives to the current system and would like to be a constructive participant in efforts to improve or replace the current process. I would, however, like to raise a word of caution with regard to some of the proposals under consideration which could, as currently structured, pose serious problems for the information technology industry in particular and for U.S. workers and the economy as a whole.

Several options under consideration would employ a subtraction type VAT structure as the principal vehicle of taxation or as the principal vehicle of taxation applied to business income. The most detailed of these is, perhaps, the USA Tax Act of 1995 (the "USA tax") proposed by Senators Pete Domenici (R-N.M.) and Sam Nunn (D-Ga.).

Under the USA tax, capital expenditures and expenditures for equipment would be fully deductible but deductions for wages and employee benefits would be eliminated. The loss of the deduction for wages and benefits would be partially offset by a reduction in the corporate tax rate and a credit for payroll taxes. However, the resulting tax increase would still be dramatic for companies in labor intensive industries, particularly those high growth, high wage industries such as information technology services which are the engines of economic growth and high wage employment for the future. It is probable that the tax burden of many high technology companies would rise by as much as 50 percent.

In addition, under the USA tax proposal, wages would be taxed twice, once at the corporate level and once at the individual level. In the case of a pure subtraction VAT, the double taxation of wages would be eliminated, but the burden on labor intensive companies would be even greater because the corporate tax rate would have to be much higher under a pure subtraction VAT system. While such systems are typically regarded as "consumption" taxes, it is important to note that a subtraction VAT is in essence a tax on payroll.

There are a number of problems that could arise from these systems. Because wages and benefits are not deductible and the costs of plant and equipment are immediately deductible, the systems dramatically increase the costs of labor in comparison with the costs of equipment. Thus, industries that are heavily dependent on the contributions of individual workers would be disadvantaged, especially those industries that employ highly skilled workers and pay good salaries and provide good benefits. In addition, these systems would encourage companies to replace workers with technology, because the costs of labor would be artificially high in comparison with the cost of machines. Finally, the systems would provide an incentive to locate labor intensive work outside the United States.

As mentioned earlier, the Domenici-Nunn proposal attempts to mitigate the negative effect on labor intensive industries by allowing a payroll tax credit and reducing the corporate tax rate to 11 percent. However, even a 7.65 percent payroll tax credit will not offset the 11 percent coporate tax with respect to low and middle income workers, and it provides no offset whatsoever with respect to benefits or to wages that exceed the Social Security cutoff. Moreover, there is a strong tendency for tax rates to increase over time, and there is little likelihood that the credit would increase proportionately.

We realize that the discussion of alternative systems is in a very early stage, and we would very much like to continue to be a part of that discussion. We hope that any system that is adopted will not have a disproportionate affect on labor intensive industries, particularly those industries where the United States is a world leader. I would be happy to provide additional information on the effects of various proposals on our industry as the discussions progress.

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11 June 1995

Mr. Philip D. Mosely
Chief of Staff
Committee on Ways & Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Mr. Mosely:

This past week the House Committee on Ways & Means, chaired by Representative Bill Archer, held hearings about overhauling the collection of taxes by the Federal government.

I am writing to share my preference with the Committee as to what I would like to see replace the current Federal income tax system. ***I favor the imposition of a national sales tax***, collected by the individual states along with their own sales taxes, ***in place of the current system***, for several reasons. Here are five:

- **INCREASE COMPLIANCE RATE:** I understand that there is something like a 98% compliance rate here in Texas for the collection of sales taxes. I understand that the compliance rate for Federal income tax is *much* lower. A national sales tax will be fairer.
- **ENCOURAGE SAVINGS AND INVESTMENT:** Income-tax payers are penalized for saving and investing. Sales-tax payers are rewarded for these activities. A national sales tax should lead to greater financial security for individuals and the country.
- **REVEAL CURRENTLY HIDDEN TAXES:** Our current system prevents consumers from seeing what fraction of what they pay for goods and services goes to the Federal government in the form of taxes. A national sales-tax system would make those taxes obvious. This should make the Federal government more accountable.
- **ELIMINATE MOST COMPLIANCE EXPENSES:** Various groups estimate that we spend billions of dollars annually to comply with the current system. A national sales-tax system should eliminate these expenses and add only fractionally to the sales-tax compliance expenses required to make *state* sales-tax payments. This should save billions annually.
- **INCREASE PEACE OF MIND:** The current system strikes fear in the hearts of taxpayers, most of whom honestly file their returns but fear being audited by the IRS. A national sales-tax system will eliminate fear of audits, which has an immeasurable but definitely negative effect of the nation's productivity.

Recognizing that everyone has basic expenses, some would argue that food and housing be exempt from a national sales tax. After all, even the poorest in this country must buy food and housing. However, I tend to favor ***NO exemptions*** for any product or service, including food or housing, because I believe that exemptions, exceptions, etc., are ***a corrupting influence***.

Instead, I favor vouchers being included in the system. A voucher would be sent to each American each month. This would be financially equivalent to what we have now: an income level below which we do not charge taxes.

Sincerely,

Kirk Mahoney

Kirk Mahoney, Ph.D.
Owner

June 06, 1995

Philip D. Moseley
Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Richard C. Foreman
8835 Via Diego Lane
Lakeside, California 92040-5045

Hearings held June 6, June 7, and June 8, 1995-
Main Committee Hearing Room
1100 Longworth House Office Building

Distinguished Ladies and Gentlemen,

I would like to commend you on the task upon which you now embark. The income tax as it presently stands is an infringement upon the rights and freedoms of all Americans wether they are rich, poor, or "middle class". The income tax as it presently stands enslaves the rich into a lifestyle of deceit, enslaves the poor in their welfare prison, and enslaves the "middle class" into forced labor with both spouses finding it necessary to leave the home and find employment or live in abject poverty.

To state my views quickly let me just ask that you include the book "The Tax Racket: Government Extortion From A to Z" by Martin Gross, a name you should all be familiar with. I feel that the proposal for the "National Sales Tax " would serve our nation best, but only if the 16th Amendment is repealed, the Internal Revenue Service is abolished, and the IRC, and all regulations promulgated by this agency, be incinerated. Pardon my over-zealousness.

I thank you again.

Richard C. Foreman

Philip Mosley - Chief of Staff
House Committee on Ways and Means
US House of Representatives
1102 Longworth House
Washington D.C. 20515

June 7, 1995

Dear Sirs:

I am in favor of a retail consumption tax **if the sixteenth amendment is repealed**.

If you would eliminate income taxation and all the monitoring and compliance infrastructure necessary to enforce it; you would not only save a great deal of money on these unnecessary functions, but **you would restore hope to the nation**.

You would see the floodgates of productivity and creativity burst open in this nation once again. You would see people anxious to work because **they would keep what they earned**. They wouldn't have to be afraid anymore.

They wouldn't fear that they had inadvertently violated one of the thousands and thousands of petty bureaucratic rules. They wouldn't have to submit to the **unconscionable TCMP anal exams of the IRS**.

When I first heard that there would be open hearings on possible replacement of the income tax my heart rejoiced. I never dreamed the possibility existed that in my lifetime that any elected representatives would ever seriously consider reversing the totalitarian trends of the late twentieth century. Please restore the equal standing of all men before the law; everyone should pay the same thing. The government's proper role is to provide justice for its citizens. Remember, **Fairness is the enemy of justice**.

Steven R. Friedrich
5661-A Gold Hill Road
Placerville, CA 95667-9434
(916) 642-8731

Tax Reform
House Ways and Means Committee
Longworth Building
Washington, D.C. 20515

June 13, 1995

Dear Legislators:

Following are recommendations for Tax Reform:

1. Balanced budget amendment.
2. Repeal the XVI Amendment.
3. Abolish the IRS.
4. Establish a ten percent (10%) tax on commodity purchases, proceeds of which may be used to operate Federal Government within bounds of Constitution, except in case of war declared by Congress.
5. Voluntary tax:
   50% for federal senators, divided equally.
   25% for representative;
   25% as designated by citizen.

With kind regards and best wishes for your success in this endeavor.

Johana Moon Garrison
260 Butte Drive
Baywood Park, CA 93402
(805) 528-8720

5621 Charlotte Way, #31
Livermore, California 94550
June 15, 1995

Phil Mosely
Chief of Staff
Committee on Ways and Means
1102 Longworth Office Building
Washington, D. C. 20515

Dear Mr. Mosely:

A tax on income discourages wealth creation and savings. When applied to business, it encourages debt and discourages the accumulation of equity. Also, the additonal record-keeping required of businesses amounts to a hidden tax in itself.

The present system requires the intrusion of a bureaucracy into the lives of citizens. To make things worse, the IRS is largely exempt from the requirements of due process.

I believe that either a flat tax or a consumption tax would be an improvement on the present system.

Sincerely yours,

Michael E. Goldsby

Sidney J. Gutting, DC
947 Central Avenue
Louisville, Kentucky 40208-1213
May 29, 1995

House Ways & Means Committee
ATTN: Phillip Mosley
Longworth House
Washington, DC 20515

Dear Representative,

This letter is being sent and is to be read before the House Ways and Means Committee on Tax Reform scheduled for June 6,7, & 8. I feel that it is imperative that my view be expressed concerning the following issues or areas of interest.

Personal exemption in respect to taxes should be raised to about $12,000 or more before being taxed. We pay taxes on items as we buy them with the money that is income that we are taxed on before we receive it, whether salary or wages. Sounds like double taxation. Though one of the following examples is more of a state level issue, many similiar situations exist in Federal Government: In my family I pay a tax for schools and have no say in their running because I have no children attending those schools - I have no children in private schools - I have NO CHILDREN, but pay taxes for public education. Federal level might be the Food Program, I pay for food for children and I have nc children, I also pay for many children's programs in welfare, but I have no children. Additionally the Federal Programs do not recognize me as a professional - I am a Chiropractor, a professional in the medical community that is ignored as a recognizable appropriate care within Federal Employee and Care Programs. These examples sound like examples of taxation without representation both at State and Federal levels.

The above and the fact that the Revinue Act of 1862 is antiquated and needs to be not only reviewed but updated to today, rather than war time, are reasons that support a flat tax. If everyone paid taxes - the same reasonable amount (approximately 8%) - on items purchased then it would ensure that no one "got away" from paying their faire share and would dramatically simplify filing of taxes. The process of filing taxes has gotten so involved and complicated that a person almost needs to be a CPA to begin the process of calculating and completing the forms.

Also, one issue that needs to be addressed by all is the fact that taxes began as a temporary, voluntary act that would help the country, therefore we had no true liability to pay. Now do not get me wrong I love my country and the freedoms that exist, I only want to see the original intent of the founding of this great country continue rather than it becoming as the Soviet, Communist communities (which by the way have FAILED!! Socialism does not work). As time has gone by the areas that are being "helped", however, has increased to such an extent that the cooperative volunteers of this country

are being victimized - raped, if you will, by their own government. A government that is increasingly endeavoring to control and overpower it's constituency.

Another example of this power would be, the priveledge that IRS has to seize assets before wrong doing has been established. I personally have been on the other end of IRS erroneously claiming a debt. One year they claimed that I owed about $200.00 more in taxes due to an addition error. Outcome, I did not owe this - there was an addition error, but on their part. The very next year they claimed I owed about $266.00, rather than research it (there did exist a remote possibility I could have made an error and owe some) I sent a check for the full amount. About four to six months later, they were penalizing me $5.00 for not signing?? a form that I had made a copy of and returned to them. They threatened all types of repercutions if I failed to pay this $5.00 over something I had signed, dated, made copies of (why would I do this and not return the form?), and returned; they could not find the original so acused us of not following their directions. The letter they sent us was not very polite or consideration given to the fact that they might have been in error. Then when we called, they wanted us to send a letter, copies of items, etc. and request that this $5.00 be corrected, they claimed that they could not correct this charge without additional paperwork! This amount of money may seem small BUT similiar situations could and have occured with larger sums involved and no reacquition of losses (personal properties) were able to be recognized.

There has also been a discussion of a change in the tax programs to change inheratence taxes. Think for a moment, many parents strive all their lives just to help their children have a better life; now the government is wanting to take more of this away from people. Where is the encentive in this country anylonger to prosper, even slightly - answer is there is none. If we are honest, we know already that by the time I am old enough to draw social security it will probably be non-existent. Example of a tax that was established, misused, and this one no one was ever given the opportunity to not participate. It was mandated that we all pay into this program. Had we, the hard working people of this country trying to make a living for ourselves and families, been given the option to invest these monies rather than loose them, there would be little to no need for social security.

The waste, misuse, opression must stop. I work often six days a week just to make ends meet, my wife works with me and works numerous additional weekends, and you want more of me? This is no longer the country our forefathers faught and died for, it has become what they fled.

Sincerely,

Sidney J. Gutting, DC

Sidney J. Gutting, DC

Sandy Harper
20 Corte Almaden
San Rafael, CA 94903'
June 11, 1995

P.D. Moseley
Ways and Means Committee
U.S. House of Representatives
Longworth Building
Washington, D.C. 20515

Re: Review of U.S. Tax Policies

Dear Mr. Moseley:

I believe that your committee is planning on studying the revision of our tax policy. Hurrah! We have long needed to have our elected officials listen to our voices and make some significant changes in this antiquated tax system. Under the Internal Revenue Service we have watched the system become a monster without a master who has been left to run amuck. There is no need for such a complicated tax system paying for who knows what.

I would like to see a flat tax or a national sales tax type alternative to the system now in place. It is outrageous to have to hire a tax accountant to file taxes. Please look at simplifying our tax laws so this task will evenly distribute the tax burden and at the same time make the yearly reporting to be done on one page without the assistance of an accountant.

I have found the tax laws to be encumbering and discouraging. Our country was founded with the idea that a person could strive to get ahead with hard work and an entrepreneurial spirit. Because of the tax system that we now live under that is rarely possible.

My request to you is to simplify, grow government smaller and distribute the tax burden more evenly.

Sincerely,

Sherry Harper
20 Corte Almaden
San Rafael, CA 94903
June 11, 1995

P.D. Moseley
Ways and Means Committee
U.S. House of Representatives
Longworth Building
Washington D.C. 20515

Re: Review of U.S. Tax Policies

Dear Mr. Moseley:

I understand that your committee is beginning a study to revise the current tax policy. I am thrilled that this has finally reached a place of priority with our elected officials. I am in favor of any kind of revision to our tax laws that will finally bring some relief to the citizens of this country. We have become so controlled and bogged down by the current system of tax laws and have grown to dread anything that has the Internal Revenue Service insignia stamped on it. I would favor a flat tax or some form of national sales tax to simplify our system and balance the taxation to be evenly distributed among our citizenry.

At my birth in the mid 1940's the tax laws asked for less than 15% of a person's income and still provided the basics necessary to run this great country. Since then we have witnessed the growth of "Big Government" to a place where an average middle income person (such as my parents were) being saddled with outrageous taxes. These undue taxes all but bring our free enterprise system to a screeching halt since it discourages the "American Dream" to get ahead and succeed. There is no incentive to grow a business or reach higher if it only creates more taxation and regulation. This, I believe will eventually kill our great country.

Please study the tax laws carefully and simplify. The smaller we can make the regulatory system (especially the I.R.S.) the better. It is absolutely ludicrous that it takes a tax accountant to file our yearly tax reports. Bring this down to a single page and we will all be better off.

I will be anxiously awaiting a new tax program. Thanks for giving this matter your time and energy.

Sincerely,

Sherry Harper

6-7-95

S Haxby
327 E Pearson Ave Apt 1
Anaheim, CA 92802-4334

Phil Moseley
Chief of Staff
Ways and Means Committee
House of Representatives Office 1102
Washington D.C.

Dear Sir,
As a Sr citizen I believe that the new tax structure being considered should be looked at in the form of a consumption tax. I cannot have to pay any tax on things I didn't buy, therefore if I had any money I could save it to help feed me. I do not think clothing, food and medicine should be taxed for these are things one can not exist without. Anything else should be tax at consumption as is GASOLINE! Also as state sales tax at present.
It's about time the I.R.S. which has become the American form of a "GISTAPO" is stopped!!
Sincerely
Susan Haxby.
Add this to my friends letter.

Helming
Consulting Services, Inc.

June 8, 1995

Congressman Bill Archer
House of Representatives
Washington, D.C. 20515

Chairman Archer:

I respectfully request that the attached income tax reform proposal be made part of the record for the hearings on tax reform held June 6, 7, 8, 1995.

The consumption tax proposal I am advancing is the subject of my upcoming book. The proposal calls for the complete elimination of the current income tax system. Eliminated also would be all other taxes on income, such as taxes on capital gains, inheritance, gifts, and profits. Taking the place of all federal taxes would be a 4-level, point of sale, consumption tax. At each point of sale the rate of tax collected would range between 1.5 and 10 percent. The plan, as proposed, would generate approximately 1.3 trillion dollars annually.

This plan is inherently less regressive by its design. The necessities of life such as food, housing and medical needs are either not taxed or are taxed at a low rate. Those who have more money to spend over and above the necessities will be paying more in taxes.

But perhaps the most appealing feature of this plan that contributes toward non-regressivity is that wealthy businesses and wealthier individuals will pay much more in taxes than ever before while they have the ability to make more money than ever before.

The elimination of the tax on capital gains and profits will generate more activity of the buying and selling of companies, real estate, and other assets because there will be the opportunity to make more money on appreciation, expansion and success. On the front side of the transaction, before new profits and appreciation, the tax is collected. This will be a high source of Federal revenue that will greatly broaden the tax base and reduce regressivity.

In my opinion, this plan could be put into effect without a lengthy transition period. In fact, the Social Security and Medicare structure for raising revenues is the only area I see as needing transition time which I have accounted for in my plan.

7917 Bond
Lenexa, KS 66214-9866
Phone: (913) 492-3330
Fax: (913) 492-6229

I also do not believe that there would be a catastrophic affect, as some have stated, to the domestic or international markets. To the contrary. I believe taking this bold and aggressive action will send the long-awaited message to the world that we are taking control of our economic destiny to remain the leading world economic power. Further, I believe that the rest of the world will eventually follow our lead and convert their own beleaguered tax systems to consumption based systems.

In addition, I do not believe that converting to this system will create any long-term inflationary pressures. At this point in our economic cycle, the consumer simply cannot afford higher prices. Therefore business will not be successful in passing on 100% of the tax. Business will absorb part of the cost in order to stay competitive.

It should be noted that I have been researching and developing this plan for well over ten years. And, I have been publicly speaking to thousands of people and writing about this subject since 1987.

I am an economist residing in the Kansas City area. I have owned my own consulting business for 22 years. My economic forecasting expertise includes the world and U.S. general economy and the world and U.S. agriculture and food economy. I have an excellent track record and reputation for identifying long-term economic trends.

Two individuals who have encouraged me to submit my plan to you include: James Powell, Texas rancher and businessman. Telephone: (915) 653-1688 and Bill Holubec, Certified Financial Planner, San Angelo, Texas Telephone: (915) 942-9932.

Congressman Archer, I concur with you completely on your assessment that a complete replacement for the income tax system is necessary. Furthermore, I also agree that while a flat tax may be a short-term improvement over the current system, it is by no means the longer term solution for all of the reasons you have publicly stated. The case for a consumption tax is so compelling for the long-term health of our economy, it must be bolstered and advanced so that the general public can understand the concept and recognize it as being a credible solution.

I firmly believe that, because of where we are in the long-term 50-65 year economic business cycle, an income tax replacement is eminent. Our economy has been disinflating since 1981 and these deflationary forces will continue to force down real wages, for another 10-15 years. Contrary to popular opinion, I believe this deflationary cycle will run its course forcing the U.S. and the rest of the world to lower prices and increase value in order to increase savings and reduce debt. Therefore, regardless of political philosophy and Federal Reserve policy, the economy will force the necessary changes which ultimately will include creating a way for people to keep more of their income in order to maintain an acceptable standard of living, borrow less and save more.

As I have stated, I have talked to thousands of people over the years about the concept of a national consumption tax. Ten years ago, my audience would say "sounds good, but it will never happen". Now the overwhelming reaction is "how can we get it done." My response to these reactions has remained the same over the years. That is, when there is pain there is gain. When the choices where to cut the budget become more painful and when economic reality sets in, then the climate will be conducive for change. Without a doubt, I believe we are approaching that time of economic reality.

I would very much appreciate the opportunity to discuss my plan with you further. I am confident that I could contribute greatly to the development, formulation and presentation of a consumption tax plan that the American people could understand and embrace.

Sincerely,

Bill Helming
Economist and Consultant

Encls.
BH:es

Executive Summary

Of

A Proposed New National Consumption Tax System For The United States

For

Congressman Bill Archer
Chairman

House Ways And Means Committee
U.S. House Of Representatives
Washington, D.C. 20515

Prepared By

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June 8, 1995

Helming
Consulting Services, Inc.

KEY ELEMENTS OF THE PROPOSED NATIONAL CONSUMPTION TAX SYSTEM

A. **Would Completely Replace the Present Federal Government Tax System** - This national consumption tax system would replace all present federal government taxes, including the complete personal income tax, the taxation of business and corporate profits (including those of self-employed persons), the taxation of interest income and dividends, the taxation of capital gains, and the taxation of estates, gift, and inheritance, plus the present national sales taxes on such items as gasoline, diesel fuel, alcohol, and tobacco products. The only exception is the overall social security system, wherein all employees under this new tax system would pay a **5%** social security tax, all employers would pay a **5%** social security tax, and all self-employed persons would pay a **10%** social security tax. All remaining money required to adequately fund the total social security tax system would come from the tax revenues generated from the proposed national consumption tax system.

B. **The Present Tax System Is Counterproductive and Is Complicated** - The present U.S. federal government tax system penalizes and/or discourages hard work, self-initiative, creativity, innovation, improving productivity, savings, new investment, economic growth, new job creation, and the creation of new wealth. Taxing consumption will have just the opposite affect and will send all the right and desirable signals for America, plus helping the U.S. become more competitive in global trade and will significantly enhance our U.S. level of total exports in the future. The present U.S. tax system and code is far too complicated, costly, and time-consuming for consumers, families, businesses, and for the government.

Finally, the present U.S. tax base is far too narrow, unfair and it is **not** equitable. As a result, tax rates are far higher than they should be and what is necessary. It is very important to no longer tax income and wages.

C. **Specific Categories that Will Not be Taxed** - Following below are the specific items that will **not** be taxed under the proposed national consumption tax system:

1. All wages, personal income of all kinds, and business/corporate profits.

2. All interest income, dividends, and capital gains.

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3. All gifts, donations, estates, and inheritance.

4. All debt service payments for interest and principal, including apartment/condominium payments and rent, and all home mortgage payments.

5. All life, health, property damage and liability insurance premiums.

6. All education, job training, and child care expenses incurred by individuals and families.

7. All savings accounts and plans, all investments in stock and bonds, all monies in retirements plans and all cash.

8. All wages, salaries, bonuses, retirement contributions and all deferred income payments and profit sharing by businesses and corporations.

9. All insurance premiums for workers compensation, liability, property damage, and company paid health care premiums.

10. All debt service payments for principal and interest made by business and corporations.

11. All company working capital, cash equity, and retained earnings.

12. All business and corporate employee training, education, and child care expenses.

D. **What Will Be Taxed, How, and By Whom** - Except for the specific items mentioned in Part C above, all products, goods, commodities, raw materials, equipment, machinery, tools, vehicles, trucks, real estate and businesses of all kinds, all exports, and all services will be taxed when there is a sale, purchase and/or trade involving the above items. The consumption tax will always be paid by the buyer and collected by the seller, regardless of whether that involves individuals, families, businesses and corporations, organizations and institutions, churches, government entities, and many other examples.

This proposed and recommended national consumption tax system will have four specific tax levels and tax rates. These four tax levels and rates are summarized below.

Level 1 - The Level 1 tax rate is **1.5%**. This level and tax rate applies to all raw materials,

commodities, mining, fishing, oil and gas drilling and development, forestry, all farming and agricultural production, all manufacturing, all construction of all kinds, and to all wholesale businesses. All services purchased by these businesses and operations in this category will also be taxed at the same **1.5%** rate. These are typically businesses that add value. We have assumed that on the average the added value process is a multiple of 5. Therefore, the accumulative tax for this key sector of the U.S. economy is **7.5%** in total. For integrated companies or businesses, the consumption tax would be **4%**.

Level 2 - The Level 2 tax rate is **3.0%**. This level and tax rate applies to all actual food expenditures for the at-home or away-from-home consumption and services, not including alcohol or tobacco products, plus all prescription medicines, doctors fees, and hospital and medical expenses, supplies, and services of all kinds. These two key categories are taxed at a very low level to allow for the fact that food and medical services expenditures are a necessity for all persons, including those with low or modest income levels.

Level 3 - The Level 3 tax rate is **5.0%**. This level and tax rate applies to all actual purchases of all real estate and private and publicly owned businesses of all kinds, throughout the United States. For example, this includes all purchases of farm and ranch real estate, existing and new home real estate, apartment and condominium real estate, all commercial, industrial, wholesale, and retail real estate properties, and all hotel, motel, resort, golf course, sports complexes, amusement parks, entertainment and all other kinds and types of real estate that are purchased and sold in the United States.

The Level 3 tax category and **5.0%** tax rate also applies to all private and publicly owned businesses and/or fixed assets that are purchased and/or traded in the United States. All company stock purchases that amount to **10%** or more of the total company stock and value of the private and/or publicly owned companies shall be subject to the **5%** tax paid by the buyer and collected by the seller.

Level 4 - The Level 4 tax rate is **10.0%**. This level and tax rate applies to all actual purchases by individuals, businesses, organizations, institutions, and government agencies, of all products, goods, vehicles, equipment, machinery, supplies and services of all kinds by consumers, families, and businesses at the retail and finished consumer-ready level.. There are numerous examples of items that would fall into this category. A few examples would be automobiles, movie tickets, the dry cleaners, utility bills, consumer hardware supplies, soap and toilet paper, legal fees, gasoline, and thousands of other examples.

Chart 1 summarizes the 4 consumption tax levels that range from **a 1.5% to a 10.0%** tax

rate for individuals, families and self-employed wage and income earners. Chart 2 summarizes the 4 consumption tax levels that range from **a 1.5% to a 10.0%** tax rate for all businesses, corporations, institutions, and organizations in the United States.

Chart 3 shows the comparison of the 1994 tax rates on income for individuals, couples, families, and self-employed persons vs. Bill Helming's proposed national consumption tax. The present tax rate is **20 to 38 percent** vs. a consumption tax rate of **1.5 to 10.0 percent**. Chart 4 shows the comparison of the 1994 tax rates on profits for corporations, companies, businesses, organizations, and institutions vs. Bill Helming's proposed national consumption tax. The present tax rate for businesses is **15 to 34 percent** vs. a consumption tax rate of **1.5 to 10.0 percent**.

E. **Total Taxes Collected Under the Proposed National Consumption Tax System** - For the year 1994, the total federal government tax revenues would have been at least **1.3 trillion dollars** as shown in Chart 5. The total taxes collected by the federal government in 1994 (period ending on September 30, 1994) was **1.257 trillion dollars** under the present federal government tax system. The total net consumption expenditures (purchases) for 1994 were at least **14.0 trillion dollars** under my 4 level consumption tax plan. As noted in Chart 5, the total consumption tax revenues for 1994 would have been **1.049 trillion dollars** and the 10% total social security tax would have generated and additional **251 billion dollars**. Therefore, the total taxes generated by the proposed new national consumption tax plan and the 10% social security tax would have generated at least **1.3 trillion dollars** in total federal government tax revenues for 1994.

As the U.S. economy grows, total tax revenues increase. Over the span of any given ten year time period, the realistic average annual rate of growth for the overall U.S. economy and for federal government tax revenues would be **2.4%** per year. Therefore, total tax revenues under this new federal government tax plan and system would be at least **1.333 trillion dollars** for the year 1995 or would increase between about **33 to 40 billion dollars** per year. Obviously, the rate of increase in total annual federal government spending should not exceed more than **2.4%** per year.

F. **The Role of the IRS Would Dramatically Change** - Under this proposed national consumption tax system and plan, there would no longer be any personal, business, and corporate tax returns filed, no deductions, no depreciation schedules no non-profit status organizations and institutions from an IRS standpoint. The time, cost, and people involved relative to complying with the consumption tax system would be reduced by at least **80%** compared to the present federal government tax system. This by itself will be a great benefit for consumers, families, businesses, and will save billions of dollars.

The national consumption tax system will dramatically simplify the present tax system. The future role of the IRS under this proposed national consumption tax system will be to monitor the tax collection system. Under this proposal, all taxes would be collected by the seller of all commodities, products, goods, vehicles, equipment, machinery, tools, businesses, real estate, and services for Levels 1, 2, 3, and 4, and paid for by the buyer at the time and point of purchase. They will then complete a very simple IRS one-page form showing and documenting all purchases and sales, and send such documentation along with a check to the IRS in a timely manner. These will primarily be businesses of all different kinds, public and private, large and small.

G. **Major Benefits of the National Consumption Tax System** - Following below is listing of the major benefits of the federal government national consumption tax system that I am proposing:

1. The most fundamental and greatest benefit of the proposed national consumption tax system is that it would finally give the power of taxation to the American people. Simply stated, when Americans chose to save and/or invest a portion of their money, they wold not be taxed at all. When Americans decided to spend their money and therefore purchase all sorts of products, goods, equipment, vehicles, machinery, services, real estate, businesses, etc., they will then pay a Level 1, 2, 3, or 4 consumption tax, whichever applies.

Bottom line, under this proposed national consumption tax system, Americans will have a choice, as shown in Chart 6. This will go a long way toward many more Americans being able to improve their standard of living and to realistically achieve the "American Dream". Under the present federal government tax system, we have no choice as shown in Chart 7. This represents a huge and very important difference. Many people in government want to foster growth in government bureaucracy and socialism and the present tax system gives them that power. Remember, the power to tax is also the power to destroy and to control the lives of individual people.

2. Will greatly encourage hard work, private initiative, improved productivity, increased savings, and lower interest rates, as shown in Chart 8.

3. Will greatly improve investment, economic growth, and new job creation. For example, it will result in the U.S. economy growing at least 35% more than under the present tax system that taxes wages, incomes, profits, interest income, dividends, estates, capital gains, etc. This is well illustrated in Charts 9 and 10.

4. Will greatly encourage and increase the rate of growth in the creation of new wealth, new business and small business formation, increased wages and incomes, and new job opportunities for employees and for the self-employed people in America.

5. It will very realistically give more Americans the opportunity to actually improve their standard of living. This represents a major benefit and win-win change for all aspects for our economic, social, and political structure in America, as shown in Chart 11.

6. Will greatly encourage people in America to take more responsibility for themselves and thereby become less dependent on government and others for help and survival. It will foster and encourage more compassionate capitalism, free enterprise, and entrepreneurship, and it will discourage socialism, bigger and more expensive government, higher taxes, and government control of the lives of the American people.

7. It will dramatically lower tax rates and will sharply reduce the amount of taxes now being paid by many of those who now pay taxes in the United States. It will greatly broaden the tax base. It will force the underground, drug and other cash transaction portions of our total U.S. economy to finally start paying their fair share of taxes. Today there is at least one trillion dollars per year that never gets taxed because of the nature of the present tax system. The national consumption tax system would be much more fair, equitable, and simple, compared to the present tax system.

8. Regressivity is reduced because wealthy businesses and individuals will be paying more taxes than ever before. This is made possible by increased business investment and activity because there no longer is a tax on profits, capital gains, and inheritance. Therefore, businesses and individuals will also have the ability and opportunity to make more money than ever before.

Regressivity is also greatly reduced by the necessities of life, such as food, housing and medical expenses being either taxed at a very low rate or not taxed at all. This is made possible because of the much broader tax base as a result of the proposed national consumption tax system.

9. Combines the best and different aspects of (a) a national value-added tax (VAT), (b) a national sales tax, and (c) a national consumption tax.

10. Allows time for Social Security and Medicare program reforms. The consumption tax plan as proposed leaves the existing structure for raising revenues partially in place to allow the time necessary to reform the Social Security/Medicare program. Should Social

Security/Medicare become a "means tested" program for future generations, the Social Security/Medicare payroll deduction could be completely eliminated and the program would be entirely funded by the consumption tax.

11. It would dismantle the IRS as we know it. Most Americans would welcome and applaud a substantially reduced IRS involvement in their lives and business activities.

12. It would be bullish for the U.S. financial markets, including the stock and bond markets, and would also help improve the U.S. trade balance and be supportive for the U.S. dollar. This plan, along with Congress following through on significantly reducing federal government spending, will truly be bullish for America and our economy over the next 10 years and beyond. It also establishes an excellent blueprint for all state and local governments adopting a similar tax plan.

Chart 1

National Consumption Tax Rates For Goods and Services Purchased at Levels 1, 2, 3, and 4

For single people, families, couples and self-employed wage and income earners.

Goods and Services Tax Levels	Gross Tax Rates
Level 1	1.5%
Level 2	3.0%
Level 3	5.0%
Level 4	10.0%

Level 1 = All purchases of production, manufacturing, construction, wholesale, value-added process and services prior to the retail sale.
Level 2 = All purchases of food, medical, hospital, doctor and prescribed medicines.
Level 3 = All purchases of all public and private businesses and all types of commercial, industrial, retail and residential real estate.
Level 4 = All other purchases of goods and services at the retail level.

Chart 2

National Consumption Tax Rates For Goods and Services Purchased at Levels 1, 2, 3, and 4

For businesses, companies, corporations, institutions, and organizations.

Goods and Services Tax Levels	Gross Tax Rates
Level 1	1.5%
Level 2	3.0%
Level 3	5.0%
Level 4	10.0%

Level 1 = All purchases of production, manufacturing, construction, wholesale, value-added process and services prior to the retail sale.
Level 2 = All purchases of food, medical, hospital, doctor and prescribed medicines.
Level 3 = All purchases of all public and private businesses and all types of commercial, industrial, retail and residential real estate.
Level 4 = All other purchases of goods and services at the retail level.

Chart 3

The Federal Government Income Tax System vs. Helming's National Consumption Tax

Tax Rates On Income VS. Tax Rates on Consumption For Individuals, Couples, Families and Self-Employed

1994 Income Tax 1/	Helming's Proposed Consumption Tax
20% to 38%	1.5% to 10.0%

1/ Estimated by Meara, King & Co., CPA, Kansas City, MO.

Chart 4

The Federal Government Income Tax System vs. Helming's National Consumption Tax

Tax Rates on Profits VS. Tax Rates on Consumption for Companies, Businesses, Corporations, Organizations and Institutions.

1994 Income Tax 1/	Helming's Proposed Consumption Tax
15% to 34%	1.5% to 10.0%

1/ Estimated by Meara, King & Co., CPA, Kansas City, MO.

Chart 5

Estimated Total Consumption and Tax Revenues using 1994 as an example

Levels 1, 2, 3, and 4 Combined

Total Net Consumption	Total Tax Revenues Generated 1/
$14.0 Trillion	**$1.3 Trillion Dollars**

1/ Includes the $1.049 trillion generated from the Level 1, 2, 3, and 4 **National Consumption Tax**, plus $251 billion generated from the Social Security/Medicare tax, with 5% paid by employees, 5% paid by employers, and 10% paid by the self-employed. The remaining 5.3% Social Security/Medicare tax, or $129 billion, is funded by and is a part of the $1.049 trillion **National Consumption Tax** for 1994. The total Social Security tax in 1994 was about $380 billion.

Chart 6

Under my proposed national consumption tax system, American's will decide how and when to spend, save, or invest their money

Before

"Uncle Sam" receives his tax revenues!

We Will Have A Choice Under The National Consumption Tax System!

Chart 7

Under today's federal Government tax system, Americans decide how and when to spend, save or invest their money

After

"Uncle Sam" takes 20% to 38% off the top!

We Have No Choice Under The Present Tax System!

Chart 8

Taxing Personal Income Is Wrong and Counterproductive For These Reasons:

1. Salaries and bonuses, after taxes, result in less take-home pay.

2. With an annual salary of $70,000 for a two-income family, total federal, state and local taxes account for 40%. The total taxes paid are $28,000. This leaves $42,000 for living expenses.

3. As taxes go up, savings and investments go down.

4. The incentive to work harder, to be more productive, innovative and creative is reduced.

5. Moderates economic growth and consumer spending, reduces the standard of living, and encourages companies to substitute capital for labor.

Chart 9

Taxing Business and Corporation Profits Is Wrong and Counterproductive For These Reasons:

1. Taxing business profits between 15% and 34% contributes to lower wages, high layoffs and reduced job security, less investment by business, slower economic growth, and a reduced standard of living for at least 70% of Americans.

2. Not taxing business profits will typically result in higher wages, more new jobs, more investment by business, stronger economic growth, an improved competitive economic advantage in the global marketplace, and an improved standard of living for many more Americans.

Chart 10

Taxing Capital Gains Is Wrong and Counterproductive For These Reasons:

- Contributes to lower wages, less new business or existing business development and expansion, less business investment in fixed plant, capital and new technology and less business investment in employee education.

Not Taxing Capital Gains Will Result In:

- Higher wages, more business investment in capital and people, improved economic growth, improved economic advantage in the global marketplace and an improved standard of living for many more Americans.

Chart 11

The Single Greatest Challenge and Opportunity for the U.S. Economy

Decrease Socialism
and
Increase Capitalism

"More government and higher taxes is not the answer. The answer is more savings, more investment, improved economic and new job growth, higher wages and improved productivity, smaller government and reduced government spending, and lower taxes."

Bill Helming

2211-13th Ave. E., #103
Seattle, WA 98102
June 12, 1995

Dear Ways + Means Committee Members,

I understand you're in the process of looking at ways to change our existing tax system/structure. I applaud your willingness to examine this problem!

May I encourage you to support the consumption tax, instead of the flat tax? The problem I have with the flat tax is that it fails to eliminate the need for the IRS, which is one of the biggest reasons for revising the tax system in the first place. If the flat tax is based on annual gross income, the IRS will still want to invade people's privacy to make sure all their income is being reported. The invasion of a government agency into the private lives of it's citizens is unconstitutional and is exactly why we must change the tax system. Also, the cost of supporting such a system is tremendous, which is another good reason to eliminate the IRS.

I support a consumption tax, using rebates so there would be no additional tax burden on the poor. Basic necessities of life, such as food + housing, would be exempt. Such a system would be fair, easy to administer and would lead to the economic growth we need. A National Sales Tax would be collected by retailers at the time of sale and

would replace both the individual and corporate income taxes, as well as gift, estate and federal excise taxes. Forty-six states currently collect sales taxes.

Such a tax has many benefits. Here are some of the major advantages:

- Replacing the income tax, the national sales tax creates more than 1½ million new jobs
- Boosts economic growth by over 40% and makes the U.S. far more competitive on the international scene.
- It will help keep inflation down and put an average of $1,500 more money into the pockets of American workers after taxes.
- The US federal deficit would be 45% less than under the current tax system - a net reduction of over $3.5 trillion *

A National Sales Tax is impossible to hide from Americans - we will see it every time we make a purchase and we will feel the impact of the tax. This produces the level of public awareness that is needed to bring this country back to where the government provides the services to the people, visibly exchanging with those who support it in ways they can see and understand.

People will once again be rewarded for being responsible. They will receive the fruits of their labor for hard work and be encouraged to save. The economy will expand and prosper.

* See "The Impact of a National Sales Tax in the United States Economy" by Dr. John H. Quails.

The unfairness of a tax system, which double axes savings, will be replaced by a true reward for hard work and the kinds of activity which bring about economic growth and a higher standard of living for our children and us.

Also, the underground economy, with its drug dealers and organized crime, will finally be taxed when they buy their fancy cars, boats and jewelry. Recent estimates put this underground economy in excess of $900 billion per year. With the current system, we, the honest taxpayers, are now carrying this burden.

With the implementation of a consumption tax, we should repeal the 16th amendment which would no longer be necessary as Article I, section 8, of the constitution already gives Congress the power it needs.

Most Sincerely,

Paula B. Henderson

June 12, 95

Dear Mr. Mosley

We most certainly need to change our present tax system. The IRS has got to go! and never be revived, please!

I think a flat tax would be fair to all citizens, but I know several other plans are being studied and, we the U.S. taxpayers, must have a break.

So please evaluate carefully all the plans being proposed and come up with a tax that's fair to all –

Thank you

Carol Henry
6412 64 th Ave Ct N.W.
Gig Harbor WA 98335

c/o 1400 S. Sunkist St. #213
Anaheim, California PZ=92806
(714) 999-1486
Fax: (714) 999-1486

June 11, 1995

D. Mosley, Chief of Staff
U.S. House of Representatives
Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

RE: IRS and Federal Reserve Abolishment

Dear Mr. Mosley:

Enclosed for the record are:

1. An IRS mailing (Contract and Declaration of Citizenship) from a typical non-taxpayer (six sheets).

2. An IRS mailing requested a determination letter (one sheet).

The purpose of these seven sheets is to show that, when answered, the IRS has no option, under law, but to determine "no tax due, no filing required", and if they do not answer, estoppel and acquiescence prevails.

3. A one-sheet synopsis of IRS illegalities, the Federal Reserve System (the real problem), and what I know to be the solution.

Please make these eight sheets part of the Committee's records.

Sincerely,

Robert T. Hibbard

RTH/krh

Enclosures (3)

cc: Representative Chris Cox
Representative Bob Dornan
Orange County Register

CONTRACT AND DECLARATION OF CITIZENSHIP

California Republic)
) KNOW ALL MEN BY THESE PRESENTS
Orange County)

WHEREAS, THE ETERNAL AND UNCHANGING PRINCIPLES OF THE LAWS OF COMMERCE ARE:

1. A matter must be expressed to be resolved.

2. In commerce, TRUTH is sovereign.

3. TRUTH is expressed in the form of an AFFIDAVIT.

4. An unrebutted AFFIDAVIT stands as TRUTH in commerce.

5. An unrebutted AFFIDAVIT becomes the judgement in commerce.

6. An AFFIDAVIT of TRUTH, under commercial law, can only be satisfied:

   (i) through a rebuttal Affidavit of Truth, point for point,

   (ii) by payment,

   (iii) by agreement,

   (iv) by resolution by a jury by the rules of Common Law

7. A workman is worthy of his hire.

8. All are equal under the law..

The foundation of Commercial Law is based upon certain eternally just, valid, and moral precepts and truth, which have remained unchanged for at least six thousand (6,000) years, having its roots in Mosaic Law. Said Commercial law forms the underpinnings of Western Civilization, if not all Nations, Law, and Commerce in this world. Commercial Law is **non-judicial** and is prior and superior to, the basis of, and cannot be set aside or overruled by the statues of any governments, Legislatures, Government or Quasi-Governmental Agencies, Courts, Judges, and law enforcement agencies, which are under an inherent obligation to uphold said Commercial Law.

KNOW ALL MEN, THAT I CERTIFY IN THIS AFFIDAVIT OF TRUTH THAT THE FOLLOWING FACTS ARE TRUE, CORRECT AND COMPLETE.

I, Kathryn R. Hibbard, Sui Juris, the undersigned, a Citizen of the California Republic (state), domiciled in Orange County, c/o 1400 S. Sunkist Street #213, Anaheim, California, do solemnly swear, affirm, declare, attest and depose:

1. That I am of lawful age and am competent to make this Affidavit.

2. That I have personal knowledge of the facts and stated herein.

3. That I am not under the lawful guardianship or disability of another. This sworn affidavit is made as a matter of record of my own right, sui juris, in my own proper status, propria persona.

4. I was naturally born in the continuous Florida Republic (state), and I am domiciled in Orange County, where I have occupied such status since approximately July of 1987, for a period of approximately 7 years and 11 months.

5. I, Kathryn R. Hibbard, as a natural born, sovereign, preamble, de jure Citizen of one of the 50 sovereign Republic, freely associated complete American states.

6. I am a Citizen under the Constitution of 1787, the Bill of Rights, ratified in 1791, and precedent decisions of Article III Justice Courts of Law.

7. I have rights which are inalienable and were endowed by my Creator and secured by the Constitution. I do not waive any of my rights at any time.

8. The government of the United States may assume no power over the People of the 50 sovereign states that were not specifically delegated to it in said Constitution.

9. I do not owe my Citizenship to the 14th Amendment.

10. I am not liable for the Title 26 USC, Internal Revenue Code (IRC), Subtitle A, §1 graduated income taxes for reasons on my alienage to the State of the forum of United States Tax Laws.

11. I was born in a territory over which the United States is sovereign.

12. I am not the citizen subject to its jurisdiction, as such term is defined in 26 CFR 1.1-1(c).

    (c) **"Who is a citizen:** Every person born or naturalized in the United States and subject to its jurisdiction is a citizen."

2A Am Jur 1420, Aliens and Citizens "A Person is born **subject to the jurisdiction of the United States**, for purposes of acquiring citizenship at birth, if this birth occurs **in a territory over which the United States is sovereign...**"

13. I am "nonresident to" and "not a dweller within" the jurisdiction of the "State of the Forum" of **Art. I, §8, Cl. 17 and Art. IV, §3, Cl. 2** of the Constitution for the United States of America, in which Congress "exercises **exclusive Legislation in all Cases whatsoever**, over such District **not exceeding ten Miles square**," beyond the seat of Government, or places legally ceded by the states for the Erection of Forts, Arsenals, and other needed buildings, or any other territories of properties "belonging to" the United States. I am, therefore, not liable for the Title 26 USC, Subtitle A, §1 graduated income tax for reasons of my nonresidence to such State of the Forum.

"It is a well established principle of law that all federal legislation applies only within the territorial jurisdiction of the United States unless a contrary intent appears."

Foley Brothers v. Filardo, 336.U.S. 281

14. I am not a "resident of", "inhabitant of", "franchisee of", "subject of", "ward of", "property of", "chattel of" or "subject to the jurisdiction of", the State of the Forum of any United States, the corporate State, corporate County, or corporate City, Municipal, body politics created under the primary authority **of Art. I, §8, Cl. 17 and Art. IV, §3, Cl. 2** of the Constitution for the united States of America and I am not subject to any legislation created by such authorities and I am not subject to the jurisdiction of any employees, officers or agents deriving their authority thereof. Further, I am not a subject of Administrative and Article I Courts or bound by precedent of such courts.

"Legislation enacted by Congress applicable to the inferior federal courts in the exercise of the power under Article III of the Constitution cannot be affected by legislation enacted by Congress under Art. I, §8, Cl. 17 of the Constitution." *D.C. Code, Title 11 at p. 13.*

15. As a Sovereign Citizen of one of the 50 states, under the Constitution and Law, only Article III Justice Court of Law decisions are applicable to me.

16. TAKE NOTICE that I hereby cancel any presumed election made by the United Sates Government of any agency or department thereof that I am, or ever have been, a citizen or resident of any territory, possession, instrumentality or enclave, under the sovereignty or exclusive jurisdiction of the United States as defined and limited in the Constitution for the united States of America in Article I, §8, Cl. 17 and Article IV, §3, Cl. 2. I further cancel any presumption that I ever voluntarily elected to be treated as such a citizen or resident.

17. TAKE NOTICE that I revoke and cancel all of my signatures on any other forms which may be construed to give the Internal Revenue Service or any other agency or department of the United States Government, created under the authorities of Art. I, §8, Cl. 17 and Art. IV, §3, Cl. 2 of the Constitution for the united States, authority or jurisdiction over me. I revoke, rescind and make void ab initio, all powers of attorney, in fact, in resumption, or otherwise, signed either by me or anyone else, with or without my consent, as such power of attorney pertains to me, by but not limited to, any and all governmental/quasi/colorable, public, Governmental entities or corporations, on the grounds of constructive fraud and non-disclosure.

18. I am not an officer, employee, or elected officer of the United States, the District of Columbia or any agency or instrumentality of the United States or District of Columbia.

19. I am not an officer of a Corporation, under a duty to withhold.

20. **I am not an "employee"** as such "term" is defined in Law and in the Internal Revenue Code. **Federal Register, Tuesday, Sept. 7, 1943, §404.104, pg. 12267: Employee:** "The term 'employee' **specifically includes** officers and employees, **whether elected or appointed**, of the United States, a State, territory, or political subdivision thereof or the District of Columbia or any agency or instrumentality of any more or more of the foregoing."

21. Because I am **not an "employee", I do not earn "wages"** as such terms are defined in the Internal Revenue Code. The term wages is defined in §3401(a) as: (a) Wages -- "...the term 'wages' means all remuneration...for services performed **by an employee** for his employer..."

22. Further pursuant to the Public Salary Act of 1939, Title I, §1, **I do not earn "gross income"** as such term is defined therein.

    Public Salary Act of 1939, TITLE I -- SECTION 1. §22(a) of the Internal Revenue Code relating to the definition of "**gross income**" (is **amended** after the words "**compensation for personal service**") includes [only] personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing."

23. I am not involved in any type of "revenue taxable activities" including, but not limited to, the manufacture, sale or distribution of alcohol, tobacco, or firearms or any other regulated industry, trade of profession. I am not involved in any wagering activities.

24. I do not reside in or obtain income from any source within the District of Columbia, Puerto Rico, the U.S. Virgin Islands, Guam, or any other Territory, Possession, enclave or instrumentality of the United States or of the District of Columbia.

25. I am not a United Sates Person, United States Resident, U.S. Individual, U.S. Corporation or "citizen subject to its jurisdiction", as such "words of art" are defined in the Internal Revenue code and other applicable U.S. Codes.

26. The 16th Amendment did not repeal the Constitutional apportionment restrictions imposed on direct taxes (Art. I, §2, cl. 3, Art. I, §9, Cl. 4). Taxes on Personal property are direct taxes, not taxable by the federal government unless apportioned according to the census of the states.

27. **Compensation for labor** and **exercise of the Right to Labor** are personal **property** and, as such are items of income under the Constitution (Art. I, §2, Cl. 2, Art. I, §9, Cl. 4), and not taxable by the Federal Government as a graduated income tax. Compensation earned and exercising the Right to Labor is **excluded from "Gross Income"** and **is exempt from taxation under Title 26**, under the authority of Title 26, CFR ('39) §9.22(b)-1, as follows:

    26 CFR (1939) §9.22(b)-1 "Exclusions from gross income -- *The following **shall not** be included as gross income and shall be **exempt from taxation** under this title:*

    (b)-1 Exemptions; exclusions from gross income. *Certain items of income...are exempt from tax and my be excluded from gross income...those items of income which are under the Constitution, not taxable by the Federal Government."*

28. The 16th Amendment is limited to **only** indirect taxes.

29. The income tax is an excise tax. My compensation for labor is my personal property and is not taxable by the federal Government except by rule of apportionment.

30. An excise tax CANNOT be imposed upon the [natural] person measured by his/her income, because such a tax would be a direct capitation tax, subject to the rule of apportionment and not an excise tax.

31. The requirement to pay an excise tax involves the exercise of a privilege. I am exercising no taxable privileges.

32. I provide for my existence by working in a nontaxable occupation of common right.

> "The individual, unlike the corporation, cannot be taxed for the mere privilege of existing. The corporation is an artificial entity which owes its existence and charter powers to the state; but the individual's Right to live and own property are natural Rights for the enjoyment of which an excise cannot be imposed... We believe that the conclusion is well justified that a tax laid directly upon the income of property, real or personal, may well be regarded as a tax upon the property which produces the income." Redfield v. Fisher, Oreg. Sup. Ct. 292 at 813, 827, 819. (1930)

33. My compensation constitutes the "fruits of my labor". This is my substance and my personal property and the Government may not deprive me of any portion of my property by appropriating it against my will.

34. The Victory Tax Act of 1942 [56 Stat, Ch 619 Pg. 884 10/21/42] which implemented "withholding" and 1040 Return requirements, stated:

> **§476 "The taxes imposed by this subchapter shall not apply with respect to any taxable year after the date of cession of hostilities in the present War [World War II]."**
>
> On May 29, 1994 (58 Statutes at Large, Cap 210 §6 (a) REPEAL OF VICTORY TAX pg 235) the Victory Tax and its provisions for Withholding was repealed.

IN SUMMARY:

a) I am not an "employee" earning "wages" and have no "gross income" as such "terms" are defined in the Internal Revenue Code, the Public Salary Act of 1939 and in Law.

b) I am exercising NO taxable privileges and I earn no income upon which a direct "excise" tax may be imposed. The Brushaber court and other supreme Courts have ruled the "*taxation on income is in its nature an excise.*" Flint v. Stone Tracy Co. 220 U.S. 10, ruled "*the requirement to pay Excise taxes involves the exercise of a privilege.*" Further the supreme Court case of Peck v. Lowe, 247 U.S. 165, ruled that a tax sustained upon a [natural] person would be a "capitation" tax (subject to apportionment) and not an excise tax.

c) I am not the "citizen subject to its jurisdiction" as defined in 26 CFR §1.1-1(c) upon whom the Subtitle A, §1 Graduated Income Tax is imposed.

d) I did not incur a tax liability last year, pursuant to 26 USC 871(a) or §871(b), and I do not anticipate that I will incur a tax liability from said sections in the future. However, if I do receive income subject to taxation under those sections in the future, I will file the appropriate Form.

e) I am not required to pay the income tax. I am not "liable for" or "made liable for" the income tax. I am not "subject to" the income tax and I am not required by regulation to file a 1040 tax return.

Please respond to this Affidavit within 30 days to:

Kathryn R. Hibbard
c/o 1400 S. Sunkist Street #213
Anaheim, California (Postal Code 92806)

If you do not feel this is a reasonable period of time, please request an extension in writing. Failure to respond will mean that you have acquiesced to this Affidavit and Supporting Documentation it its entirety and from this date forward the doctrine of "estoppel by acquiescence" will prevail.

Any statements or claims in this AFFIDAVIT, properly rebutted by facts of law, or overriding Article III supreme Court rulings, such shall not prejudice the lawful validity of other claims not properly rebutted or invalidated by facts of law.

I declare under penalty of perjury under the laws of the united States of America that the foregoing, to the best of my knowledge, is true and correct.

Executed at Anaheim, California on _____

Kathryn R. Hibbard
Signature

_____
Witness

_____
Witness

Certified Mail #
Assistant Commissioner of Operations
National Office of the Internal Revenue Service
111 Constitution Avenue NW
Washington, D.C. 20224

Certified Mail #
Internal Revenue Service Center
Philadelphia, PA 19255

Certified Mail #
Secretary of the Treasury
Washington, D.C. 20220

Certified Mail #
District Internal Revenue Director
2400 Avila Road
Laguna Niguel, CA 92656

Written Request for Verified Determination of Status for Tax Purposes Letter, Prior to Filing of Tax Returns

Pursuant to Internal Revenue Laws, and based upon the facts contained in the attached Affidavit, this letter constitutes a written request for an attested, verified **Ruling and/or Determination Letter** from the National Office, the Director of International Operations and the District Director, determining my status for tax purposes, prior to my filing of a tax return. As soon as your agency makes this written determination, I shall file the appropriate form, as required by the laws of the United States of America.

Technical **page 1218-125 (10-25-88)**

RULINGS, DETERMINATION LETTERS, AND CLOSING AGREEMENTS...
P.L.-(11)-23, (approved 6/14/87)
"Rulings and Determination Letters in General:
"Ruling and determination letters are issued to Individuals and organizations upon written requests....as to their **status for tax purposes**...prior to their filing of returns or reports **as required by the revenue laws**. Rulings are issued only by the National office. Determination letters are issued only by District Directors and the Director of International Operations..."

MT1218-196 **P-(11)-30**

Sincerely,
Without Prejudice, All Rights Reserved U.C.C. 1-207

Kathryn R. Hibbard
c/o 1400 S. Sunkist St. #213
Anaheim, California (Postal Zone = 92806)

The enclosed Documents which the wife and I have sent (completed) to the IRS shows conclusively that we and 90% of working Americans are not subject to the so called "income tax" unless they are coerced into, get this, "voluntary compliance". The way out for Citizens is that they had to knowingly enter into this agreement with the Fed (through the 1040 fraud) contract. Many of us, 20-30 Million, non-taxpayers have "noticed", legally, the IRS of their Fraudulent Entrapment.

The IRS must be disbanded and their illegal activities, until they are gone, must stop immediately! The real root problem is the Federal Reserve System (the IRS being the collection agency for the phoney Fed Res holdings of debt).

"Permit me to control the currency of a nation and I care not who makes it's laws!"- Baron de Rothchild.

If I could print up money on my very own private press and loan it out to all my friends at staggering high interest, it would not take too long until I would own the whole neighborhood. That's what the feds been doing since the Congress unconstitutionally transferred this authority to a private mostly foreign owned (pvt stock) organization - the Federal Reserve.

This Fed has created a debt based economy. It creates nothing. Every dollar that America spends it borrows from someone else. Every Fed Res note in your/my pocket is nothing more than a debt certificate. America (through a Criminal congress) has given its greatest power, monetary creation, to the Fed Res. If our Nation can issue a dollar bond, it can issue a dollar bill! I want the Fed Res out, gone, sent packing back to Europe and Congress to (for example):

(1) Congress purposes a 300 Billion, 100 Million budget, requiring 100 Million in currency
(2) This budget is voted on and approved by the Congressional Representatives of the people.
(3) The bureau of Printing and Engraving for the United States of America prints and issues 100 Million in "currency for the united States of America" at a cost of two and a half cents per bill!
(4) The **Treasury of the United States of America** puts $300 billion in credit and $100 million in currency into circulation in exactly the same manner as the federal reserve! Our government is merely providing the up-front capital to finance the future productivity of the American People! It is this "Productivity" that would give the currency and credit its value!
(5) The people, who are the basis for the backing of the funding, accept this currency and credit as payment of their labor, products, services, technology, etc.
(6) There is no longer a compounding federal debt and a need for illegally taxing the compensation for labor (misrepresented as "income") of American Citizens, who will then have more expendable (legal) dollars to improve their Quality of life.
(7) The people buy more products, more jobs are created, the economy is stimulated and the **ECONOMY BOOMS! COST TO WE THE PEOPLE: Absolutely 0!**

45th Congress Ch 146
Chapter 276 - An act to forbid the further retirement of United States legal tender notes.
An act of Congress that has never been repealed. Where are those United States Notes that were lawfully to be kept in circulation and not retired? The law was specific, even if such notes were mutilated, they were to be replaced. These United States Legal Tender Notes were and still should be "gold certificates." It is required that they are reissued in "like denomination in their stead as now provided by law."

CALVIN A. HILL
40 Avenue D 13-E
New York, N.Y. 10009
212-353-3353

May 30, 1995

PHILLIP D. MOSELEY
Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: FC-7 Hearing dates June 6 through 8, 1995

A. Opening statements

B. Personal disclosure

C. Ignored abuses

D. What is the present system, <u>really</u>?

E. Can we <u>honestly</u> support this system in its basest form?

F. Why the abuses continue

G. An honest, unintrusive solution.

This is my statement to be made available to the committee for review and printing.

Yours truly,

I am greatly encouraged that Chairman Archer feels committed to "tearing the income tax out by its roots". I am troubled, however, by the fact that whenever this particular dialogue takes place among politicians that they tend to show more allegiance to the Treasury Department and special interests than to their oath of office.

If this is to be an honest debate with an honest effort to expose this abusive system, then our elected officials must consign themselves to their oath of office. The only oath that they have sworn before God and country is to protect and defend the Constitution of the United States of America against all enemies foreign and domestic. And this liberty defying system that has sent hither swarms of Officers to harass our people and eat out their substance, under the guise of representative taxation, can only be described as DOMESTIC ENEMY #1.

In the interest of full disclosure I am compelled to say that I have been convicted of tax evasion in a U.S. Federal Court. I reveal this out of a sense of honor as I find no shame in the consequence. It is nothing that I feel I must hide, or be ashamed of, or be bitter about. Having to relinquish a job that I enjoyed, my residence, and the camaraderie of friends and family for the period of my incarceration was a small price to pay for the crisis of conscience that I would have suffered had I not stood by the courage of my convictions.

In the aftermath of the tragedy in Oklahoma City, President Clinton made a speech castigating Americans who, living in the freeset country in the world, said that they live in tyranny. "How dare they", he said. "How dare they" claim to be subjected to tyranny. On the very next THIS WEEK WITH DAVID BRINKLEY, Sam Donaldson echoed President Clinton's statement. I would ask Misters Clinton and Donaldson: when armed IRS agents in Alaska approached a woman in her vehicle, smashed her window, and literally pulled her out to confiscate her car for allegedly owing back taxes, what would they call that? When a band of armed IRS storm a Michigan day care center, herd the children into a room, hold them hostage and refuse to release them until their parents made a payment to the center, because the owners allegedly owed back taxes, what would they call that?

If we are to be totally honest about this present system, we must initially disregard the obvious need to raise revenue and tackle it at its basic and most simplest roots. Imagine that you are at your monthly poker game along with Thomas Jefferson, James Madison, Ben Franklin and your federal district Congressional representative. As the game and the conversation begins the representative reveals the new method that the Congress will adopt for raising revenue and illustrates the high points:

1. The right to work will no longer be inalienable. All citizens will be required to make application to a federal agency for a national identification number. Any employer found to hire any person without that number will be subject to heavy fines.

2. The national identification number will be required to obtain insurance, use private financial institutions, licenses, and any other public or private endeavors as determined by the Treasury Department.

3. Every working person will be required to reveal to the government all monies earned from the fruits of their labor and investments.

4. Every working person will be required to reveal to the government the names and amounts of every church, charity and non-profit organization that they have contributed to.

5. Each year all working persons will be required to reveal to the government the names of every person that they took to breakfast, lunch or dinner on business, where they dined and the amount spent.

6. Every working person will be required to reveal to the government every member of their family who was ill and sought medical treatment, who treated them, where they were treated, what they were treated for, what treatment they received, and how much it cost.

After all of the information is available, the government will levy an amount of money at a value determined by the Congress. Any person who refuses to provide the required information will have their paychecks, homes, bank accounts and other properties confiscated without the benefit of a trial or public hearing before an impartial magistrate and may be subject to criminal penalties.

Would it be very difficult to gauge the reaction of the members of your poker circle? I don't think so. That an administrative agent of the government could take a form from their desk, fill it out, and prevent an American citizen from receiving their hard earned wages, from receiving their savings or from entering their government padlocked home would outrage them. They experienced this. It is why the Constitution was very specific about direct taxation, trials by jury, just compensation, security in our papers, persons and effects, deprivation of property without due process, and suits at common law. Everything about this present "tax" system makes a mockery of those liberties. It is the stuff that citizen militias are made of.

Criminal investigations for possible "tax" crimes seem to follow those representatives who speak out to House Oversight on IRS abuses. It happened to Senator Long in the '60's, Senator Montoya in the 70's, and Idaho Congressman George Hansen in the 80's. This is not taxation. It is tyranny.

I think that Chairman Archer has the correct idea concerning a consumption tax. For those who oppose it on the grounds that it is regressive and hurts the poor, why do they not argue that very point about the present system. After all, it is the employers who pay the tax, not the employee. When a poor person buys a loaf of bread, they are paying the cashiers "income tax". In addition, that poor person is also paying the tax of the trucker that delivered the bread, the bakers and those who sliced and wrapped it, the millers, etc. The employers must forward this "tax" to the government. And as such, they could not afford it without adding it to the cost of their products and services. So we have an income tax that is a consumption tax that, in addition to raising revenues, violates the very basic tenets of constitutional liberty. It is on the basis of those violations that the present system must be eradicated. It cannot stand against the conscience of a Congress that is true to its oath.

P. O. Box 176
Half Moon Bay, California 94019
June 1, 1995

The Honorable Bill Archer
Chairman, Ways and Means Committee
United States House of Representatives
Washington, D. C. 20515

Dear Chairman Archer:

Subject: Comments for The Committee on Ways and Means Concerning a New Tax System- and Abolishing the IRS

1. The new tax plan/system must take away from goverment as much of our hard earned tax money as possible. It is an inviolate principle-**Government will spend all the tax payer's money it can get and then spend more (go into debt).** You will notice that I do not use the term federal funds-tax payer's money is the correct term.

The government must get less of the citizens money, and be put on a starvation diet.

2. Future Congresses must not be able to just amend the new system to reinstitute the IRS, a destructive ad valorem tax, or return to a system such as today's job destructive progressive income tax.

3. I personally favor the flat tax approach proposed by Majority Leader Dick Armey if the 17% level is either lowered or not increased. Again, the government bureaucracy must not be given any more money no matter how badly they and the special interests scream.

The sales tax approach that you have suggested also seems to be a good one if the Congress is somehow prevented from adding other taxes such as the ad valorem tax or from increasing the sales tax rate on the whim of the crying towel liberal elites.

4. Punitive provisions of the old tax codes such as the requirement to buy at least as expensive a home as the one sold or pay tax on the gain must not be carried forward into the new tax law in any way shape or form.

5. The IRS must be abolished as soon as possible in its entirety. Tax functions greatly reduced with either the flat tax or a sales tax should be handled by the Treasury without additional bureaucracy.

6. The punitive and savings destructive aspects of the current system must be abolished with either new approach. Let me give you a personal example that my wife and I are now dealing with. Some years ago when I took an early retirement, we were able to invest several thousand dollars in U. S. Savings Bonds (due to a good rate at the time and the safety involved). Now we are fully retired and must cash some of these bonds to puchase an automobile. Now we must pay taxes on the money we withdraw for the purchase. Such savings disincentives have virtually destroyed the capital base that the U. S. needs so badly to build a productive economy in a hostile and very competitive world.

7. The anguished cries and screams that will come from the bureaucrats, special interest groups, and the other myriads of those feeding at the hog trough of government that surrounds the present system can be answered this way. Accountants would love to give up tax accounting work for real accounting work. Even the myriads of tax attorneys that feed off the present system can be retrained to do productive work in the economy without destroying the mouths that feed them.

The bureaucrats and special interest groups can also obtain productive jobs that contribute to a growing U. S. economy. Big government in all its facets has destroyed much that was good and productive in the nation. The minority in the house and senate are in denial because they have meticulously built their voter base on the backs of hard working. tax paying American citizens.

In closing, I would like to remind all of you of what you are already

well aware of. The present day federal government is actually the enemy of the people, of families, and of national progress and liberty as the founding fathers desired it to be.

As George Washington so clearly stated, "Government (federal, state, and local-my addition) is a dangerous servant and a fearful master."

You and your colleagues in both the House and Senate must be successful in this initiative. I am convinced that the productive forces for national good that will be unleashed by ending the current tax syetem will amaze us all.

May the good Lord Bless your deliberations and give you the success that we so desperately need.

Very truly yours,

Wayne L. Hinthorn

Wayne L. Hinthorn

3 June 1995

Philip Mosely, Chair, House Ways and Means
U.S. House, Longworth Building
Washington, D.C.

Dear Representative Mosely:

I understand that your committee is meeting this week to consider a significant change to the federal tax system. Here is my input (6 copies):

A flat tax merely simplifies the extortion of income taxes. That's how we got "Tax Simplification" --fewer tax brackets and higher taxes.

Consumers already pay all income tax. The corporate income tax and the extra wages required to enable employees to pay their individual income tax are both a cost of doing business that is added to the cost of every American product. A national sales or consumption tax has appeal, because it would eliminate the cost of the IRS bureaucracy and compliance costs. However, neither a flat tax nor a national excise tax are self-limiting. I submit that you don't need new legislation to improve our tax system. You only need to acknowledge a fraud.

Practically every amendment to the constitution perverted its intent and imbalanced its finely tuned balance of powers and interests. Of those amendments, the 16th and 17th were the most destructive.

The 16th amendment eliminated the requirement for the apportionment of taxes among the states according to the census. The dispersed cost to taxpayers and concentrated benefit to beneficiaries divided Americans into warring groups and made increased government spending inevitable. Repealing the 16th would again make non-uniform (progressive) taxation illegal, and eliminate a powerful tool of privilege used by congresspersons to attract support from favored groups and businesses, and extort campaign funds from threatened groups and businesses. That's why there is always at least talk of amending the IRS code (26 USC) every election year.

The 17th amendment converted senators into glorified representatives, who are easily swayed by public sentiment as manipulated by special interests via a gullible and lazy press. Its repeal would again make senators, elected from and by the state legislatures, truly representative of the state governments. Then when someone suggests that the federal government buy or do something, senators will resist because no senator wants to return to their state to tell their governor and fellow legislators they have to raise state taxes in order to pay more federal taxes.

A return to direct taxes upon the states would eliminate our horribly costly and destructive national income tax. The states can raise the money any way they want, which is usually via a state excise tax, which is great, because it's self-limiting. Reaffirming that states can't tax government securities or commercial paper, i.e. Federal Reserve Notes, would eliminate most state income tax. Better yet, encourage states to elect state senators from and by county supervisors, and directly tax the

counties to pay for state functions. Then there would be a natural resistance to state spending as well.

You can simply declare the 16th and 17th null and void, because they were never lawfully ratified by the states, they were merely declared ratified by Philander Knox. "*The Law That Never Was*" describes the hard evidence (certified copies of state archives) accumulated by Red Beckman and Bill Benson, that proves the 16th amendment fraud. Similar evidence supposedly exists for the 17th amendment fraud, but in reality only one "no" vote was needed to kill the 17th because no state can be denied its representation in congress. The courts acknowledge the fraud of the 16th, but say it's now "a political issue," while the congressional Judicial Committee claims it's a judicial issue. Perhaps it's time for you to make it a political issue.

It's no coincidence that the 16th and 17th amendments and the Federal Reserve Act were all enacted into law in 1913 on 2/25, 5/31 and 12/23, respectively. Federal Reserve Notes have to be taxed out of the economy nearly as fast as they are pumped in to maintain their artificial value, so any real resistance to taxation must be eliminated (17th amendment). By controlling the relative input and removal of Federal Reserve Notes, inflation and deflation can be created at will, which some have argued is necessary to counter wage reduction resistance. (People tend to ignore supply and demand when it comes to their wage. Employees will resist a reduction in wage even if prices are falling and the net effect is an increase in buying power.) However, government control of money has repeatedly proven itself to be harmful to all but those in control.

The Federal Reserve, in conjunction with the legal tender laws, enabled the federal government (12 USC 95) to control the value of "money" and effectively steal from savings, which enslaved retirees as welfare (social security) voters. These clearly unconstitutional acts also enabled the federal government to borrow fiat money without limit and steal from future generations, enslaving Americans as taxpayers from birth. Abolish the legal tender laws and good commodity money will drive out bad commercial paper, i.e. Federal Reserve Notes.

The Federalists did not intend the lengthy process of amendment ratification by three-fourths of the states to be supplanted by the simple act of approving a treaty. Clearly, treaties should not have precedence over the federal constitution as currently alleged. Emergency Powers (50 USC 1601-1706 and 50 USC Appendix) are another perversion of constitutional intent. These should no longer be used as excuses to maintain the status quo.

Acknowledge the fraud.

Sincerely,

William T. Holmes
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TSEditor@AOL.com or 72010,3003

TESTIMONY OF SARA E. MELÉNDEZ
INDEPENDENT SECTOR

INDEPENDENT SECTOR (IS) is a nonprofit coalition of 800 corporate, foundation and voluntary organization Members with national interest and impact in philanthropy and voluntary action. The organization's mission is to create a national forum capable of encouraging the giving, volunteering, and not-for-profit initiative that help all of us better serve people, communities and causes. Attached is our Membership list.

The organizations of INDEPENDENT SECTOR and its mission derive from its Members' shared commitment to fundamental values relating to the creation and maintenance of a truly free society. Our Membership list is attached.

Some tax policy officials and analysts believe that the complexity of the current tax code causes an undue amount of unfairness and inefficiency in the raising of tax revenues. These concerns have prompted what are known as "flat tax" proposals. Such proposals have been offered over the last several years, and several are currently under consideration by Congress. The basic goal of a "flat tax" proposal is to apply a single, or "flat", tax rate to all income. A key to the single tax rate actually being flat across all taxpayers is for it to apply to all income. Thus, exclusions from income, and deductions not necessary to properly measure income, are generally not allowed in a flat tax proposal. To the extent deductions consistent with social policy are disallowed, the unintentional effect will be a tax code that is inconsistent with social policy. We believe that a flat tax proposal and similar proposals that disallow a deduction for charitable contributions contain such an inconsistency with the social policy of encouraging private support of charitable causes.

Individuals are motivated to make charitable contributions primarily by their altruistic nature. However, as with any decision related to the use of limited resources, the amount a person gives to charitable causes will be influenced by the cost to them of giving. This cost of giving can be significantly changed by the tax treatment of the gift. The current deductibility of charitable gifts reduces the taxes an individual pays, and thus reduces the net cost of giving. If deductibility of charitable giving is eliminated, then the cost of giving will increase. Generally the more an activity costs, the less of the activity an individual will engage in. A large body of research has shown that tax incentives can have a powerful effect on the amount individuals give. Tax laws can also have important effects on the types of gifts and on the types of groups that receive these gifts.

We discuss below the impact that the proposals would have on contributions to charitable organizations. First, we want to explain why charitable organizations are important to America.

THE IMPORTANCE OF CHARITABLE ORGANIZATIONS TO AMERICA

Nearly one million charitable, educational, religious, health, and social welfare organizations create, nurture, and sustain the values that frame American life. They promote altruism, in a society that reinforces self-interest; community, in a society that reward individual achievement; and pluralism, in a society sometimes threatened with divisiveness. They provoke, challenge, and question. They also teach, mediate, and heal.

Collectively, these organizations represent an increasingly important sector of our society: the independent sector. They function on a not-for-profit basis, entrusted with public purposes and barred by law from private gain. They are exempted from tax on their assets and on income from their public-purpose activities. Those who support them with gifts can deduct those gifts from their own taxable income. Volunteers provide their boards with essential leadership, stewardship and accountability, and play vital roles at all levels.

The independent sector has become a major force in the American economy. In 1990 alone, organizations in this sector received an estimated nearly $123 billion in financial contributions, and volunteer time and energy from nearly 100 million people, as well as income from endowments and revenue-generating activities. That same year, they spent an estimated $389 billion in providing vast and varied services.

Independent sector organizations have played important roles in almost all of American society's major advances – in human rights, health, knowledge, ecology, creativity, and other fields. As with other institutions in our society – government, business, the professions – they are under especially critical scrutiny today. Questioned on what they contribute to the public good, they must be prepared to explain their roles to the public, and give full and frequent accounting of their activities.

At the same time, they must maintain a spirit of diversity and openness that gives them their special character. They must be free to express divergent, even unpopular ideas. And they must not be asked to assume tasks properly performed by government with its vastly greater resources. Only thus can the sector they represent meet the challenge of its independence.

As leaders from other countries are recognizing, organizations of the independent sector reflect and express much of what is best in the American character. They embody and sustain fundamental social, cultural, and spiritual values, including:

Altruism. Independent sector organizations affirm that all human beings have basic moral obligations to look beyond themselves, and to undertake activities for the betterment of other people and other species – present and future. They further affirm that regard for others must balance the self-regard of the marketplace in a duality that engenders the dialogue and compromise essential to democracy.

Altruism is the most fundamental unifying principle among the diverse organizations of the independent sector. It is the root of their other values: compassion, humility, respect for others, concern for the community, and justice for all.

Pluralism. America's multitudes, with our countless heritages, cultures, political philosophies, and religious beliefs, reflect an unparalleled pluralism. This diversity cradles our society's creative energies, and represents a core value of its life.

For the organizations of the independent sector, encouraging and sustaining pluralism represents a second unifying principle. They affirm that our nation gains strength from respecting differences among its citizens and fostering the free and creative expression of ideas and opinions. Each organization owes its own creation to individuals who acted upon distinct ideas and values.

Some organizations work in areas barred to government: religion in particular. Some speak out in the forum of public discourse, and resist government intrusion lest it suppress dissent. Some spring up swiftly, responding in crises to special human needs. Others provide alternative responses to constant needs.

Community. The principle of community reaches beyond geographic or demographic entities. Communities are groups of individuals who share common values, interests, purposes, or goals. They are critical to our economic, political, social, intellectual, and cultural life. The independent sector itself is a vast community.

Organizations of the independent sector create, nourish, enlarge, and sustain communities. Education equips individuals with the scholarship, discipline, and creativity to contribute effectively to community life. Arts, culture, and the humanities stimulate community self-discovery, self-awareness, and self-definition. They preserve a community's heritage, challenge its assumptions, and refine its perceptions.

Human service, health, and religious groups bring commitment to the community's welfare. They instill compassion for community members in need, and provide the mechanisms to address particular community problems. Human rights, environmental, and public policy groups teach leadership, consensus-building, and citizen participation skills that ensure community vitality. They empower individuals to lead, and offer them leadership opportunities.

In summary, business and government alone cannot sustain altruism, pluralism, and community - principles fundamental to American society - nor the underlying values of trust, compassion, justice, and moral behavior that bind us together.

The independent sector has become America's linchpin. Business, government, and in fact all Americans have a fundamental stake in preserving and strengthening it.

HOW CHANGES IN THE DEDUCTIBILITY OF CHARITABLE CONTRIBUTIONS AFFECT GIVING TO CHARITABLE ORGANIZATIONS

A deductible contribution actually costs the giver the amount of the contribution less the reduction in taxes due to the deduction. Thus, a $1 gift costs $1 less the applicable marginal tax rate (1 - marginal tax rate). Economists define this as the price of giving. For example, the price of making a $1 deductible contribution for a taxpayer with a 25 marginal tax rate would be 0.75 (1 - 0.25).

The effect of a change in the price of giving on the amount a person give depends on how responsive they are to the price of giving. Empirical evidence indicates that, generally, the percentage change in the amount of giving due to a change in the price of giving will be -1.13 time the percentage change in the price of giving. For example, assume that a person with a 25 percent marginal tax rate is giving $1,000 when the contribution is deductible (e.g. the price of giving is 0.75). If the contribution is made non-deductible, the price of giving increases to 1.0, a 33% increase. Thus, this person's giving would fall by 38% (33% x -1.13), or by $380. In this example, eliminating deductibility of the contribution reduces giving from $1,000 to $620.

The foregoing illustration demonstrates that while the federal government gains $250 in revenue by disallowing the charitable deduction, charitable causes lose $380 as a result of the decreased incentive to give.

Stating the foregoing in the positive, it's a good investment by the federal government to allow the charitable tax deduction. The federal government, by "investing" $250 in revenue lost as a result of the charitable tax deduction, gains $380 or 52% in funds expended by the charity on public purposes such as feeding the homeless, comforting the sick, rehabilitating drug abusers, supporting community arts groups, preserving historic houses, protecting wetlands from pollution and neighborhoods from crime, and serving countless other local, regional, national and even international purposes.

THE MAGNITUDE OF THE EFFECT ON CHARITABLE CONTRIBUTIONS OF A FLAT TAX WITH NO DEDUCTION FOR CHARITABLE CONTRIBUTIONS

The effect of a change in tax rules on the amount of charitable contributions will depend on a number of factors, including the responsiveness of the taxpayers, the speed at which taxpayers adjust their behavior, the distribution of the magnitude of the tax change across taxpayers of different characteristics, and the response of charitable organizations with regard to their fund raising activities. While many flat tax proposals are similar in structure, apparently minor differences can have significant implications for the overall effect of the proposal on the level of charitable contributions. However, the following discussion is meant to provide an indication of the effect a flat tax with no deduction for charitable contributions could have on the level of charitable contributions.

Itemizers can currently deduct their charitable contributions, and the amount they give reflects this incentive. Most flat tax proposals would expand the measure of income subject to tax and reduce the tax rate. In expanding the amount of income subject to tax, some of these proposals would provide no deduction for charitable contributions. If [the] deductibility [of charitable contributions] were eliminated, itemizers would reduce the amount they give. In 1992, approximately 32 million itemizers reported approximately $63 billion of charitable contributions. If the deductibility of contributions were eliminated, this level of giving would likely have been more than $20 billion lower. While charitable organizations may be able to offset some of this reduction by more aggressive fund raising techniques, a substantial short-fall is inevitable.

Most flat tax proposals are designed to be neutral with regard to tax revenues - e.g. to raise the same amount of tax revenues that are raised by the current tax rules. While some flat tax proposals would result in lower total individual income taxes, they generally increase corporate income taxes by a like amount. Since all taxes are ultimately paid by individuals, such revenue neutral flat tax proposals will have no effect on the aggregate tax burden, and thus provide no increase in total after-tax income out of which to give to charitable causes. To the extent some individuals do experience a reduction in their tax liability as a result of a flat tax proposal, the additional after-tax income would likely be relatively small, and would be apportioned among a large number of consumption alternatives as well as savings. Thus, any increase in charitable contributions from increases in after-tax income would be expected to be quite small, and not nearly large enough to offset the reductions due to the increased cost of giving.

In addition to affecting the total amount of charitable contributions, the above tax law changes would significantly affect the proportion of gifts going to different types of recipients. For example, the $20 billion reduction in itemizer giving would likely come disproportionately from educational institutions, cultural institutions, and private foundations.

CONCLUSION

Although not the primary reason for individuals making charitable contributions, the tax treatment of charitable contributions can have very significant effects on both the level and composition of individual gifts. Enactment of a flat tax with no deduction for charitable contributions would result in a substantial reduction in the amount of individual charitable contributions relative to what would be given under the current tax rules. This reduction would come on top of a drop of 24% of household giving to charities, from 1989 to 1993, according to latest information available as reported in Giving and Volunteering in the United States - Findings from a National Survey by INDEPENDENT SECTOR, 1994.

INDEPENDENT SECTOR VOTING MEMBERS

AAFRC Trust for Philanthropy
AASK America Adopt a Special Kid
Access Video Fund
ACCESS: Networking in the Public Interest
Accountants for the Public Interest
The Advertising Council
Advocacy Institute
Aetna Foundation
Affiliated Leadership League of and for the Blind of America
Aga Khan Foundation U.S.A.
Agricultural Educational Foundation (AEF)
Aid Association for Lutherans
Aid to Artisans
Alcoa Foundation
Horatio Alger Association of Distinguished Americans
Alliance for International Educational and Cultural Exchange
Allied-Signal Foundation
Alzheimer's Association
America's Charities
America's Development Foundation
American Arts Alliance
American Association for Higher Education
American Association for the Advancement of Science
American Association of Community Colleges
American Association of Fund-Raising Counsel
American Association of Museums
American Association of Retired Persons
American Association of University Women
American Autoimmune Related Diseases Association
American Cancer Society
American Chemical Society
American Committee on Africa
American Council for the Arts
American Council of Learned Societies
American Council on Education
American Craft Council
American Diabetes Association
American Dietetic Association
American Express Company
American Farmland Trust
American Fisheries Society
American Foundation for AIDS Research
American Foundation for the Blind
American Fund for Dental Health
American Heart Association
American Humane Association
American Humanics
American Indian College Fund
American Indian Graduate Center
American Institute for Cancer Research
American Institute of Philanthropy
American Leadership Forum
American Library Association
American Medical Association
American Museum of Natural History
American Red Cross National Headquarters

American Social Health Association
American Solar Energy Society
American Stock Exchange
American Symphony Orchestra League
American Tinnitus Association
American Women Composers
Americans for Indian Opportunity
Americans for Medical Progress Educational Foundation
Amigos de las Americas
Amoco Foundation
Apple Computer
The Arc of the United States
Arca Foundation
ARCO Foundation
Arizona Community Foundation
ARNOVA - Association for Research on Nonprofit Organizations & Voluntary Action
ARROW
Arthritis Foundation
Arts & Business Council
Asian Pacific American Legal Consortium
The Aspen Institute
The ASPIRA Association
Associated Grantmakers of Massachusetts
Association for Healthcare Philanthropy
Association for Volunteer Administration
Association of Advanced Rabbinical & Talmudic Schools (AARTS)
Association of America's Public Television Stations
Association of American Universities
Association of American University Presses
Association of Art Museum Directors
Association of Black Foundation Executives
Association of Catholic Colleges and Universities
Association of Episcopal Colleges
Association of Governing Boards of Universities and Colleges
Association of Jesuit Colleges and Universities
Association of Junior Leagues International
Association of Lutheran Development Executives
Association of Performing Arts Presenters
Association of Science-Technology Centers
AT&T Foundation
Atlantic Foundation of New York
Mary Reynolds Babcock Foundation
Bainbridge Educational Foundation
Ball Brothers Foundation
Association of Baltimore Area Grantmakers
Battle Creek Community Foundation
The Bauman Foundation
BellSouth Corporation
Benton Foundation
Beverly Foundation
Big Brothers/Big Sisters of America
Bing Fund Corp.
Blandin Foundation
Blanton-Peale/Institutes of Religion and Health
H&R Block Foundation
Borden Foundation

Boston Foundation
Boy Scouts of America
Boys and Girls Clubs of America
Brain Trauma Foundation
Otto Bremer Foundation
Greater Bridgeport Area Foundation
Bristol-Myers Squibb Foundation
Brunswick Foundation
The Burnett-Tandy Foundation
Edyth Bush Charitable Foundation
The Bush Foundation
Patrick and Aimee Butler Foundation
California Association of Nonprofits
California Community Foundation
California Wellness Foundation
Camp Fire Boys and Girls
Cancer Care
CARE
Carnegie Corporation of New York
The Annie E. Casey Foundation
Catalyst
Caterpillar Foundation
Catholic Charities USA
CBS Foundation
Center for Applied Linguistics
Center for Corporate Public Involvement
Center for Creative Leadership
Center for Creative Management
Center for Foreign Journalists
Center for Media Education
Center for Non-Profit Corporations
Center for Nonprofit Management University of St. Thomas
Center for Policy Alternatives
Center for Public Service, Seton Hall University
Center for Research in Ambulatory Health Care Administration
Center for the Study of Philanthropy-City University of NY
Center for the Study of the Presidency
Challenger Center for Space Science Education
Champion International Corporation
Chase Manhattan Bank, N.A.
The Chevron Companies
The Chicago Community Trust
Chicago Tribune Foundation
Child Care Action Campaign
Child Health Foundation
Child Welfare League of America
Children's Aid International
Children's Fund of Connecticut
Chorus America (APVE)
Christian Church Foundation
Christmas in April USA
Chrysler Corporation Fund
Church Women United
Citibank
Citizens' Scholarship Foundation of America
City Cares of America

City Innovation
City of Hope National Medical Center
City Year
Edna McConnell Clark Foundation
Clearinghouse for Midcontinent Foundations
The Cleveland Foundation
Van Cliburn Foundation
The Clorox Company Foundation
Close Up Foundation
The Coca-Cola Company
CODEL - Coordination in Development
College and University Personnel Association
College Board
Colonial Williamsburg Foundation
Colorado Association of Nonprofit Organizations
The Colorado Trust
Columbia Foundation
Columbus Foundation
Combined Health Appeal of America
Comerica Incorporated
Committee for a Responsible Federal Budget
Commonwealth Fund
Communications Consortium
Community Anti-Drug Coalitions of America
Compeer
Compton Foundation
Conference of National Park Cooperating Associations
Conference of Southwest Foundations
Congress of National Black Churches
The Conservation Fund
Consortium of Endowed Episcopal Parishes
Continental Corporation Foundation
Cooperative Development Foundation
Coordinating Council for Foundations
Corning Incorporated Foundation
Coro/Eastern Center
Corporation for Enterprise Development
Council for Advancement and Support of Education
Council for American Private Education
Council of Better Business Bureaus/Philanthropic Advisory Service
Council of Energy Resource Tribes
Council of Independent Colleges
Council of Jewish Federations
Council of Michigan Foundations
Council on Economic Priorities
Council on Foundations
Council on International and Public Affairs
Counterpart Foundation
Cowles Media Company/Cowles Media Foundation
CPC International
Cystic Fibrosis Foundation
Dade Community Foundation
Charles A. Dana Foundation
Dance/USA
Dayton Hudson Foundation
Deafness Research Foundation

Delaware Association of Nonprofit Agencies
Direct Relief International
Geraldine R. Dodge Foundation
Dole Foundation for Employment of People with Disabilities
Gaylord and Dorothy Donnelley Foundation
R.R. Donnelley & Sons Co.
Donors Forum of Chicago
Donors Forum of Ohio
Donors Forum of Wisconsin
The Dow Chemical Company
Joseph Drown Foundation
Peter F. Drucker Foundation for Nonprofit Management
The Drug Policy Foundation
The Duke Endowment
DuPont
The Durfee Foundation
Earth Share
Eastman Kodak Company
Ecolab Foundation
Ecumenical Center for Stewardship Studies
Educational Testing Service
El Pomar Foundation
Elderhostel
Elderworks
Enterprise Foundation
Environmental Defense Fund
Environmental Support Center
Epilepsy Foundation of America
The Equitable Foundation
Eureka Communities
Evangelical Council for Financial Accountability (ECFA)
Evangelical Lutheran Church in America
Exxon Corporation
Fairfield County Community Foundation
Maurice Falk Medical Fund
Families International
Fannie Mae Foundation
Fel-Pro/Mecklenburger
First Interstate Bank of California Foundation
First Nations Development Institute
First Nonprofit Companies
Father Flanagan's Boys' Home
Community Foundation of Greater Flint
Florida Association of Nonprofit Organizations
Food Research and Action Council
The Ford Foundation
Ford Motor Company Fund
Henry Ford Museum and Greenfield Village
Foreign Policy Association
The Foundation Center
Foundation for Advancements in Science and Education
Foundation for Independent Higher Education
Foundation for the Carolinas
Foundation for the National Capital Region
The Freedom Forum
The Fresh Air Fund

Frey Foundation
Friends of the National Library of Medicine
Lloyd A. Fry Foundation
H.B. Fuller Company
The Fund for New Jersey
Fund for Theological Education
GE Fund
General Board of Global Ministries The United Methodist Church
General Conference of Seventh-day Adventists
General Mills Foundation
General Service Foundation
The Wallace Alexander Gerbode Foundation
J. Paul Getty Trust
Gifts in Kind America
Giraffe Project
Girl Scouts of the U.S.A.
Girls Incorporated
Global Fund for Women
Richard & Rhoda Goldman Fund
Morris Goldseker Foundation of Maryland
Goodwill Industries International
Goodyear Tire & Rubber Company
Edwin Gould Foundation for Children
Graco Foundation
The Grand Rapids Foundation
Grantmakers in Health
Grantmakers of Western Pennsylvania
Lucile & Robert H. Gries Charity Fund
Grotto Foundation
GTE Foundation
George Gund Foundation
Alan Guttmacher Institute
Miriam and Peter Haas Fund
Walter and Elise Haas Fund
Evelyn and Walter Haas, Jr. Fund
Habitat for Humanity International
Hallmark Corporate Foundation
Luke B. Hancock Foundation
Mary W. Harriman Foundation
Harris Bank Foundation
Hartford Foundation for Public Giving
Hawaii Community Foundation
Charles Hayden Foundation
Hazelden Foundation
Edward W. Hazen Foundation
Healing Community
William Randolph Hearst Foundations
The William and Flora Hewlett Foundation
High/Scope Educational Research Foundation
Hispanic Association on Corporate Responsibility
Hispanic Policy Development Project
Hispanics in Philanthropy
Hitachi Foundation
Hoblitzelle Foundation
Hoffmann-La Roche Foundation
Hogg Foundation for Mental Health

Honeywell Foundation
The Hospital for Special Surgery
Hostelling International-American Youth Hostels
Housing Assistance Council
Hudson-Webber Foundation
The Huffy Foundation
Human Life International
Humboldt Area Foundation
Huntington's Disease Society of America
IBM Corporation
Illinois Association of Nonprofit Organizations
IMPACT II
Independent Charities of America
Indiana Donors Alliance
The Indiana University Center on Philanthropy
Innovation Network
Institute for Educational Leadership
Institute for Women's Policy Research
Intel Foundation
InterAction-American Council for Voluntary International Action
Interlochen Center for the Arts
International Alliance of Executive and Professional Women
International Center for the Disabled
International Development Conference
International Executive Service Corps
International Primate Protection League
International Service Agencies
International Society for Third Sector Research
The James Irvine Foundation
Ittleson Foundation
Jacksonville Community Foundation
JCC Association of North America
Jerome Foundation
The Jewett Foundation
JM Foundation
Johnson & Johnson
The Johnson Foundation
Walter S. Johnson Foundation
Christian A. Johnson Endeavor Foundation
Robert Wood Johnson Foundation
Joint Action in Community Service (JACS)
Joint Center for Political and Economic Studies
Josephson Institute of Ethics
The Joyce Foundation
JSJ Foundation
Alexander Julian Foundation
Junior Achievement
Henry J. Kaiser Family Foundation
Kaman Corporation
Greater Kanawha Valley Foundation
Ewing Marion Kauffman Foundation
W.K. Kellogg Foundation
James S. Kemper Foundation
Harris and Eliza Kempner Fund
Kerr Foundation
Charles F. Kettering Foundation

Kids Voting USA
Carl B. & Florence E. King Foundation
John S. and James L. Knight Foundation
Kosciuszko Foundation
KPMG Peat Marwick Foundation
The Kresge Foundation
Samuel H. Kress Foundation
Albert Kunstadter Family Foundation
Land Stewardship Project
Land Trust Alliance
Laubach Literacy Action
Laurel Foundation
Lawyers' Committee for Civil Rights Under Law
League of Women Voters of the United States
Sara Lee Foundation
Leukemia Society of America
Lilly Endowment
Eli Lilly and Company
Lincoln Filene Center
Literacy Volunteers of America
Local Initiatives Support Corporation
George Lucas Educational Foundation
Lupus Foundation of America
Lutheran Brotherhood Foundation
John D. and Catherine T. MacArthur Foundation
Mallinckrodt Group
MANA, A National Latina Organization
Mandel Center for Nonprofit Organizations Case Western Reserve University
March for Life Education & Defense Fund
March of Dimes Birth Defects Foundation
Marin Community Foundation
John and Mary R. Markle Foundation
Marsh & McLennan Companies
Maryland Association of Nonprofit Organizations
MATHCOUNTS/NSPE Education Foundation
Matsushita Electric Corporation of America
Mayo Foundation
McConnell Foundation
Robert R. McCormick Tribune Foundation
McGregor Fund
McKesson Foundation
McKnight Foundation
The Meadows Foundation
Medical Education for South African Blacks
Richard King Mellon Foundation
Memorial Sloan-Kettering Cancer Center
Community Foundation of Greater Memphis
The Menninger Foundation
The John Merck Fund
Mercy Medical Airlift
Merrill Lynch & Co. Foundation
Metropolitan Association for Philanthropy
Metropolitan Atlanta Community Foundation
Metropolitan Life Foundation
Metropolitan Museum of Art
Mexican American Legal Defense and Educational Fund

Eugene and Agnes E. Meyer Foundation
Michigan Nonprofit Forum
Midwest Center for Nonprofit Leadership L.P. Cookingham Institute
Miles Inc. Foundation
John Milton Society for the Blind
Milwaukee Foundation
The Minneapolis Foundation
Minnesota Council of Nonprofits
Minnesota Mutual Foundation
Mississippi Center for Nonprofits
Mobil Foundation
Monsanto Fund
Moore Foundation
Stewart R. Mott Charitable Trust
Charles Stewart Mott Foundation
Muscular Dystrophy Association
Museum Trustee Association
Muskegon County Community Foundation
Mutual of New York
NAACP Legal Defense and Educational Fund
National Academy of Public Administration
National Action Council for Minorities in Engineering (NACME)
National AIDS Fund
National Alliance for Choice in Giving
National Alliance for the Mentally Ill
National Alliance of Breast Cancer Organizations
National Alliance of Business
National Assembly of Local Arts Agencies
National Assembly of National Voluntary Health and Social Welfare Organizations
National Assembly of State Arts Agencies (NASAA)
National Assistance League
National Association for Bilingual Education
National Association for Community Leadership
National Association for Visually Handicapped
National Association of Community Action Agencies
National Association of Homes and Services for Children
National Association of Independent Colleges and Universities
National Association of Independent Schools
National Association of Schools of Art and Design
National Association of Schools of Dance
National Association of Schools of Music
National Association of Schools of Public Affairs and Administration
National Association of Schools of Theatre
National Association of Service & Conservation Corps.
National Association of Student Personnel Administrators
National Association of United Methodist Foundations
National Association on Drug Abuse Problems
National Associations in Colorado Springs
National Audubon Society
National Board for Professional Teaching Standards
National Catholic Development Conference
National Catholic Educational Association
National Center for Learning Disabilities
National Center for Nonprofit Boards
National Charities Information Bureau
National Civic League

National College Access Network
National Committee for Responsive Philanthropy
National Committee to Prevent Child Abuse
National Community Reinvestment Coalition
National Concilio of America
National Conference
National Congress for Community Economic Development
National Consumers League
National Council for Adoption
National Council for International Visitors
National Council for Research on Women
National Council of Educational Opportunity Associations
National Council of La Raza
National Council of Nonprofit Associations
National Council of Private Agencies for the Blind
National Council of the Churches of Christ in the USA
National Council on Child Abuse & Family Violence
National Council on Economic Education
National Cultural Alliance
National Down Syndrome Society
National Easter Seal Society
National Executive Service Corps
National FFA Foundation
National Foundation for Cancer Research
National Fund for Medical Education
National Geographic Society Education Foundation
National Headache Foundation
National Health Council
National Health Foundation
National Hispana Leadership Institute
National Hispanic Scholarship Fund
National Home Library Foundation
National Hospice Organization
National Humanities Alliance
National Institute for Dispute Resolution
National Institute for the Conservation of Cultural Property
National Interfaith Hospitality Networks
National Leadership Coalition on AIDS
National Lekotek Center
National Medical Enterprises
National Medical Fellowships
National Military Family Association
National Multiple Sclerosis Society
National Neighborhood Coalition
National Network of Runaway and Youth Services
National Network of Women's Funds
National Park Foundation
National Parkinson Foundation
National Peace Corps Association
National Press Foundation
National Public Radio
National Puerto Rican Coalition
National Retiree Volunteer Coalition
National Society for Experiential Education (NSEE)
National Society of Fund Raising Executives
National Stroke Association

National Trust for Historic Preservation
National Urban Fellows
National Urban League
National Victim Center
National Wildlife Federation
National Youth Employment Coalition
Native American Rights Fund
Natural Resources Defense Council
The Nature Conservancy
Neighborhood Reinvestment Corporation
New Hampshire Charitable Foundation
The Community Foundation for Greater New Haven
The New York Botanical Garden
The New York Community Trust
New York Life Insurance Company
The New York Public Library
New York Regional Association of Grantmakers
New York Times Company Foundation
Nokomis Foundation
Nonprofit Academic Centers Council
Nonprofit Coordinating Committee of New York
Nonprofit Management Association
Nonprofit Management Program, New School for Social Research
Nonprofit Resource Center
The Nord Family Foundation
Nordson Corporation Foundation
North American Association for Environmental Education
North Carolina Center for Nonprofit Organizations
Northern California Grantmakers
Northwest Area Foundation
NOW Legal Defense and Education Fund
NYNEX Foundation
Oakleaf Foundation
OICs of America
Older Women's League (OWL)
OPERA America
Operation Smile International
Outward Bound USA
Pacific Telesis Foundation
David and Lucile Packard Foundation
Paget Foundation
Community Foundation for Palm Beach & Martin Counties
Park Ridge Center for the Study of Health, Faith and Ethics
Partners of the Americas
Pax World Service
Peninsula Community Foundation
William Penn Foundation
J.C. Penney Company
University of Pennsylvania Center for Community Partnerships
People-to-People Health Foundation
Pew Charitable Trusts
The Pfizer Foundation
Philip Morris Companies
The Piton Foundation
The Pittsburgh Foundation
The Planetary Society

Points of Light Foundation
Population Council
Population Resource Center
Premier Industrial Foundation
Presbyterian Health Foundation
Presbyterian Women
Presidential Classroom for Young Americans
Prince Charitable Trusts
Princeton Project 55
Private Agencies Collaborating Together (PACT)
Private Sector Initiatives Foundation
Pro Choice Resource Center
Procter & Gamble Fund
Project SEED
Prudential Foundation
Public Affairs Council
Public Agenda Foundation
Public Allies
Public Education Fund Network
Public Leadership Education Network
Public Radio International
Puerto Rican Legal Defense and Education Fund
Quest International
Radio and Television News Directors Foundation
Rainbow Research
Raychem Corporation
Raytheon Company
Reader's Digest Foundation
Reading is Fundamental
Recording for the Blind
Religion in American Life
Research! America
Resourceful Women
Retirement Research Foundation
Charles H. Revson Foundation
Rhone-Poulenc
Sid W. Richardson Foundation
Fannie E. Rippel Foundation
Rochester Area Foundation
Rockefeller Brothers Fund
Rockefeller Family Fund
Rockefeller Financial Services
Rockefeller Foundation
Rohm and Haas Company
Rosenberg Foundation
Roy A. Hunt Foundation
SAFECO Insurance Companies
The Saint Paul Companies
Saint Paul Foundation
The Salk Institute for Biological Studies
Salvation Army
San Antonio Area Foundation
San Francisco Foundation
University of San Francisco-Institute for Nonprofit Organization Management
Save the Children Federation
Dr. Scholl Foundation

School Food Service Foundation
The School for Field Studies
Sears, Roebuck and Co. Sears/Allstate/Homart
Seattle Foundation
Second Harvest
Shepherd's Centers of America
Sherwin-Williams Company
Sierra Club
Sierra Health Foundation
Harry Singer Foundation
The Sister Fund
The Skillbuilders Fund
Skillman Foundation
Alfred P. Sloan Foundation
Smithsonian Institution
John Ben Snow Foundation
Social Welfare Research Institute Boston College
Society for Values in Higher Education
Southeastern Council of Foundations
Community Foundation for Southeastern Michigan
Southern California Association for Philanthropy
Southern Education Foundation
The Spencer Foundation
Spunk Fund
W. Clement & Jessie V. Stone Foundation
Levi Strauss & Company
Student Conservation Association
Student Pugwash USA
The Studio Museum in Harlem
Subaru of America Foundation
Support Centers of America
Synergos Institute
Taconic Foundation
Taft Institute
Tandy Corporation
Community Foundation of Metropolitan Tarrant County
TechnoServe
Tenneco
Texaco Foundation
Theatre Communications Group
3M
Time Warner
Travelers Aid International
The Trilateral Commission
The Parish of Trinity Church in the City of New York
Trust for Public Land
U.S. Trust Company Foundation
Union Institute-Center for Public Policy
United Cerebral Palsy Associations
United Leukodystrophy Foundation
United Negro College Fund
United Scleroderma Foundation
United States Catholic Conference
United States Committee for UNICEF
United States-China Educational Institute
United Way International

United Way of America
UPS Foundation
US West Foundation
Vellore Christian Medical College Board (USA)
Vesper Society
Visiting Nurse Associations of America
Volunteers of America
Volvo North America Corporation
Izaak Walton League of America
Washington Center
Washington Council of Agencies
Washington Mutual Savings Bank
WAVE
The Wege Foundation
Weingart Foundation
Weyerhaeuser Family Foundation
Whirlpool Foundation
Mrs. Giles Whiting Foundation
Amherst H. Wilder Foundation
Woodrow Wilson National Fellowship Foundation
The Winston-Salem Foundation
Wisconsin Energy Corporation Foundation
Women and Philanthropy
Women in Communications
Women's College Coalition
The Women's Philharmonic
Women's Research & Education Institute
Robert W. Woodruff Foundation
Woods Fund of Chicago
Greater Worcester Community Foundation
World Federation for Mental Health
World Resources Institute
World Vision
Wyman Youth Trust
Xerox Corporation
YMCA of the USA
Young Audiences
Youth Service America
YWCA of the USA
Zellerbach Family Fund

Kathy Jabour, CFP
Certified Financial Planner

June 16, 1995

Mr. Phillip Mosley, Chief of Staff
Committee on Ways & Means
US House of Representatives
1102 Longworth
Washington DC 20515

Dear Mr. Mosley,

I am in complete support with eradicating our current tax system which as you know penalizes the productive people of this country.

I think the National Sales Tax would be the best system to replace our current system for these reasons:

1. It is the form of taxation our Constitution allows.
2. It would require everyone to pay. Drug dealers, prostitutes, and other illegal money makers would finally contribute to our system.
3. It would not allow the Congress to eliminate the deductions and then raise the tax, like they could if we had a flat tax.

A flat tax would still allow for cheating and wasted time preparing forms for the IRS. We must eliminate the IRS and all the wasteful acts associated with preparing our tax returns.

I personally spend too much time with accounting for my business, my husband's business, our joint business and our rental properties. I'm sick and tired of it all!

Lastly, I'm sick of my husband and I paying 15.3% of our income in Social Security taxes in addition to income taxes because we're self employed. I know without a doubt, that I can prepare for my retirement much better than the government, since advising people on this issue is what I do for a living.

If the employees of this country had to come out of their savings like we do, this debate would have taken place many years ago.

Please push towards the National Sales Tax.

Thank You,

Kathy Jabour, CFP

P.O. Box 5561 • Vacaville, CA 95696
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FINANCIAL PLANNING

ECONOMIC STABILIZATION PROGRAM P.O. Box 1948 Waianae, HI 96792

June 7 1995

Mr Bill Archer
Committee on Ways and Means
Longworth House Office Building
Washington, D.C. 20515-6348

Dear Mr. Archer;

It is most difficult to change antiquated methods . That have been used more than two thousand years. Many American citizens demand that corrective action must be taken. The method of correcting the present tax situation must be properly accomplished. Since America and many other nations are dependent upon world economic stability.

An appropreate award is requested. Due to the magnitude of the situation.

Adoption of the ECONOMIC STABILIZATION PROGRAM By the President and Congress. in session. With members of the supreme court and national media in attendence. Will result in the following;

No reduction in any State or Federal agencies activities, nor reduction in any military branch will be required. All will receive full funding.

A period of time of two to three hours will be required to present the program to the nation.

Negotiations are invited at the earlyest.

Respectfully,

H. Johnson

H. Johnson
Ph. (808) 696 2115

Roger L. Johnson
575 Wisteria Street
Chula Vista, CA 91911

6 June 1995

Honorable Phillip D. Moseley
U. S. House of Representatives
Ways and Means Committee
1102 Longworth Office Building
Washington, D.C. 20515

Re: *Elimination of the Internal Revenue Service*

Dear Representative Moseley:

As I understand it, the two directions we are headed are a FLAT TAX OF 17% or a NATIONAL SALES TAX. As you deliberate, look at these two options from the viewpoints of taxpayers at the bottom, middle and upper end of the income spectrum. I make roughly $50,000 per year and pay about 14% in federal taxes. I would be hurt by a 17% flat tax. Since our last child gets married this weekend, my wife and I can could drastically reduce our monthly purchases, thereby making the sales tax look good. But...

With a national sales tax, the poor person (who spends every dollar every month just to survive) will be impacted much more than the rich person (who only spends a small part of his income each month to achieve that same goal). With a flat tax, the poor person will likewise be impacted more than the rich person because the poor are paying a much smaller percentage of their income (in the present tax system) than the rich. WITHOUT SOME ADJUSTMENT, THE POOR WILL BE HURT BY EITHER SYSTEM, WHEREAS THE RICH WILL BE HELPED.

I give my vote for the national sales tax, but only if the necessities of life upon which the poor spend nearly all their income (food, clothes, shelter, medical, utilities, etc) are exempt from the tax.

Whatever you do, you must get rid of the IRS! May God help you in your deliberations.

Very respectfully,

Roger L. Johnson

Roger L. Johnson

4715 Rittenhouse St
Riverdale, Md 20737
301-277-2242

20 June 1995

Dear Congressman Archer,

I am writing to ask the ways and means committee to consider a "location value tax" for tax reform. It is also known as site value, land, or single tax.

The tax is levied on the location value of the land a land owner is using.

Regarding the four conditions the committee set out:

1. It would be easy to comply with as the land one is using would have a market value (assessed by similar system to present property value assessment) and the tax rate. Only land owners would be taxed. It is a simpler tax on a lower portion of the populace.
2. Since property, income, and sales taxes could be replaced with the location value tax, greater investment and savings can take place. Improvements to property would be made since the present disincentive of property tax would be removed savings could increase because the burdens on production of income and sales taxes would be removed
3. The location tax encourages "best economic use" on any property because to adjacent properties will have the same tax (example a city lot with an office building will be paying the same tax as an empty lot next to it – the owner of the vacant lot will be encouraged to move pop to the best economic use) with the whole of our land use moving to best economic use – american labor and capital will be internationally competitive.
4. The land that is used cannot be hidden from the tax collector and since the location value subsumes all the economic activity, all the economy will be subject to taxes and there will be no underground economy

I am available for more details

sincerely,
Jack R Jones

6791 Jasper Place S.E.
Port Orchard, WA 98366

Representative Phillip Moseley
Chief of Staff, House Ways & Means Committee
U.S. House of Representatives
Washington, D.C. 20510

May 27, 1995

Re: Tax Reform

Dear Representative Moseley:

Please allow me to submit the following input in six copies for consideration and entry into the Congressional record:

I would like to voice my strong support for the Armey flat tax. Every year Americans are tasked with the burdensome duty of filing their income tax. With the large number of tax forms, schedules, and tax laws that are always changing, even the most educated individual finds this chore extremely difficult. I fail to see why a duty of all Americans has to be so difficult that professional assistance is often required and the best results are not guaranteed.

The appeal of the Armey flat tax is that it is fair and equitable to all Americans. Under this plan people would have less of a tax burden and there would still be plenty of revenue generated. Another appealing aspect is the form for filing your taxes would be about the size of a postcard. Truly, the Armey flat tax is a brilliant idea whose time has come.

If I could incorporate any changes into the Armey flat tax, I would allow deductions for charitable contributions to encourage people to continue giving to their favorite charities, and deductions for home mortgages. Many people purchase homes because of the tax advantage and home sales only serve to better the economy.

Thank you for allowing me this opportunity.

Sincerely,

Craig

Craig R. Kenwood
Port Orchard, WA

Law Offices of

RONALD ALAN KUNS

SAUSALITO OFFICE:
3020 Bridgeway
Suite 107
Sausalito CA 94965

MAILING ADDRESS:
P.O. Box 751088
Petaluma CA 94975-1088
Tel. (707) 765-4890
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SANTA ROSA OFFICE:
2455 Bennett Valley Rd.
Suite 218-C
Santa Rosa CA 95404

June 7, 1995

P.D. MOSELEY
Ways and Means Committee
U.S. House of Representatives
Longworth Building
Washington D.C. 20515

RE: Review of U.S. Tax Policies

Dear Sir or Madam:

It is my understanding that your Committee is planning on studying the revision of our tax policy with a possibility that a "flat tax" or national sales tax (or other alternative) may replace the travesty that we now have under the current Internal Revenue Code. I have recently read Adams book "For Good and Evil, etc." which I heartily recommend if you have not read it. His treatise on the history of taxation in the world is something everyone should read.

Please count my vote for a complete revision of the insanity we now have. I dream of the day when a tax return is a post card, we no longer have to fear the IRS because it has been disbanded, the billions that are spent on tax preparation can be more effectively used in our economy than subsidizing government bureaucreats, accountants and tax attorneys, and, most importantly, more total revenue is raised from the contributions of all taxpayers to meet the obligations of government (which I trust will be declining under the political regimes to follow this current joke in Washington.)

We will be watching closely to see what is done.

Best regards,

RONALD ALAN KUNS
RAK/sd

Jacqueline Laird
16023 Butte Mountain Road
Jackson, California 95642

June 10, 1995

Dear Mr. Mosley,

Concerning your debate in the House on June 22, please consider the following suggestions on tax reform:

1. Strongly suggest that you get rid of the entire current system. Replacing it with either a flat tax or a consumption tax is equally acceptable to me.

2. I suggest that you either eliminate or drastically lower both capital gains tax and estate taxes.

3. I believe that you should eliminate the restrictions on IRA's when we also have a company pension that were set up in the 1986 tax revision act.

4. To encourage savings, the annual amount of monies we can put in IRA's, 401(k)'s, etc. should be increased since company pensions and social security are being reduced.

Thank you for your time,

Jacqueline Laird

Jacqueline Laird

Original and 6 copies of this letter included, as requested.

15 June 1995

Dear Congress,

As a Conservative [redacted] Republican, I'm so glad The GOP has taken over Congress - and hopefully The White House in 1996. We must do what we can to simplify The tax system and lower taxes to stimulate economic growth. I'm giving you some of my ideas on how to lower taxes, I don't know if all of my ideas are realistic, but we must do something about lowering our debt.

Although I don't specialize in tax law, [redacted] I think some of my ideas are valid. Please read them and ~~are~~ tell me what you think. My number is (818) 296-9696.

Thank you and God Bless America.

Sincerely yours,
U. J. LaRouche

Business ~~Company~~ Tax Relief Program

Preamble: To simplify IRS paperwork, red tape, and bureaucracy, companies have the choice to participate in the Company Tax Relief Program. This program will eliminate tax avenues that cripples the economy to a minimum. The company will save money on taxes, keep more of their profits, and have incentives to invest money to help their businesses grow.

How It can work: Let's say a company with 100 regular employees plus managers and executives and 1 CEO ~~have two~~ ~~this~~ makes $10,000,000 a year. Without participating in the program, the income and tax structures may look like this.

Employees	Salary for Each:	Total Income:
100	$25,000/year	$2,500,000
Managers	Salary for Each:	Total Income:
7	$55,000/year	$385,000
Executives	Salary for Each:	Total Income:
2	$85,000/year	$170,000
CEO	Salary:	Income:
1	$200,000/year	$200,000

The total income for all 110 people is $3,255,000. If the company makes $10,000,000, the capital-gains tax will probably be 31%. This leaves the company $6,900,000, of which $3,255,000 will be given to its workers. Now the money left over is

$1,825,000
$ 245,650
$ 110,500
$ 120,000
$2,321,150

$3,645,000 to spend to improve the company and pay for other expenditures. (Benefits, petty cash funds) Now all 110 people must pay their own income taxes. Let's say the employees pay 27%, the managers pay 31%, the executives pay 35%, and the CEO pay 40%. Knowing this, everybody's net pay (take-home pay) would be:

Employees:

Number:	Ave. Salary:	Tax Rate:	Ave. Net Pay:
100	$25,000	27%	$18,250

Managers:

Number:	Ave. Salary:	Tax Rate:	Ave. Net Pay:
7	$55,000	31%	$37,950

Executives:

Number	Ave. Salary:	Tax Rate:	Ave. Net Pay:
2	$85,000	35%	$55,250

CEO:

Salary:	Tax Rate:	Net Pay:
$200,000	40%	$120,000

For all 110 people, the Net Pay is (100 × $18,250) + (7 × $37,950) + (2 × $55,250) + (1 × $120,000) = $2,321,150. This means that $933,850 - or 27.6% - of everybody's combined salary is taxed. Add that to the $3,100,000 taken away from the capital-gains tax, and the total amount that the company and the workers must pay in taxes is $4,033,850. In other words, 40.34% of the company's income goes to taxes be-

fore anybody takes any money home. This is wrong!

Now, out of the $3,645,000 left over, $2,500,000 is spent on other expenses, like benefits, equipment, and other things. This leaves $1,145,000 in profit.

This is not bad, but lowering taxes will make the situation much better. Here's how the Company Tax Relief Program will work.

<u>The Program:</u>

The basic concept behind the 'Business Tax Relief Program' is that only the company - not the workers - will pay taxes. All individual income taxes will be eliminated, while the company pays only a capital-gains tax. If all employees are willing to work as a team, they should pay taxes solely as a team. The employees should be taxed only once - not twice! Here is what would happen.

1) The CEO of the company goes to the IRS and says, "I want my company to partake in the 'Business Tax Relief Program'."

2) The company is now required to hire an accounting firm made up of at least 1 Certified Public Accountant. The company may or may not already have one. In either case, the CPA should represent the company, <u>not</u> <u>the government</u>!

3) Under the program, the capital-gains tax will be automatically reduced from 31% to 30% and can be reduced more in the future. Remember, a capital gains tax affects everybody, from the CEO to the

lowest employee.

4) All individual income taxes will be eliminated. (How about that for a pay increase!!) All paperwork will now be handled by the accounting firm.

5) The company cannot decrease any employee's salary, even if the decrease is less than the original net pay compared to the new tax-free salary. For example, if an employee's net pay is $18,250 from a $25,000 salary, the company cannot lower that employee's salary to - let's say - $20,000 in a tax-free salary.

6) All employees have the option to be paid only once a month - reducing the paperwork and red tape.

The Results:

For the company earning $10,000,000, 30% will go to the IRS due to the capital-gains tax. This leaves $7,000,000. Now this money can be used to pay all employees.

Employees:

Number	Ave. Salary	Total Net Pay
100	$25,000/yr	$2,500,000

Managers:

Number	Ave. Salary	Total Net Pay
7	$55,000	$385,000

Executives:

Number:	Ave. Salary:	Total Net Pay:
2	$85,000	$170,000

Accountant:

Number:	Ave. Salary:	Total Net Pay:
1	$50,000	$50,000

CEO:

Number	Ave. Salary:	Total Net Pay:
1	$200,000	$200,000

The Total Net Pay for all 111 people - with an accountant now included in the equation - is $3,305,000. Now, out of the $7,000,000 left over, the company has $3,695,000. This is only $50,000 more compared to the $3,645,000 left over from our previous example. Now, let us look at everybody's taxes individually.

Surprise! Surprise! Surprise!

Don't look now! There are no individual taxes! This saves the people in the company $933,850, saving the company a total of $983,850. Let's now examine how this will help the individuals.

Economy Psychology:

For the people making $25,000/year, each will save $6,750 per year since their incomes are now tax-exempt. Think of how America's economic behavior will change since ~~they~~ the people now have more money.

1) They will be less likely to demand a raise.
2) They won't go on strike as often.
3) They will work harder for the money and produce more for the company.
4) They will have fewer health problems due to economic stress.
5) They'll invest more money into a saving account, an IRA, and the stock market.
6) They will donate more money to worthy charities.
7) They can put their children through college - and pay in cash.
8) They will patronize booming businesses that would have otherwise gone bankrupt.
9) They will buy the finer things in life.
10) Company CEOs will employ more people.
11) Improvements in technology will grow at a faster pace.
12) Interest payments - for college loans, cars, and credit cards, for example - will dwindle to almost nothing.
13) They will restore their pride in America.
14) Crime will decrease drastically.
15) They will be better educated.
16) They will be much less dependent on the government after retirement, making life better for all.
17) They will work less and accomplish more.
18) They will spend vacation time <u>on vacation.</u>
19) They will work together as a team.
20) Unemployment will go down greatly.
21) They will not complain nearly as often.
22) They will be nicer to each other.
23) Two-parent households will increase.
24) Personal problems will be solved faster.

25) The Democratic Party will no longer exist.
26) They will be their brother's keeper.
27) Homelessness will be almost non-existent.
28) Teen pregnancy will go down.
29) They will live much longer.
30) They will help strangers in times of need.
31) They will be more physically fit.
32) The size of government will go down.
33) They will laugh much more often.
34) Preventable expenses and suffering will go down.
35) They will be more likely to say "no" to drugs.
36) They will watch more sunsets and less television.
37) Children will grow in more stable households.
38) They will be much less tolerant towards immorality.
39) They will take more risks and fewer changes.
40) Drunk driving will go down.
41) They won't take the Lord's name in vain as often.
42) There will be more orphanages and fewer foster homes.
43) They will borrow more sugar and less money.
44) They will celebrate November 8th as Independence Day. (Think of the year 1994!)
45) There will be more (first-time) weddings and fewer divorces.
46) They will no longer think of "God Bless America" as an oxymoron.
47) Companies will be more conscious about customer service.
48) Young people will give more respect to elderly folks.
49) They will honor old-fashioned family values much more.
50) They will build more and destroy less.

CAN YOU THINK OF MORE!

Reducing (Eliminating) Tax Avenues:

In order to reduce taxes, America must reduce tax avenues. We must eliminate the number of ways Americans are taxed to increase tax revenue and to stimulate the economy. Here's my proposal.

1) Capital-Gains Tax:

The Business Tax Relief Program will give all participating companies a flat capital-gains tax of 30%. This will give companies a greater incentive to invest and hire more people.

2) Individual Income Taxes:

The Business Tax Relief Program will immediately eliminate all individual income taxes. This will help people patronize many other business, help them reduce their interest rates, save for retirement, and help them gain independence from government subsidies.

3) State Sales Taxes:

State sales taxes for all 50 states and the District of Columbia will be immediately eliminated. It's bad enough people are taxed through ~~to~~ their companies for earning money. Why should the government penalize people for buying something? Eradicating the sales tax will stimulate the economy by encouraging people to buy things.

4) Luxury Taxes:

Imposing luxury taxes only weakens the economy and ~~forcing~~ forces hard-working, middle-class Americans to be unemployed. All luxury taxes should be immediately

eliminated.

5) Tobacco and Alcohol Taxes:
Although all Americans should avoid Tobacco and alcohol products of all Kinds, the government should never impose Taxes to discourage consumption. Instead, let a grass-roots movement curb Tobacco and alcohol use. The government should eliminate all Tobacco and alcohol taxes.

6) All Other Taxes:
Don't even think about it.

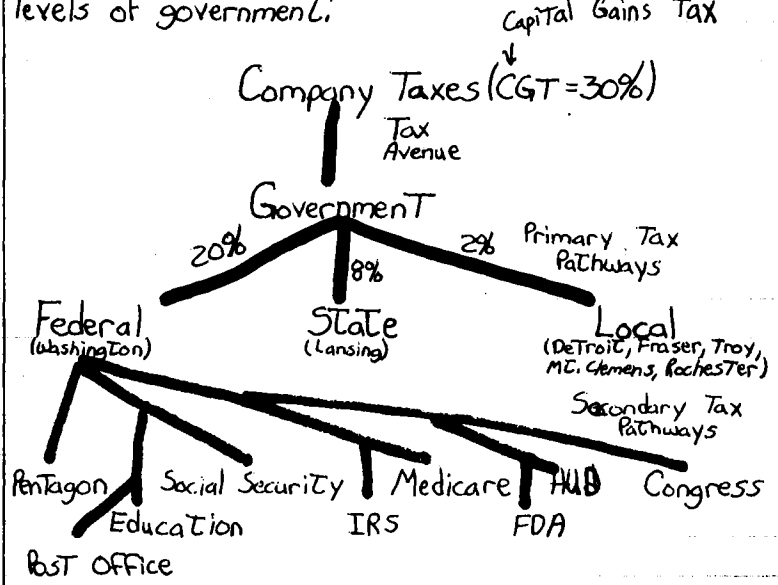
Of course, we should also eliminate all Tax exemptions, Tax deductions, Tax loopholes, Tax returns, and any other Tax avenue That gives money back To Tax payers. By doing This, we will spare Tax payers of needless bureaucracy. If The government wants To cut Taxes, then it should just cut Taxes. Period.
Now let's look at Tax pathways.

7) Property Taxes:
Eliminate property taxes that will go To public schools; lets make all schools private to enhance competition in education.

8) Inheritance Taxes:
Let's give This Tax The booty. Help the older generations give something to generation X so that young people can live The American Dream.

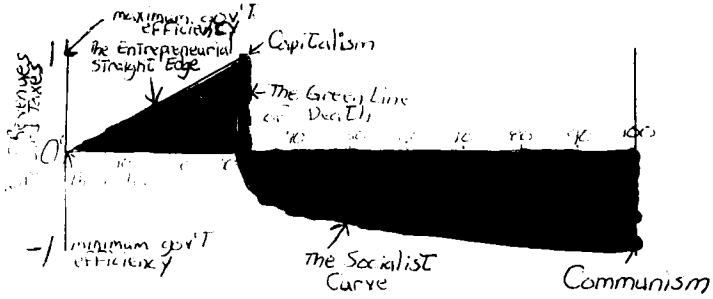
Tax Pathways:

A Tax pathway is a route where tax dollars are distributed. After the capital-gains tax takes 30% of revenues made by a company, these tax dollars will be distributed throughout the various levels of government.



The 30% should be distributed among the Federal, State, and local goverments using a ratio of 20:8:2, respectively. Let these percentages be iron-clad to keep the whole system simple.

The Taxation Curve: What It Is and What It Means



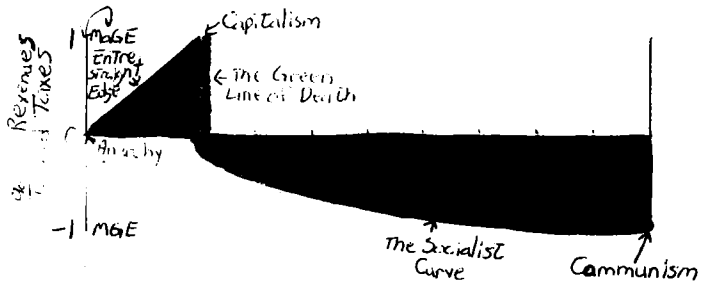
~~2005~~ 1996!

This graph represents what would happen when a certain percentage of ~~Tax~~ revenue goes to taxes. When no money goes into the government, we have anarchy. We have no government, no defense, no law and order.

With a moderate amount of revenues going to the government, it gives us security and morality and useful, sensible controls to make society work. According to the chart above, a 30% tax (from the capital-gains tax) gives a good balance between entrepreneurial freedom and moral government. This is much better than paying 40-50% in taxes ~~of~~ of all kinds today.

Going beyond this point, however, can lead to economic oppression for the people. Companies won't hire people; workers will not save enough for retirement; interest rates ~~are~~ will be higher; people would be pressured to put money into tax-free loopholes instead of investing in their businesses; the economy will weaken; tax revenues will actually decrease.

Lowering taxes - according to the Business Tax Relief Program - will help people save money so they can



2005!

be less dependent on government after retirement. They'll patronize businesses so they can stay in the black. They'll pay for their children's education with cash and almost eliminate their interest payments on loans and credit card payments. Instead of creating a dependency class, America will have an independency class. Unemployment, inflation, and interest rates will remain low.

Despite 30% being relatively lower than what it is today, we can systematically reduce it to 20%. The 30% will be distributed in the following ways: Federal, 20%; State, 8%; Local, 2%. From the year the Business Tax Relief Program becomes law, Congress should implement a 10-year plan to reduce the Capital-Gains Tax from 30% to 20%. To see how this 10-year plan breaks down, please see the chart on the following page.

Year	CG Tax	Federal	State	Local
1996	30%	20.00%	8.00%	2.00%
1997	29%	19.30%	7.75%	1.95%
1998	28%	18.60%	7.50%	1.90%
1999	27%	17.90%	7.25%	1.85%
2000	26%	17.20%	7.00%	1.80%
2001	25%	16.50%	6.75%	1.75%
2002	24%	15.80%	6.50%	1.70%
2003	23%	15.10%	6.25%	1.65%
2004	22%	14.40%	6.00%	1.60%
2005	21%	13.70%	5.75%	1.55%
2006	20%	13.00%	5.50%	1.50%

Having a capital-gains Tax of 20% by The year 2006 will stimulate the economy greatly. Any economic and governmental improvements created from The start of These new Tax laws will become even bigger when Taxes go down.

A 20% capital-gains Tax will help millions of Americans prosper and give Them a chance To donate money To These who need it.

Now let's see how The Business Tax Relief Program will help Americans save money and spare Them of needless bureaucracy.

The Transition

The Business Tax Relief Program will transfer accountants working for the IRS and other governmental agencies to the private sector; they'll be working for companies under the program. These accountants will now handle all IRS paperwork for the companies. They will tabulate all revenue going into their companies and take 30% out for taxes.

The companies will take the other 70% and give it to their workers and buy new equipment. All employees - and employers - will ~~be~~ pay no individual income taxes. They will also pay no other kinds of taxes - sales tax, luxury tax, etc.

On top of that, people will be spared needless paperwork and bureaucracy. Examples of this include:

1) No figuring out income taxes during precious weekends;
2) No hiring accountants to help people figure out their taxes;
3) Much less paperwork going to the IRS.
4) No risk of procrastination (You won't see long lines of cars heading to the postal office on April 15th at 11:58 p.m. so people could drop off their tax forms on time.);

At the end of the year, each participating ~~companies~~ company will receive tax form 1040C. The

~~companies~~ company accountant(s) will collect all of the company's W-2 forms (12 in all; 1 for each month) and claim it on Tax Form 1040C. The accountant sends Tax Form 1040C to the IRS, which sends the company a receipt confirming all the revenues the company claimed - plus all the taxes taken out.

The Concept Behind Having One Tax Avenue:

I think government believes complexity is a Badge of Honor. I do not! It's bad enough the IRS has to handle a phenomenal quantity of paperwork. Why can't the IRS consolidate tax collecting into a single tax avenue?

I'm sure IRS employees are stressed out from the paperwork as much as people and companies are. If a company earns $10,000,000 in a year, everybody - from the CEO down to its lowest employees - contributed to the company's success. If the people in the company were willing to work well as a team, the government should tax the people in the company solely as a team. Why can't the IRS just take 30% of a company's earnings and leave the rest alone? Why can't the government rely entirely on that single tax avenue and then distribute the money among all the agencies on the federal, state, and local levels?

Creating so many kinds of taxes only adds to the bureaucracy and red tape. No more state sales taxes for people buying cars or furniture or diapers. No more luxury taxes for people buying 60-foot yachts or 24-karat gold jewelry. No more individual income taxes! Imagine that!

Of course, all tax loopholes, tax exemptions, tax deductions, and tax returns should also be eliminated. All paperwork involving these transactions are at taxpayer expense, anyway. And since the people of this country will be taxed so much less in the first place, they won't miss these 'benefits' at all.

Businesses now must claim everything. Failure to do so will mean detrimental penalties for the guilty companies. I'm sure all company CEO's would never put ~~his company~~ their companies or ~~his~~ their employees in bad standing with the IRS. (Unless they don't mind the risk of having their workers lynch them.) Remember, all employees of all ~~gen~~ tax evading companies will be penalized as a team. Lowering taxes and forcing all companies to claim everything will simultaneously boost the economy and increase tax revenues.

Let our government's simplicity be its badge of honor!

Special Notes For:

1) Spence Abraham (Republican Senator - Michigan): Congrats on being a newly-elected Senator from the great state of Michigan! Good luck with everything. I'mglad you've been elected in time for the 2nd American Revolution. (I call it that because, just like the 1st Revolution, Americans have spoken against economic and governmental oppression.) I would also like Congress to create a New Crime Bill. In fact, I'd rather call it a Punishment Bill. Let's repeal the present gun bans and include federal laws that will enforce capital punishment on murderers and surgical castration on rapists! In the meantime, urge Mitt Romney to run for the U.S. Senate against Carl Levin in 1996. I think you two would work well together. Don't worry about Ted Kennedy - his terms are numbered!

2) Senator Bob Dole (R-Kansas; Majority Leader): I know you are frustrated for not being elected President. I think the nation would've been in good hands with you in the oval office. However, you've been a great Senator, but I ask a special favor from you the moment the Republicans take over the White House. Please make ~~you~~ sure you boost the defense budget! It's disgusting how the

Clinton Administration has decreased the defense budget and increased the budget of so many needless programs. If anybody can convince a Republican administration to boost the defense budget, it's you. You served in World War II. You were wounded. You know how well the country works when defense is strong, and you know the consequences the country faces when defense is weak. And unlike President Clinton, you do feel the pain war veterans face. Bill Clinton is as un-American as any President in American History. Please boost the federal defense budget and put Bill Clinton in his place.

3) Senator Phil Gramm (R-Texas): From what I have heard, you are going to be a popular choice to be the GOP candidate for President. In that case, you will be the next President. I can't say how effective the Gramm Administration will be but I know it would last eight years. In fact, you can start moving into the White House now. You know, a couch here and a dining set there. I may not be an economist like you, but I hope I gave you a few ideas. Even if lower taxes increase tax revenues, Congress must still decrease spending. First, get rid of the Food and Drug Administration. Deregulate medicine so doctors can give all of us better care and give doctors

more control over their treatment options. Transfer all welfare power to the states and decrease welfare spending by 5% per year until it goes down to a reasonable level. Also transfer all education money to the states and give the states the option to commercialize all schools. Make the tax system simpler to downsize the IRS. There's so much the Republicans can and will do, but please take your time. You can't overturn the New Deal mentality our goverment has adopted over the past 62 years overnight.

4) Rep. Richard Armey (R-Texas, House Majority Leader): I'm so glad somebody has enough common sense to lower taxes and simplify tax bureaucracy. I like your 17% flat tax, and I hope my ideas will give you more insight. I don't, however, like your idea of tax payers writing checks to the IRS. I know you want people to realize how much they're paying in taxes, but the risk of tax evasion would be way too great! But for the most part, I agree with your philosophy - as noted by how hard you were laughing at the opposition on "Meet the Press". Never underestimate the power lower taxes, lower bureaucracy, and a dynamic military will have on America and on Americans. If all goes well for the Republicans, maybe

you and Mr. Newt will receive your Tenure.

5) Rep. Newt Gingrich (R-Georgia, Speaker of the House): First of all, don't listen to any of your critics. It's amazing how a group of freshmen congressmen who are trying to make life better for all Americans can receive such nonsense from the elite media and from liberal democrats. Remember, they will give you and all Americans the impression that the national debt is some uncontrolled act of nature - like a tornado or a hurricane! And now it's up to the Republicans to stop the dam from overflowing. The national debt is now $4.8 trillion, and cutting spending is the only way to lower it. The sad part is that a huge part of the national debt is a result of welfare spending - about $5 trillion worth. The federal government, the nation's most notorious middleman, will take up to 60% in transaction costs. If we completely eliminated programs that the private sector could pay for, the debt would go down drastically. Americans are far and away the most giving people on Earth. Let them take care of the poor. Let them give to charities - like public television. By lowering taxes, bureaucracy, and spending, the people will have more power to help those in need. Now people may ask "What will happen to the poor people?" The

answer: businesses will expand, more jobs will be created, and everybody will have more money. Prosperity will linger and the need for welfare will decrease. Please be patient, Mr. Newt. Everything will be for the best. In the meantime, I'll vote Republican!

Phillip Marsh
378 Golden Gate Ave. #326
San Francisco, Calif. 9410
(415)292-2412

May 27, 1995

Cong. Arnold
Commitee of Ways and Means
Main Commitee Hearing Room
Longwood Bldg.
Washington, D.C.

Dear Sir:

I understand that you are having hearings on the abolition of the Internal Revenue Srevice on the 6th of next month.

I support that idea one thousand percent !!!

The following are a few reasons that I feel that your commitee should look into. I am in a position to verify documentarily, each of the following statements and would further be willing to testify before your commitee if called upon to do so.

1. The I.R.S is NOT a government agency. They claim to be with the Treasury Department, but Title 31 U.S.C. Sec. 301 is the organizational chart for the Treasury Department and it does not list the I.R.S. as one of it's components !

The funds that the I.R.S. steals do NOT go to the United States Government to run the country on. Look at the endorsement stamp that the I.R.S. uses on the back of the checks they are given. It reads: "Pay to the FRB, to the CREDIT of the U.S. Treasury, to reduce U.S. obligations". In other words, all of the so called Tax Dollars that the I.R.S. steals from the American People go only to pay the phony uncollectable INTEREST on the phonier National Debt, which is also as phony as an eight dollar and fifty cent bill !

The abuses of the law by the I.R.S. are too numerous to mention but as for the law that requires an American to file a 1040 Tax return, there is NO SUCH LAW. I know, because last year, I underwent a three long months of trial on tax evasion charges (among other phony trumped up charges) and I offered in front of the Judge as well as the jury, to plead guilty and go to jail, just as soon as the A.U.S.A. could show me the law that required the filing of a Federal Tax Return. My request was met with stony SILENCE !There IS NO SUCH LAW. This scam MUST STOP ! Please do your duty and expose this monster for what it is .

Sincerely,
Phillip Marsh

THE UNIVERSITY OF TEXAS AT EL PASO
UTEP

Department of
Accounting
College of
Business Administration

June 12, 1995

Mr. Philip C. Mosley
Chief of Staff
United States House Ways and Means Committee
1102 Longworth House Office Building
House of Representatives
Washington, DC 20515

Re: Tax Reform Hearings

Dear Mr. Mosley:

I am submitting six copies of each of two items which I wish to be considered by the committee in regard to tax reform:

1. A guest column which I wrote for the El Paso Hearld- Post February 11, 1995, entitled "Flat-tax Proposal Won't Be Simple."

2. An article which I wrote which appeared in March 6, 1995, Tax Notes in summary form, and also in Tax Notes Today in its entirety: "An Analysis of the Armey Flat-tax Proposal."

Please include them in the record. Thank you.

Very truly yours,

Frank A. Mayne, PH. D., CPA

FORGING THE FUTURE

El Paso, Texas
79968-0542
(915) 747-5192

El Paso Herald-Post, February 11, 1995

Flat-tax proposal won't be simple

By Frank A. Mayne

SPEAK YOUR PIECE

The recent editorial "flat tax finds more converts" and news reports on the issue have struck a nerve with me, as I am an accounting professor at UTEP and also prepare some tax returns professionally each spring. My teaching assignments often involve trying to make the tax law more intelligible to aspiring accountants. The editorial asserted that "There is not a taxpayer in the country, we would wager, who would not cheer the demise of the infinitely complicated income tax forms and rules, and their replacement with a post card."

We already do have a form that simple — the 1040 EZ — for single persons with only salary and wages and less than $400 of interest. The form requires only copying W-2 information onto the appropriate blank, a couple of elementary addition and subtraction operations and a look in the tax table. Yet legions of citizens still troop to professional tax preparers, the IRS, IRS-sponsored help centers or helpful friends for assistance with Form 1040 EZ. The problem at the 1040 EZ level is definitely not "infinitely complicated tax forms."

If we go up the next level of tax form, the 1040 and 1040A, I have found that when most rank-and-file taxpayers refer to "complexity" they are referring to the calculation procedures involving personal exemptions, itemized versus standard deductions, and various credits for individuals (i.e., child care). Yet, this is only the tip of the iceberg. In the typical introductory college course that we call "Individual Tax," these basics of calculation will have been covered by the second week of a 16-week semester. Those basics are really the easy part of the course.

The individual tax college course gets more and more complicated as the semester goes, as the rules for proprietorships, investments and the like are covered in connection with such concerns as losses, depreciation and accounting methods. We follow the individual tax course with a second course at the undergraduate level covering partnerships, corporations, estates and trusts. For those who are really gluttons for tax courses, UTEP also offers a master of accountancy with a concentration in taxation, a degree which includes five more taxation courses.

I think the students who have been through any of those courses would say that they were only given a sampling of the many issues involved. Hopefully most of them left the respective course(s) with an appreciation for the complexity that really exists in income taxation of business and investment activity.

> *'The flat tax is being pitched by some as simplification. It should not be. If only the tax rate and the personal exemptions and standard deduction are changed, as in the Armey proposal, all of the real complexity will remain.'*

Mayne

Note that the complexity that I describe is not complexity of mathematically computing the tax. The real complexity is in arriving at taxable income, i.e., the dollar figure to which the tax rate will be applied.

The flat tax is being pitched by some as simplification. It should not be. If only the tax rate and the personal exemptions and standard deduction are changed, as in the Armey proposal, all of the real complexity will remain. As long as the income tax continues to be the principal revenue source for the federal government, all of the current complexity will remain because of the underlying complexity in the determination of taxable income on business and investment.

What the reformers are proposing primarily is a decision involving the economics of the tax burden and the related federal budget deficit, rather than a tax simplification. For comparison, a single person with a $99,999 salary and no other income, deductions, or dependents pays $24,444 under the current tax, but only $17,380 in the 20 percent tax version of Armey's proposal — a whopping $7,064 reduction.

A single person earning $29,000 would pay $3,420 under the current system but $3,180 under the 20 percent Armey proposal, difference of $240. As the editorial pointed out, everybody gets a tax reduction under the Armey 20 percent tax proposal. It is just that the higher-income taxpayers will get a much larger reduction, thus proportionately shifting the burden of the total tax being collected toward lower income taxpayers.

Note that there would definitely be a revenue shortfall in the near term with the Armey 20 percent flat-tax proposal as generous as it now stands. If government spending levels remain constant, and everybody's taxes go down, less revenue will be collected, and we will be increasing the budget deficit by leaps and bounds.

Supply-siders will jump in at this point and point out that the tax reduction will stimulate the economy, which in turn will increase business profits and the number of jobs. The growing economy will eventually increase tax collections. Will the growth be enough to eventually reduce the deficit? Who knows?

Unfortunately, the answer will have to be trial-and-error experimentation, just as it was with the last series of major tax-rate reductions in the 1980s, after which we were left with enormous budget deficits. Those deficits are still being financed as part of the accumulated federal debt.

In fact, interest on the federal debt is the third largest line item in the federal budget. Would we really want to elevate interest on the debt to second or even first place?

In summary, the principal issues being considered here are two-fold: the equity of the tax burden and the size of the near-term budget deficit. To me, those are the real fiscal issues that are being put on the table with the Armey flat tax proposal, not simplification.

Frank A. Mayne is a Ph.D. and CPA who has been an assistant professor at UTEP since 1978.

An Analysis of the Armey Flat-tax Proposal

Frank A. Mayne, Ph. D., CPA

A flat-tax proposal is on the Congressional agenda again. House majority leader Dick Armey has a plan with a 20% rate to start, with eventual reduction to 17% by the third year. The Armey proposal also calls for personal allowances which would be larger than the standard deduction and personal exemption system in current law. However, itemized deductions would be eliminated. The plan calls for personal allowances of $13,100 for a single person, $26,200 for a married couple filing jointly. and $17,200 for an unmarried head of household. Each dependent would increase the allowances by another $5,300.

The Armey plan promises tax reduction for most taxpayers. However, the tax reduction is much more pronounced at upper income levels. Compare the 20% rate to the current top marginal rate of 39.6%, and intuitively there will a revenue shortfall compared to the revenue raised by the current tax law. Conversely, with a revenue shortfall, the federal deficit would be increased by leaps and bounds.

To demonstrate the impact of this proposal, analysis will be presented at both the taxpayer level and the macroeconomic government finance level. Several examples have been prepared, based on typical taxpayers, to demonstrate who will gain and who will lose. Aggregate income statistical data is also used to analyze the impact on the federal treasury.

In the examples which follow, 20% will be assumed throughout for the Armey proposal. Table 1 compares the tax paid by a married couple, with no dependents, at adjusted gross incomes of $40,000, $62,500, and $75,000 respectively. These income levels

were selected in order to be at the midpoint of the statistical reporting brackets used by the IRS in *Statistics of Income* published by the U. S. Treasury. The average itemized deductions reported in the IRS statistics for 1992, the last year which has received complete analysis in *Statistics of Income,* makes a realistic example of an itemizing couple's return. The Armey plan indeed does significantly reduce taxes for all three income levels. The couple with the $87,500 AGI has a reduction of $7,307 and the other couples save $1,631 and $5,307 respectively.

Table 1. Comparison of Three Married Filing Joint Income Levels for 1994 Law and the Armey Plan

1994 Law:				
	Adjusted Gross Income	$40,000	$62,500	$87,500
	Itemized Deductions*	10,736	13,381	17,864
	Personal Exemptions	4,900	4,900	4,704
	Taxable Income	$29,264	$44,219	$64,932
	Tax from Tax Tables	$ 4,391	$12,567	$19,567
Armey Plan:				
	Adjusted Gross Income	$40,000	$62,500	$87,500
	Personal Allowances	26,200	26,200	26,200
	Taxable Income	$13,800	$36,300	$61,300
	Tax using 20% rate	$ 2,760	$ 7,260	$12,260

*Itemized Deductions are assumed. Amounts used reflect *Statistics of Income* (Fall, 1994) averages for income brackets in 1992 data for which assumed income is midpoint of bracket.

The impact of the large personal allowances can be shown in Table 2. The example taxpayers have been selected with one each for the three personal allowance filing statuses. Also, the adjusted gross income has been set so as to be the largest income where the Armey plan would zero out the tax. The table shows the current law does indeed assess significant tax, i.e., $1,031, $2,246, and $1,376 for single, married filing joint, and unmarried head of household, respectively.

Table 2. Comparison of Three Filing Statuses at Income Levels for 1994 Law and the Armey Plan, so as to show maximum adjusted gross income under Armey Plan prior to tax being paid.

Filing Status		Single	Married Filing Jointly	Head of Household
1994 Law:				
	Adjusted Gross Income	$13,100	$26,200	$17,200
	Standard Deduction	3,800	6,350	5,600
	Personal Exemptions	2,450	4,900	2,450
	Taxable Income	$ 6,850	$14,950	$ 9,150
	Tax from Tax Tables	$ 1,031	$ 2,246	$ 1,376
Armey Plan:				
	Adjusted Gross Income	$13,100	$26,200	$17,200
	Personal Allowances	13,100	26,200	17,200
	Taxable Income	$ -0-	$ -0-	$ -0-
	Tax using 20% rate	$ -0-	$ -0-	$ -0-

Since the marginal rate in the Armey proposal is 20%, and 15% is the lowest rate in the current law, the question arises as to whether there might be some income level where the 20% marginal rate actually increases the tax for a person whose marginal rate is now 15%. To answer this question, intuitively, if such a situation exists, it would exist at the breakpoint where the 15% brackets end and the 28% brackets start. Therefore, the adjusted gross incomes selected for Table 3 are the breakpoints at the end of the 15% brackets in the 1994 rate schedule. Note that the Armey plan saves $240 for the single taxpayer at the breakpoint, $1,297 for the married couple, and $312 for the unmarried head of household.

Table 3. Three Filing Statuses at Taxable Income Levels which are maximum taxable incomes at 15% rate for 1994 Law with comparison to Armey Plan.

Filing Status:		Single	Married Filing Jointly	Head of Household
1994 Law:				
	Adjusted Gross Income	$29,000	$49,250	$38,550
	Standard Deduction	3,800	6,350	5,600
	Personal Exemptions	2,450	4,900	2,450
	Taxable Income	$22,750	$38,000	$30,500
	Tax from Tax Tables	$ 3,420	$ 5,707	$ 4,582
Armey Plan:				
	Adjusted Gross Income	$29,000	$49,250	$38,550
	Personal Allowances	13,100	26,200	17,200
	Taxable Income	$15,900	$22,050	$21,350
	Tax using 20% rate	$ 3,180	$ 4,410	$ 4,270

Table 4 presents some situations where the Armey plan would cause tax to go up, due to the elimination of itemized deductions. A single taxpayer, $45,000 AGI, with three different assumptions of itemized deductions, clearly shows that the large itemizer at lower and moderate income levels will be hurt by the Armey plan. In the upper income levels, the pattern would depend on the nature of the itemized deductions involved, as the current law requires reduction of state and local taxes, housing interest, contributions, job-related, and most miscellaneous deductions. Gambling losses, medical expenses, investment interest, and casualty losses are not reduced at high incomes under current law. Therefore, depending on the specific package of itemized deductions involved, there could be high income taxpayers who also lose under the Armey plan.

Table 4. Comparison of Single Returns With Different Itemized Deduction Levels for 1994 Law versus the Armey Plan

1994 Law:				
	Adjusted Gross Income	$45,000	$45,000	$45,000
	Itemized Deductions*	25,000	17,500	10,000
	Personal Exemptions	2,450	2,450	2,450
	Taxable Income	$17,550	$25,050	$32,550
	Tax from Tax Tables	$ 2,636	$ 4,064	$ 6,164
Armey Plan:				
	Adjusted Gross Income	$45,000	$45,000	$45,000
	Personal Allowances	13,100	13,100	13,100
	Taxable Income	$31,900	$31,900	$31,900
	Tax using 20% rate	$ 6,380	$ 6,380	$ 6,380

* Itemized Deductions Arbitrarily Assumed

As the examples in tables have demonstrated, significantly more taxpayers have tax reductions under the Armey proposal. Therefore, using the examples as evidence, it would intuitively seem that the federal tax revenue would fall significantly. The amount of the revenue shortfall can be demonstrated with 1992 tax return data from *Statistics of Income* published by the Treasury.

The analysis which follows estimates the amount of 1992 income which would have been removed from taxation under the Armey plan, and then assumes taxing of the remainder at the 20% flat-tax rate. That amount is then compared to the amount of tax that was collected in 1992.

An adjustment must be made in Armey's personal allowances to make the Armey plan compatible with the available statistics. For single taxpayers the $13,100 allowance is separated into a $7,800 standard deduction and a $5,300 personal exemption. For the married filing joint, the $26,200 becomes a $15,600 standard deduction plus two $5,300 personal exemptions, and for the unmarried head of household, the $17,200 becomes $11,900 standard deduction $5,300 personal exemption. The married filing separate status will have $7,800 standard deduction and $5,300 personal exemption.

The methodology in the income level analysis assumes that the "0- under $15,000" adjusted gross income bracket in *Statistics of Income* data would not produce any tax under the Armey proposal, and that bracket is disregarded in computing the tax which would have been collected under Armey. Only single taxpayers and married filing separate at the upper end of that bracket would have any tax. Under current law this bracket produced only 3% of total tax collected, and collections would obviously be much less

under Armey.

Above $15,000 of adjusted gross there are six income data brackets. In *Statistics of Income* for the five highest of those six income brackets, a significant amount of tax definitely would be collected. To estimate the impact of the Armey personal allowances, weighted-average standard deductions were computed for each bracket using the modified standard deduction amounts discussed above. Weights were applied which represented the approximate proportion of single, married joint, married separate, and head of household returns in 1992 data[1]. The weighted-average standard deduction was then multiplied by the number of 1992 returns for each income bracket to compute the amount of gross income deduction against total federal adjusted gross income.

The "$15,000 - under $30,000" bracket presents a problem. Most married joint filers in this bracket are rendered non-taxable by the Armey proposal, but singles, marrieds filling separate, and heads of household will generally pay some tax. Various adjustments were considered, but it was decided to simply omit this bracket in interim calculations, as was done with the bracket below it. Since the point of the methodology is to measure personal allowance deductions that actually would reduce tax, this is really a conservative assumption in favor of the Armey Plan, and is also an assumption that can be compensated for later. This bracket generated about 10% of total tax collections in 1992, about $48 billion. A portion of that could be added in later with

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[1] For example, if for a given income bracket, 50% of the returns are singles, 30% are married filing joint, 10% are head of household, and 10% are married filing separate, then the weighted-average is:

.5X $7,600 =	3,900
.3 X $15,600=	4,680
.1 X $7,800 =	780
.1 X $11,900=	1,190
	$10,550

no serious distortion to the methodology.

Recall that in the discussion above that the Armey personal allowances were split into standard deduction equivalents and $5,300 personal exemptions. The personal exemptions also will reduce taxable income. Thus, it would seem that the next logical step would be to multiply $5,300 by the total number of personal exemptions taken in 1992 and the result would be an estimate of the amount by which adjusted gross income would be reduced. However, there are some modifications necessary first.

The same problem exists with exemptions as existed with the standard deduction equivalent in the "0 - under $15,000" bracket and the $15,000 under $30,000 bracket. Many taxpayers would list exemptions which get counted in the IRS data, but the exemptions do not really reduce income any more because the income level is already so low in these brackets. In these brackets many of the taxpayers will likewise be reduced to a deficit taxable income by the combined standard deduction equivalent and personal exemption equivalent. Also, it is possible that in the "30,000- under $50,000" bracket that some married filing joint taxpayers with several dependents will also be reduced beyond zero taxable income, such that some of the exemption deduction doesn't actually reduce tax. Therefore, exemptions in the 1992 data taken by taxpayers in the lowest TWO brackets were ignored. It was thought that the small portion of taxpayers in the "$30,000 - under $50,000" bracket who would be zeroed out would probably be smaller than the portion of the "$15,000 - under $30,000" bracket where the exemption would be reducing tax, and this would counterbalance to some extent.

Another required adjustment is the fact that the government

statistics still include the check boxes for "over 65" and "blind" as exemptions to allow comparability to data from years when age and blindness qualified for exemptions. There is no data available on the number of "over 65" and "blind" boxes checked. A possible proxy measure was considered. The data report the number of returns which included pension and annuity income. At an unrealistic extreme, these returns could all be married couples where both spouses were over 65, but the tax return with pension income was being counted as only one return in the data. Therefore, double the number of pension returns in each income bracket was used as a conservative proxy estimate of the over 65 and blind returns. For all returns taken together, that would mean about 35 million "over 65" and "blind" check box entries.

There is another approximation, which confirms that adjustment procedure. Census data in 1990 estimates about 30 million persons over age 65. Since 1992 data is being used, and there will be some blindness entries in the data, the 35 million for total returns with "over 65" or "blind" seems realistic.

Therefore, exemptions taken in 1992, for the five highest income brackets, were multiplied by $5,300 as the estimate of taxable income reduction from exemptions.

Total taxable income reduction of the Armey plan, applied to 1992 data, is $1.101 trillion, and is summarized in Table 5.

Table 5. Summary of Taxable Income Reduction in Armey Plan - Personal Allowance Equivalents applied to 1992 Data.

	Weighted-Average Standard Deduction	Number of Returns	(000,000) Income Reduction
$30,000 under $50,000	$12,992	21,181,531	$275,198
$50,000 under $75,000	14,398	11,885,348	171,200
$75,000 under $100,000	14,928	4,005,642	59,803
$100,000 under $200,000	14,815	2,818,095	41,750
$200,000 or more	14,648	958,163	14,033
Total Income Reduction from Standard Deduction Equivalent			$561,984
Add: Personal Exemptions as adjusted, $5,300 X 116,810,000			539,423
Total Income Reduction From Personal Allowances in Armey Plan - Top Five Brackets			$1,101,407

Recall that the $1.101 trillion came principally from the top 5 income brackets of the 1992 data. Therefore, the income to which the 20% flat-tax rate can be applied must reflect those 5 brackets so as to also be consistently computed. In the 1992 data, total adjusted gross for all returns was $3.623 trillion. Consistent with the above methodology, $.261 trillion AGI from the lowest bracket and $.390 trillion AGI of the next-lowest bracket are removed to leave $2.972 trillion AGI that could remain subject to the 20% tax after the effect of the personal allowances. Now deduct the $1.101 trillion from the $2.972 trillion and the taxable is estimated at $1.871 trillion. Applying 20% estimates tax collection at $374 billion. The tax collection for 1992

actually totaled $476 billion. The financing shortfall is enormous: $102 billion. How much additional revenue would come from the one bracket that was omitted in the above analysis, i.e. the "$15,000 under $30,000" bracket? In 1992 it generated about $48 billion on $325 billion of taxable income. Using the composite weighted-average methodology in Table 5, applied to the "$15,000 under $30,000 data, a weighted-average of $11,361 and $28,485,359 returns, computes about $324 billion, approximately the amount of the taxable income that was in that bracket in 1992. Returns in this bracket were about 36% married joint and 18% head of household. Therefore it would not be unreasonable to expect only one-half to one-third of the 1992 level of income from that bracket. Therefore, $24 billion or so is probably about all that could be hoped for from that bracket, which would reduce the deficit noted above to $78 billion.

Note that every assumption in this analysis has given the benefit of the doubt to the Armey Plan. Two overly generous examples: the 35 million "over 65" and "blind" check boxes, and the assumption of $24 billion from the "$15,000 under $30,000" bracket from 1992 data. Still a large deficit looms. With the balanced budget amendment also a legislative goal, it seems counterproductive to consider a tax reform plan as generous as Armey's.

One alternative way to pursue this plan is to tinker with the flat-tax rate. Note that it will take a 25.4% rate to make this plan revenue neutral when applied to 1992 data. ($476 billion/ $1,871 trillion is 25.4%.) However, a 25.4% rate will decrease the "tax break for nearly all taxpayers" nature of the Armey plan. Note that if a 25.4% rate had been used in Table 3 instead of 20%,

the Armey plan would have been more costly to the the single and head of household taxpayers as compared to current law.

Supply-siders will argue that the tax reduction will stimulate the economy and will in turn bring more people into becoming taxpayers. However, there will obviously be a lag before any such benefit is felt. Experience with the 1981 tax-reduction demonstrated all too vividly that deficits follow tax cuts in the near term. With interest on the federal debt now the third highest item in the federal budget, any course of action which invites accumulation of more deficits should be viewed with extreme caution.

REFERENCE

United States Government. Department of the Treasury, Internal Revenue Service. *Statistics of Income* (SOI Bulletin), Fall, 1994.

M B ASSOCIATES, INC. 313/352-3455 • FAX 313/352-2847
26600 TELEGRAPH ROAD • SOUTHFIELD, MICHIGAN 48034-2487

June 15, 1995

MR. PHILLIP D. MOSLEY
CHIEF OF STAFF
HOUSE WAYS & MEANS COMMITTEE
U. S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH BLDG.
WASHINGTON, D.C.

Dear Mr. Mosley:

I am writing to you to express my support of either a flat tax or a consumption tax (National sales tax). In each case, if investment income is not taxed, it will have, in our opinion, a very stimulative effect on the economy, which will help everyone. Both of these proposals are widely criticized because of their perceived regressive nature. If in fact they stimulate job creation (which is my opinion) they are not regressive and will help most those at the lower economic levels.

We sincerely hope that these tax proposals receive earnest consideration.

Sincerely,

WILLIAM S. MITCHELL

29 May, 1995
15010-39th Avenue N.E.
Seattle, Wa 98155

Philip D. Bosley, Chief of Staff
Ways & Means Committee
Longworth Building
Washington D. C. 20515

Dear Mr. Bosley,

I believe that the tax code of the United States of America should be totally changed for the following reasons:

1.) Compliance is to complex.

Over 9,000 pages of rules is too many.

2.) Compliance is too expensive.

It costs over 1 Billion dollars to comply and this does not take into account the time it takes individuals to gather their tax information.

3.) The tax system is not fair.

It currently penalizes people who wish to work long and hard by making them pay more of their money than those who do not work as hard.

4.) Too much social engineering is done with the tax system.

It is not fair to give a tax brake (Clinton's New Plan) for sending your child to college to people earning $95,000, but not to parents earning $102,000.

Why should parents sending their children to college get tax breaks, but families whose children become mechanics or electricians do not get tax breaks?

A National Consumption tax would be most fair. Let people decide if they wish to pay the tax. Those that wish to spend money and not save it would be taxed. The second most fair method would be a National Flat Tax.

Rip out by the roots the old tax system that allows special interests to manipulate the system by contributing to the reelection campaigns of Congressman and Senators.

Sincerely,

Scott J. McCorkell

June 19 1995

Dear Committee Members,

Since hearings are being held on our complex tax system I would like to address to you my concern. Rep. Archer has my support in abolishing our present tax system. I am in favor of replacing the present system with a national sales tax in place of all the federal taxes.

I believe the benefits of a national sales tax would generate enough revenue to run the country, also enough to eliminate the national debt within a relatively short time.

I encourage all members to change our tax system to a fair tax system with a national sales tax.

Sincerely,

Adele Medlin
4 Gardenia Drive
Greenville, SC 29611

6-9-95
Meeker
18322 N. Mission Hills
Baton Rouge, La
70810

attention: Phillip Meeks

I strongly urge you to help pass Dick Armey's 17% flat tax.

Thank you - a concerned citizen

Mrs. Clino Meeker

James C. Morris
c/o 8041 Hosbrook Road #200
Cincinnati, Ohio State Republic 45236

June 5, 1995

Mr. Philip B. Mosley
Committee of Ways and Means
Main Committee Hearing Room
Longworth Building
Washington D. C. 20215

Dear Mr. Mosley:

The Genie is out of the bottle! In spite of a Government controlled and filtered education system more and more American Citizens are learning of the deceit, deception, fraud and mendacity that involves the whole "income tax" system. In fact in order to make most American Citizens "taxpayers" the IRS must LIE to their system and create an EXCISE taxable happening. Another words wages are not taxable so in order to make one LIABLE the IRS will code the IMF file identifying the Citizen as one involved in the sale of NARCOTICS! The Citizen doesn't even know they are involved in narcotics. This is just one example. There are more.

The American people are NOT going to continue to put up with the out of control GESTAPO tactics of the BATF/IRS. The biased, ignorant MEDIA cannot continue to mislead the American Citizens. It is time for you folks to step up and assume a leadership position and COMPLETELY SHUT DOWN the BATF/IRS. The IRS is responsible for forfeiture and seizure of assets of over 5000 households per WEEK. They are destroying small businesses and are directly responsible for hundreds of suicides every year. On top of that the BATF/IRS lies to CONGRESS. See attached exhibits.

The concept of a flat tax is unconstitutional and out of the question. Remember that the SUPREME COURT has ruled that you cannot tax ones' labor! Wages are labor and are not commerce and thus not taxable! The only tax that can be CONSTITUTIONAL is an EXCISE tax. Yes, a sales tax would pass that test. If there were a national sales tax there would be no need for a Federal tax collector. The States are already set up to do it. I would bet that a 5% national sales tax on all purchases excluding food, medicine and primary home purchase would raise far more revenue than is now realized. It would be fair because it would apply to all and thus ALL CITIZENS would be contributing their FAIR SHARE. It would be important to make it almost impossible for CONGRESS to raise the per-centage of the tax amount. If this is not done CONGRESS will start raising the rate and it won't be long and the country will be right back in the mess it is in now.

In spite of what the Socialist, self appointed elitists now running the Government think, most Americans are a very fair and caring people. They just can't stand being lied to and ripped off and that is what is happening now. It is time for CONGRESS to become RESPONSIBLE and get rid of the BATF/IRS once and for ALL!!! While you are at it shut down the depts. of HOUSING, EDUCATION, COMMERCE, ENERGY, and the big bad guy of all-the FEDERAL RESERVE! Look at all the money and grief you will save the CITIZENS. That is what you want isn't it?? WOW!! We could all begin to be free at last! Why wait do it now!! Also, keep the money in this country. Stop sending it to the IMF.

Sincerely,

James C. Morris

Tax payments diminish a person's possessions. Welfare payments increase a person's possessions.

In both cases, the result is to change an identity.

Income taxes transfer money from a rich person to a poor person, with a slice for the bureaucrat. The tax system converts the taxpayer from a successful businessman into a borrower headed for bankruptcy.

The same tax system converts a welfare recipient from a poor person without a job into a slave, dependent on perpetual hand - outs. If you doubt these results, look at the statistics!

Taxes on identity are used as tools to change that identity -- it is political/social control in the hands of a modern Machiavelli.

The U. S. Government uses the tax system for this purpose. More specifically, it is the *system* of collecting income taxes which is used to change identities of taxpayers. Income taxes cannot be administered without absolute certainty as to the identity of the taxpayer, and once identified, the Government then sets about to change that identity.

Sales taxes, based on the action of selling, do not require identification of persons. The Government may raise the taxes on certain types of selling, or on certain types of products, and people may then be persuaded to change their purchase habits, but these sales taxes don't facilitate a change in the very identity of the person. The system of income tax collection lends itself to identifying and then changing identities.

Those words may sound strange to you. Perhaps you'll recognize it more easily when I say that politicians designed income taxes to punish the rich and reward the poor. When you make a rich man more humble, you are affecting his identity. When you make a poor person more affluent, you are affecting his identity.

When taxes force a businessman to borrow, and then taxes and interest bankrupt him, his identity has changed as well as his possessions. When an unwed teenage girl can collect $400 welfare each month for every baby she has, what do you think she's going to do? Her identity will change from "unemployed teenager with a chance" into a "terrible mother, pregnant, with no hope for escape from poverty."[6]

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[6] News Item: "Teenage pregnancy cost the federal taxpayers nearly $22 billion in major welfare outlays last year, according to the Center for Population Options. In 1989 the government paid $21.55

Income tax differs from a sales tax because of "adjustments" to the figure being taxed. The "sale" is generally easy to get a figure for. It's the retail price on the invoice. "Income," however, takes thousands of pages of tax law for its definition. Every aspect of "income tax" is complex! There are thousands of rules. Some rules depend on the identity of the taxpayer. Some rules depend on the activity. Some rules describe the various types of "things" which the politicians want to encourage or discourage you from owning. So, the income tax has become a concoction of all the three methods of taxation -- but always aimed at controlling your identity first, then your activity, and finally your possessions.

The so-called capital gains tax has often exceeded 100%! If that sounds crazy, consider the following:

Over a period of many years the inflation rate in our country exceeded 10% per year.

A man purchased stock for $1,000. He watches that stock rise in value by 12% per year, for ten years. He would have an asset worth about $17,200, at a compounded rate.

He has an apparent "profit" of $16,200, and he might pay a capital gain tax of 30% on that profit -- or $4,860. That leaves him with net cash of $11,340 plus his original investment of $1,000. So, he now has cash of $12,340.

If you figure how much of the increase in value was because of inflation you'd find that inflation alone would have made it "worth" $15,900.

In other words, if the asset value just increased to keep pace with inflation, it would be "worth" $15,900 at the end of ten years. Since it was really worth $17,200, his real profit was just $1,300.

He paid tax of $4,860 on a profit of $1,300, for an effective tax rate of 375%.

How many people do you know who would invest in something if the tax rate on their profit was going to be 375% of the profit?

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billion in food stamps, aid to families with dependent children and Medicaid benefits for families in which the first child was born when the mother was a teenager. About 9 million adults and children were in such families." *The Spotlight*, page 2, October 15, 1990.

If you go through these same calculations using a 5% inflation rate, and a very comfortable 10% appreciation rate, you'll come up with a lower effective tax rate, but it would still be well in excess of 100%.

I tell you that the super wealthy don't put their wealth in places where it gets taxed! If you do, then it's because you don't know enough about how legal and safe it is to use the same techniques the super wealthy do.

Now we are into a nest of complexity of definitions of *What is a person? What is income? What is profit? What is an allowable deduction? What is a capital gain?*

There is much less argument about *What is an acre of land?* or *What is a $5.00 retail sale?*

The Most Damaging Basis For Taxation

This complex system of income taxes actually becomes more complicated with the introduction of one more factor. The income tax varies depending, in some cases, on what you are **thinking**!

Taxes often depend on what was the "purpose" of the individual's action! Last I heard, "purpose" was a mental phenomenon -- it was something that went on inside your head. So, tax collectors have to become mind readers, and failing that, they impute motives and purposes to you. They do that based on whatever evidence they can find or manufacture. The result is that they levy the tax on your thinking processes.

Here's a sweeping example of IRS powers, and there are a great many more in the Internal Revenue Code:

> Section 269: "Acquisition made to evade or avoid income tax."
>
> (c) "Power of Secretary [IRS] to allow deductions, etc., in part."
>
> "In any case to which subsection (a) or (b) applies [acquisition of property . . . "the principal **purpose** for which such acquisition was made is evasion or avoidance of Federal income tax . . ."] the Secretary is authorized --

> ." . . to give effect to such allowance only to such extent as he determines will not result in the evasion or avoidance of Federal income tax . . ." [emphasis added]

Tax laws give tax collectors the responsibility to determine what your "purpose" was in doing some act. Judges, in many court cases, have ruled on what someone's "purpose" was. With these precedents, it seems well settled that purpose is not exclusively a private internal, mental phenomenon. Judges now divine your purposes. Usually the judge figures out your internal purpose on the basis of someone's observation of outward actions. Thus, while your true "purposes" may still be very private, tax collectors WILL judge you on the basis of the actions that seem to portray your purposes.

There are even tax penalties which are levied depending on your knowledge! The difference between a tax penalty, or no penalty, is often the judge's decision as to whether or not the taxpayer "knew" that some tax practice was illegal. The difference between "negligence" and "fraud" is based on the knowledge inside the taxpayer's head. I have an entire Chapter in this Book on this subject. See, starting on page 277.

Your thinking processes are the final battleground of suppressive tax systems. Force used to enforce the tax on income is force applied first toward the change of an identity, and only later applied toward your money, and then only later applied toward placing your body behind bars.

Who can say that his identity has not been changed because of the threat of force from the IRS?

A slave who can still think about rebellion is not acceptable. The objective is a robot that produces and makes more little robots -- a true slave is incapable of threatening the master.

Remember, the tax collector intends to change your identity from an affluent person to a poor person, or from a poor person into a slave! He intends to inject such fear into your mind that you wouldn't even think of using the system described in this Book to reduce your taxes -- even though it is legal. Think about it. Do you have any doubt that your thinking is influenced by our tax system?

I suggest to you that the most suppressive, the most complicated taxes are intended to affect **identities** (persons), based on their **actions**, and even based on what they **think** about those actions!!!

These tax laws are suppressive for even more reasons. They include words that are hardly ever defined in simple terms, and in fact are often defined in contradictory terms!

For instance, the U. S. tax laws are apparently the only ones in the world where the identity of U. S. citizenship is sufficient to make a person liable to file a tax return.[7] U. S. tax laws require a U. S. citizen to file a tax return no matter where he lives in the world. He must file no matter how long he has been living outside the U. S. It matters not if all of his income is foreign. The tax laws say "file!."

You would look in vain for a simple statement of this rule in the tax laws. The closest you can come to words that describe this responsibility starts with Internal Revenue Code, Section 6012, which refers to:

"Persons required to make returns of income",

and says that

"every individual having for the taxable year gross income . . ."

must file a return. This part of the Code fails to define "person" or "every individual." We don't know yet whether "citizenship" is a factor in the definition of "person." Subsection 6012 (c) refers to

"For purposes of this section, gross income shall be computed . . . without regard to the exclusion provided for in Section 911 (relating to citizens or residents of the United States living abroad)."

The title of Section 911 of the Code is

"Citizens or residents of the United States living abroad."

This section presents two pages of special rules to explain what type of income would be taxable and under what circumstances for persons who live outside the United States. This is a complex section, but a simple reading of it probably would leave you with the opinion that any person who is a U. S. Citizen must file a tax return regardless of where he lives or how long he may have lived there. You would probably conclude that even a bona fide "foreigner" could be considered a "resident of the United States living abroad," and thus have to file a tax return in the U. S.

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[7] *Cook v. Tait*, 265 U. S. 47 (1924). The Supreme Court ruled in this case that the United States has the power to tax its citizens on their worldwide income solely by reason of their citizenship. "No other major country in the world taxes its nonresident citizens on their foreign-source incomes at all" according to Marshall J. Langer, Professor of Law, Miami University, author of *Practical International Tax Planning*. There is even a tax law that makes it illegal to change your U. S. citizenship for the *purpose* of avoiding taxes!

No other country goes to this extreme to attempt to put a tax on (to control) the identity of a person rather than what he does, where he lives or what he owns. No other set of tax laws that I know about has so much complexity. In no other set of laws has there been such deliberate intention to create slavery.

I'd like to get you to see that the primary target of our suppressive tax systems is a *person*, a person who must be identifiable.

PERSONS WHO ARE IDENTIFIABLE!

PERSONS WHO MUST BE IDENTIFIABLE! That is the key phrase. Systems of **suppressive income tax** start to crumble if you can't be identified. If the government doesn't have your tax numbers, your social security numbers, your licenses to exist (corporate articles, partnership agreements, licenses, etc.), you can escape slavery.[8]

A tax based on "possessions" can hardly crumble, since the tax applies on a "thing." It is physical; has its own obvious discrete existence, and location.

Consumers pay the sales tax (an activity tax). Identification of the consumer does not affect the sales tax. It is hard to hide the activity of selling. But the identity of the buyer is no concern to a sales tax. It is the income tax that most suppressively introduces a tax on identity.

I believe that a national sales tax is the hope and salvation of our taxation system. The sales tax is more broadly based than a tax on property or possessions. The sales tax does not have many of the inherent problems of an "income" tax, and I think it is the idea whose time has come. In the meantime, this trust system can protect you from the ravages of the income tax system.

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[8] Hitler had identification numbers tattooed on the arms of Jews as a means of keeping track of them, and particularly their earnings, and thus the taxes that could be collected. The U. S. Social Security number is not much different in result than the tattoos Hitler put on Jews to help enslave them. You cannot enslave people you cannot count and control. Now, of course, with the passage of the Tax Reform Act (1986) young babies must obtain their identification number, else the parents will be denied tax deductions or other "benefits."

DEMOCRACY OR REPUBLIC

From the Army Training Manual No. 200025 War Department, Washington, Nov. 30, 1928 and ordered removed by Roosevelt.

Prepared under the direction of the Chief of Staff.

Democracy; Authority derived through mass meeting negating property rights. Results in mobocracy. Attitude toward law is that the will of the majority shall regulate, whether it be based upon deliberation or governed by passion, prejudice, and impulse, without restraint or regard to consequences. Results in demagogism, agitation, discontent, anarchy.

Republic; Authority is derived through the election by the people of public officials best fitted to represent them.

Attitude toward property is respect for laws and individual rights, and a sensible economic procedure.

Attitude toward law is the administration of justice in accord with fixed principles and established evidence, with a strict regard to consequences.

A greater number of citizens and extent of territory may be brought within its compass.

Avoids the dangerous extreme of either tyranny or mobocracy.

Results in statesmanship, liberty, reason, justice, contentment, and progress.

Is the "standard form" of government throughout the world.

A republic is a form of government under a constitution which provides for the election of (1) an executive, and (2) a legislative body, who working together in a representative capacity, have all the power of appointment, all power of legislation, all power to raise revenue and appropriate expenditures, and are required to create (3(a judiciary to pass upon the justice and legality of their governmental acts and to recognize (4) certain inherent individual rights.

Take away any one or more of those four elements and you are drifting into autocracy. Add one or more to those four elements and you are drifting into democracy. Harry Atwood.

Autocracy declares the divine right of kings; its authority can not be questioned; its powers are arbitrarily administered.

Democracy is the "direct" rule of the people and has been repeatedly tried without success.

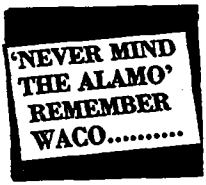
Our Constitutional fathers, familiar with the strength and weakness of both autocracy and democracy, with fixed principles definitely in mind, defined a representative Republican form of government. They "made a very marked distinction between a republic and a democracy, and said they had founded a Republic."

Professor Alexander Fraser Tyler:"A Democracy cannot exist as a permanent form of Government. It can only exist until the voters discover they can vote themselves largess out of the public treasury. From that moment on the majority always votes for the candidate promising the most benefits from the public treasury with the results that Democracy always collapses over a loose fiscal policy, always followed by a Dictatorship."

When the New Deal came into power, it withdrew from Army posts and the Government Printing Office a "Citizenship" training manual which had been in use. This manual, which has never been restored, defined clearly and concisely the difference between a democracy and a republic.. Why has this Citizenship Manual been withdrawn from the Public? Why are our political leaders and newspaper writers so often referring to our government as a democracy? Are they conditioning the minds of the people? Is it because that only under a democracy that they can gain control of the affairs of the people?

The Founders of the United States specifically repudiated "democracy," the "Father of the Constitution," James Madison, stating that it was incompatible with personal security and the right of private property; Since Sec. 4 of Art. 4 of the Constitution. which did not contain the word "democracy", by the simple act of guaranteeing to each state in the Union a REPUBLICAN FORM OF GOVERNMENT, completely bars a democracy form; and, the 1928 U.S. Army Citizenship Training Manual seals the anti-democracy verdict with these words: "The Government of the United States is NOT a Democracy BUT A REPUBLIC."

Democracies have ever been spectacles of turbulence and contention; have ever been found incompatible with personal security; and have in general been as short in their lives as they have been violent in their deaths..On a candid examination of history we shall find democracies characterized by turbulence, violence and abuse of power by the majority trampling on the rights of the minority. (James Madison, father of the Constitution)



RESPONSE LETTER
FROM
RONN JACKSON
11-9-94

In response to Volume 13, Issue 10, November, 1994, I wish to make the following comments:

I am not a "Whistle Blower" from the, BUSH-ERA. I was affiliated with the "Committee and Organization For Universal Peace and Economic Stabilization" (C.O.U.P.E.S.) from September, 1963 to, May, 1985, and off and on, through December, 1990.

The committee controls, and mandates to, the following organizations: "The Committee of 300"; "The Counsel On Foreign Relations"; "The Tri-Latterals"; The Bilderbergers"; "MJ-12"; The Federal Reserve System" and the other fourteen (14) major central banks; "The United States Government"; this is only a partial list and does not contain the "stock" and "commodity" markets and currency exchanges on a global scale.

While documentation exists that the "One World Order" started prior to the "American Revolution", the committee was formed in "1921", concurrent with the formation of the "CFR".

The purchase of 500,000 metric tons of "Gold" by the "Austrian" Government from the Philippines, has nothing to do with the Gold Standard in the United States, but is connected with the twelve (12) families who own, THE CENTRAL BANK.

No signatures or paperwork is necessary for the transfer of Gold from the Far East, South America, or the near East. (The three main repository's for all Gold.) Excluded is daily transactions of "Federal Reserve Of New York" and other "International", like facilities.

As of July, 1994, 5,400.000 tons of Gold had been returned to this country in preparation of, the return to, the Gold Standard. The transformation to the Gold Standard was halted due to an incredible blunder of the United States Government. "Public Law 94-564". The Bretton Woods Agreement. This law had three (3) purposes: 1) Creation of the world bank 2) Creation of the international monetary fund. 3) Creating and granting the President of the United States, the power to issue, extraordinary Presidential Directives, outside the scope and authority of the Constitution. Upon passage of Public Law 94-564, and the mandatory 30 day waiting period. A "PD" was issued and unknown to the American people, giving the "United Nations" the power to tax, the American people, the unknown ramifications and effect of this law is, the agency of our Government, the "Treasury Of The United States" is now controlled and in the hands of others; "The United Nations." If the Gold Standard is re-instituted in this Country, the "Federal Reserve System" must be purchased or nationalized, the blunder that our Government is guilty of is, if "FED" is purchased or nationalized, the treasury reverts to the "United Nations" and then they have control of our currency and of the Gold, in order for a "One World Order" to exist, two conditions must exist. Parity in the worlds currencies, and parity in the wages of the working class of all Countries, Now, do you understand why "President Clinton" didn't fulfill his campaign promise of a tax-cut. This Country must be kept in servitude and bondage without the "Populas" being knowledgeable. Clinton works for the "Committee" also.

While many people have written about the "Federal Reserve System" since its inception in 1913, all accounts are uniformed, and those "Hundreds" of authors, cannot name the ownership and/or control of that private agency.

While "Russbacher" is a part of "Austria's" past, he has not, and will not play a part in that countries future. He has not, nor will he be asked to play a part in any economic decision of that Country.

You people make your own decisions about your journalistic content. I will make no comment on what other papers may say to you, and the, "1st Amendment" to the Constitution Guarantees the Right for individuals to speak their minds. I only suggest you check the validity of anything you print, including this letter, if you decide to print it.

An uninformed "PATRIOT" can be every bit as dangerous as a proponent of the "ONE WORLD ORDER".

In Knowledge, Truth & Freedom,
Ronn Jackson

TO REIN IN BATF

Heavy-handed raids and abuses against law-abiding citizens, harassment of gun dealers, and the illegal computerization of out-of-business FFL dealer records are hallmarks of this rogue federal agency.

BY ILA STAFF

Ask Harry and Theresa Lumplugh. This past summer, 15 to 20 armed men burst into their rural Pennsylvania home. The family cooperates—opening safes, handing over papers—but cooperation doesn't ease the intruders' wrath. One holds a submachine gun in their faces. Another utters a racial slur. One empties vial after vial of cancer medicine and crushes it on the bathroom floor. Another stomps a pet cat to death.

Who are these intruders?

Ask 21-year-old Monique Montgomery. Four masked men break into her bedroom at four in the morning. The glaring lights and the timing of the hit are meant to maximize Monique's disorientation as she wakes from a deep sleep. And wake she does, pulling a gun for self-defense, but the intruders already have their guns drawn and let her have it—four shots, four direct hits.

Who are these intruders?

Ask Louie Katona III of Ohio—successful businessman, civic leader, part-time cop, family man, model American. One intruder pushes wife Kimberly against a wall. Kimberly begins bleeding and later miscarries.

Who are these armed terrorists?

Not a gang of neighborhood toughs. They're agents of the Bureau of Alcohol, Tobacco and Firearms, and the incidents described above are not exceptions, but recent examples of the brute force of unchecked, renegade federal power. Who are the victims? People who've broken no law, in homes where nothing illegal is found.

The terror often comes at the hands of BATF agents clad in ninja black, but the terror doesn't stop there. Even the desk jockeys in the licensing part of the agency get in their licks.

Bend to BATF's politics—or get broken.

BATF visits Randy Engelken, a gun-store owner in Seneca, Kansas, and photocopies any transaction record involving the purchase of military-style semi-automatic firearms. Why just those firearms? The agent comments on Randy's political activism—namely his vocal opposition to U.S. Rep. Jim Slattery (defeated last fall). In a style that would make the old KGB proud, the BATF agent tells Randy: "If you don't lay off Congressman Slattery, you won't have a firearms license."

Surrender your license—or surrender your reputation.

BATF is committed to driving down the number of Federal Firearms License (FFL) holders to drive down lawful gun ownership. And they'll do it any way they can. A typical case: BATF raises the zoning issue by contacting a Pennsylvania township directly, informing officials that a resident with an FFL is conducting retail sales in the township. BATF also speaks directly with a supplier to the dealer, suggesting that the dealer was lying about being a federal agent. The agent also goes to the dealer's supervisor, demeaning his reputation. In fact, no crime was committed by the dealer—who was and remains a special agent with the U.S. Department of Justice Immigration and Naturalization Service (INS)—a law enforcement professional with 25 years experience.

They'll ban what they can—whenever they can.

Ignore the fine print in the '94 Clinton Gun Ban that some firearms are "protected," because BATF ignores it. Forget the fact that the 1860 Henry lever-action was listed as protected, because, for months, BATF banned its importation—considering the cowboy rifle an "assault weapon."

And now they've got your name—and your number!

On February 15, 1995, at a hearing of the House Appropriation Subcommittee on Treasury, Postal Service and General Government, officials of the Treasury Department and BATF admitted that all the records of firearms transactions between U.S. citizens and out-of-business dealers are being entered into a centralized registration system under the control of BATF. Throughout history, registration has always been a precursor to harassment, a stepping stone to gun confiscation. Recognizing this, the U.S. Congress has spoken clearly and distinctly over the last three decades: no money, no people and no administrative expenses can ever be used to register firearms, firearms owners or firearms transactions. Period.

But BATF is not listening. They're copying, collating and computerizing (see "Knox's Notebook," p. 14)—while their agents in the field are harassing, intimidating and hurting honest citizens.

It must stop—and it can! Call your U.S. representative and U.S. senators at (202) 224-3121, and do it now. Tell them it's time to either abolish this rogue agency—or take immediate steps to (1) regain control, (2) expose and prosecute government agents and officials guilty of civil rights abuses and (3) institute strict policies and oversight to ensure that the Bill of Rights is honored, not condemned.

Make the call now . . . before the intruders target your guns, your home and your Bill of Rights.

KNOX'S NOTEBOOK

BY NEAL KNOX

BATF AGAIN REGISTERING GUNS

TREASURY'S Bureau of Alcohol, Tobacco and Firearms is again creating a central registration system of firearms—or at least laying the foundation for one—in clear violation of both criminal law and their funding restriction.

The last time they attempted to ignore congressional rejections of gun registration, by formally proposing regulations to create a registration system in 1978, they lost a chunk of their funding and were forced to change both policies and personnel. That was during Jimmy Carter's Administration; this time, under Bill Clinton, they didn't ask, they just did it.

During February 15 hearings before the House Treasury Appropriations Subcommittee, Treasury Under Secretary Ronald K. Noble denied Rep. Ernest Istook's (R-OK) charge that BATF is violating their funding restriction. For many years, despite BATF's attempts to remove it, their appropriations law has declared: "That no funds appropriated herein shall be available for salaries or administrative expenses in connection with consolidating or centralizing, within the Department of the Treasury, *the records, or any portion thereof, of acquisition and disposition of firearms maintained by Federal firearms licensees.*"

Their round-the-clock program to computerize "semi-truck loads" of out-of-business dealer records didn't violate that prohibition, Noble and BATF Director John Magaw asserted, because it only applied to dealer records; the records they were computerizing were those turned in by *former* dealers.

That's sophistry! The prohibition wasn't intended to protect gun dealers, but the privacy of citizens whose names, addresses and firearms are listed in those records!

Section 926 of the Volkmer-McClure-amended Gun Control Act is even more specific: "No such rule or regulation prescribed after the date of the enactment of the Firearms Owners' Protection Act may require that *records required to be maintained under this chapter or any portion of the contents of such records*, be recorded at or transferred to a facility owned, managed, or controlled by the United States or any State or any political subdivision thereof, nor that any system of registration of firearms, firearms owners, or firearms transactions or dispositions be established."

Then why are BATF compliance inspectors making copies of dealer records, and who paid for their portable copiers? And what happened to all those "Forward Trace" records BATF gathered on selected guns?

The long-rumored illegal computerization of former dealer records was confirmed last May on the ABC *Day 1* television program, while BATF Agent Pat Hynes was showing host Forrest Sawyer thousands of boxes of old dealer records at their new records center. "Right now there's 20 million records here," Hynes said. "*We've already computerized 60 million.*"

In a February 6 letter to Sen. Larry Craig (R-ID), Director Magaw said: "ATF does not have a computer database of gun owners" and that the agent's comments were "misunderstood." Magaw said what Hynes was referring to was "indexing of records of former firearms dealers."

Though that differs from Under Secretary Noble's claim that the prohibition applies only to current dealers, note that even Magaw's "interpretation" is prohibited by both their appropriations restriction and Sec. 926, since a gun's make and serial number are "a portion" of the records that aren't supposed to be computerized, but which Noble says are now being optically scanned.

Noble got into a heated argument with Rep. Istook, claiming that the "legislative history is clear" that the prohibition applied only to current dealers, and that BATF needed to quickly access dealer records to "fight crime."

Rep. Istook snapped: "You're claiming that Congress gave you a loophole that you could drive one of those semis through!"

Congress intended no such loophole. I was NRA-ILA Director in 1978 when BATF attempted to create a registration system that would have tracked guns from manufacturers and importers, through distributors, to dealers—though not (initially) to consumers. (BATF's complete plan, which was approved high in the Carter White House, was to next eliminate private transfers by a "minor" change in the law, and within two years make another regulation change to *include* retail dealer sales, creating a total gun registration system within one generation; the documents proving it still exist, but to protect our sources have never been made public.)

When then-Chairman Tom Steed (D-OK) was shown what was happening, his Treasury Appropriations Subcommittee cut $4.2 million (BATF's "estimate" of the first-year cost) from their budget and added the prohibition against Treasury using any of its funds to create a registration system.

Even after the House of Representatives voted 314-80 to cut their funds and impose the no-registration restriction, BATF belligerently refused to withdraw the regulations for more than a year.

ILA Executive Director Tanya Metaksa, who was then my deputy and spearheaded our study of what BATF's registration scheme would really cost, was part of this history and was outraged by Under Secretary Noble's almost-facetious arguments. She wrote Treasury Secretary Robert Rubin that gun registration "has historically been a precursor to . . . harassment of private citizens, moving on to registration freezes, and ultimately ending with the confiscation of firearms."

Unless immediately stopped, and illegally created records purged, Tanya wrote, "we will exercise all of our options to prevent the establishment of a registration system, including recourse to the courts . . . ."

After 17 years BATF still hasn't gotten the message that they are supposed to follow Congress' orders, not the other way around.

OUR LAW / THE CONSTITUTION

Our founders established this highest law of the land from very ancient Sources. The judicial branch of government is based on the Common Law, (Lex Populi), which is God law, and it is very different from Rulers law (Lex Regii). The founders wanted to avoid "Popish" Roman Civil Law which they saw in Europe, and so they built a Judicial branch of government which relied upon ancient Anglo-Saxon *Common Law*. The Unanimous Declaration of the united States of America (Declaration of Independence) explains *inalienable rights, or God-law*. It declares our intention, as a free and independent nation, to be protected by that law. The founders had expressed these rights many times before in different State Constitutions and Charters. Precedent for these rights came from the Magna Carta of England. Common Law was also fully explained in the book "Commentaries on the Laws of England" by Sir William Blackstone a famous 18th century jurist. There the founders read that the "Makers will" is called the "law of nature" (*God law*) and that "...*no human laws are of any validity if contrary to this*..." Precedent for Blackstone's comments can be found in King Alfreds' code. King Alfred the Great's Book of Dooms "Liber Judicalis" was written less than 900 years after Christ and parallels *Exodus Chapter 21 almost word for word*. Thus the ultimate source of our laws is *Biblical*, and the common law protection of rights is fundamental to our law.

Another very important function that our law serves, besides the protection of our rights, is to establish, *organize, and limit the purposes* of government. In Lacher v. Venus 177 Wis 558. 188 NW 613. 24 ALR 403, it says "The unit of the state is the individual (sovereign citizen), it's foundation is the *family*. To protect the unit in his *constitutionally guaranteed natural right* to form and preserve the family is one of the *basic principles* for which organized government is established."

Since our law is Constitutional and our form of government is a *Republic* (rule by law) then we can call our government a *Constitutional Republic*. Our government is also Federal in nature. Federal means that the sovereign citizens choose representatives, whose job is to swear to uphold and defend the Constitution after they take office. They are not supposed to use their vote to blindly obey the will of the majority, Politicians vote by democratic majority rule, so that they'll be re-elected. But principled leaders uphold their oath of office by voting to sustain the principles of Constitutional law. Thus we can also call our government a *Federal Constitutional Republic*. Since the Constitution is founded on the Common law, which is God-Law, then we can also call our, government a *Christian Constitutional Federal Republic*. There is one thing our government clearly is *NOT, IT IS NOT A DEMOCRACY!* The Founders feared the excesses and tyranny of majoritarian rule democracy as much as they did a monarchy.

In conclusion, law is the Constitution and enactments pursuant thereto, its source is *Biblical Common Law*, and its function is to protect the God given rights of the sovereign citizens by *limiting and regulating the power of government* with a constitution. As Thomas Jefferson so eloquently wrote: "In questions of power, then, let no more be said of confidence, in man, but bind him down from mischief by the chains of the constitution.

FOR MORE INFORMATION:

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THE TRUE ORDER OF AUTHORITY

Our **GOD** Almighty
And Son Jesus Christ
Creator of man. Source of all rights

↓

The **Bible** — Supreme Law Of The Universe
God's covenant with man

↓

We, The People - The Body of Christ
Sovereign Free Men - Creator And Master Party
Of Government By Constitution For The United
States Of America. Source Of All Government Rights.

↓

The **Constitution** — Supreme Law Of The Land
The Peoples Chain (Control) Of Our Government

↓

Peoples Enforcement Controls
Electoral Vote Grand Jury Petit Jury

↓

Government — Servant of We, The People
Sole Purpose is Protection Of Individual Rights.
Power And Authority Enumerated In And Restricted By Constitution.

The Separate And Distinct Function Delegated To Governmental Representatives

↓

Executive	**Legislative**	**Judicial**
Law Enforcement	Law Making	Law Application

"Persons" Subject To Government Law And Rgulation

↓

Corporations (Government Created Persons).
And Sovereigns (Freemen) Who Exchange Their Birth
Rights For Government Privileges And Become Servants
Controlled By Government Rules And Regulations

Instructions:

Study Carefully. Share with your family and friends. Make and distribute at least 100 copies particularly to your Christian leaders who continue to express dismay and inability to understand the U.S. Supreme Court decisions appearing to be contrary to the constitution for the United States of America regarding churches, church schools, banning prayers in school etc.

We can restore **God** to his rightful throne of supremacy and this great country to **One Nation Under GOD!**

AX THE TAX

Abolishing the income tax is no longer a utopian fantasy. Politicians who recognize the huge costs of the current system are seriously considering an alternative.

By Stephen Moore

National Review
150 E 35th Street
New York NY 10016
April 17, 1995

CLOSE your eyes and imagine for a moment an America without an income tax. April 15 is no longer a day of dread. The federal tax on personal income, corporate income, and capital gains is zero. Estate and gift taxes have been abolished. The most intrusive institution in America, the Internal Revenue Service, has been shut down and its 115,000 auditors and enforcement agents have been disbanded. All federal revenues are collected through a national sales tax, and it is no longer the government's business how much money you make and what you do with it once you earn it. H&R Block has gone into Chapter 11; tens of thousands of tax accountants, attorneys, and lobbyists are finding new professions; and now even drug lords pay their taxes.

That giant sucking sound you're hearing is investment, capital from all over the globe pouring into the world's newest tax haven: the United States. Freed from the shackles of an anti-204k, anti-investment, anti-saving tax system, America surges ahead of Japan, Germany, and the rest of Europe in economic growth.

Sound like a utopian fantasy? Until a few months ago it did. But increasingly there are signs that the political foundations of the modern-day income-tax system are beginning to crumble.

On November 9, Representative Bill Archer (R., Tex.), the chairman-in-waiting of the tax-writing Ways and Means Committee, stunned the Washington establishment by announcing that his top priority was the total replacement of the income tax. "On a scale of zero to ten," he said, "the income tax rates a zero." He pledged to "pull up the income-tax system by its very roots."

This month Representatives Dan Schaefer (R., Colo.) and Billy Tauzein (D., La.) will introduce legislation to repeal the income tax and replace it with a national sales tax. They note that since the great income-tax "reform" of 1986 the Internal Revenue Code has been amended some four thousand times. To his GOP colleagues who wish to "fix" the tax code, Schaefer offers this sensible advice: "Give it up. The income tax is beyond repair."

The latest convert appears to be Newt Gingrich. At his recent town-hall meetings in Georgia, the Speaker has confronted ferocious opposition to the income tax. At the February 17 gathering, Gingrich elicited ecstatic applause when he said that he too wants to "get back to an America free from the IRS ... It's time to get the IRS out of your wallet and out of your records."

Even before the turning of the political tide, the income-tax system looked to be about to collapse under its own weight. Earlier this year the General Counting Office reported that the IRS was one of the "most mismanaged agencies" in the Federal Government, incapable of collecting tens of billions of dollars of unpaid income taxes. A recent National Research Council report foresaw a "major breakdown of the tax system" by 2000.

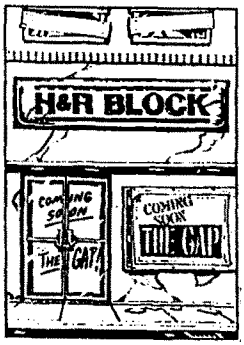
In January, *Parade* magazine ran an article entitled, "What if We Abolished the Income Tax?" *Parade* asked its readers to write in saying whether they were in favor of a consumption tax rather than an income tax. At last count, more than forty thousand responses had been mailed in, running 50 to 1 in favor of replacing the income tax. Even some IRS agents wrote in opposition to the tax code.

GRASS-ROOTS ANGER

REPRESENTATIVES Archer, Schaefer, Tauzin, and now Gingrich have seized upon an issue with potentially massive grass-roots appeal. Vic Krohn, chairman of Citizens for an Alternative Tax System (CATS), a 15,000-member group dedicated to abolishing the income tax, predicts that "the anti-income-tax movement will burst onto the political scene in the last half of the Nineties in much the same way that term limits did in the first half." At a typical CATS meeting, the audience is likely to include construction workers, housewives, school teachers, bus drivers, small-business owners: average Americans with an intense fear and loathing of the IRS. They call themselves "abolitionists," and they're fed up. As a sales assistant at a 1994 CATS event in Cleveland declared, *"The Internal Revenue Code is turning middle-class, working Americans into a criminal class."*

As with term limits, the Washington establishment has greeted this citizen-driven political movement with a yawn of contempt. Opposition on the Left is predictable and easy to explain. Liberal Democrats oppose the sales-tax alternative because the progressive income tax has been the cash cow for a half-century of government spending initiatives. The Left recognizes that any tax system that reminds Americans that they are making payments for welfare, farm programs, shark research, and the Department of Energy every time they visit the cash register threatens to make them even less enthusiastic about funding big government than they already are. The complete replacement of the income tax would require a sales tax of about 16 per cent. Every retail purchase Americans make -- from big-ticket items such as a new $18,000 Ford Bronco, to routine purchases like an 89-cent grape Slurpee at the 7-Eleven -- would include right there on the receipt a reminder of what a bad deal government really is. Eradicate the income tax, and much of the rest of the Washington empire could topple in short order.

More surprising is opposition from the Right. Many conservative leaders have greeted the abolitionist movement with heavy groans of skepticism. Conventional wisdom has it that the income tax is politically ineradicable. This is the complaint of Grover Norquist, presi-



dent of Americans for Tax Reform and conservative strategist extraordinaire. He protests that if Republicans throw their support behind the federal sales tax, America will "end up with the worst of all worlds: both a sales tax and an income tax."

It is for precisely this reason that many conservatives are rallying behind Majority Leader Dick Armey's elegantly crafted 17 per cent flat-tax plan. Modeled on a tax blueprint first developed in the mid 1980s by Stanford University economists Robert Hall and Alvin Rabushka, the Armey proposal would abolish virtually all dedications and loopholes, terminate tax withholding, end the double taxation of savings and investment, shorten the income-tax form to the size of a postcard, and eliminate the capital-gains and estate taxes.

There's very little here not to like. Jack Kemp praises the proposal lavishly calling it "the Kemp-Roth [Reagan tax cut] of the 1990s." And make no mistake about it: the Armey plan is manifestly simpler, fairer, less intrusive, and more pro-growth than our current tax code. Conservatives should support it in a heartbeat over the existing system.

Still, one gets the uneasy feeling that Armey's plan amounts to chiseling out several bricks from America's Berlin Wall at a time when the public is becoming eager to tear it down completely. "The flat tax suffers from one fundamental problem," says abolitionist Billy Tauzin. "It's still an income tax." It does not eliminate the IRS from our lives -- though it would reduce the agency's role. It would still be the business of the government to pry into the most private aspects of Americans' financial affairs each year.

LEAVE US ALONE

THIS may be a critical defect. Unlike the tax revolt during the Reagan era, which was sparked by basic pocketbook issued, the current anti-income-tax uprising is motivated at least partly by concerns about personal liberties and privacy -- the right to be left alone. Abolitionists are the radicals in the rebellion against big, intrusive government. At a CATS event in Los Angeles last year, a truck driver asked me, "Why must American citizens increasingly fear harassment and intimidation by agencies of our own government?" A flat tax won't placate him.

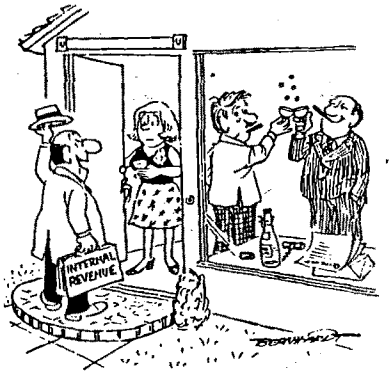
"The IRS has become a symbol of the most intrusive, oppressive, and nondemocratic institution in a democratic society," concedes Fred Goldberg, the commissioner of the agency under George Bush. Every year countless new horror stories are brought to light about people who have been terrorized by the intimidation tactics of the IRS. In one celebrated case, Miami lawyer Dan Heller endured a Kafkaesque ten-year IRS investigation and a four-month prison term. When a federal appeals court eventually overturned the conviction, the IRS was forced to pay Mr. Heller $500,000 in reparations for "gross government misconduct." Even when the IRS ultimately loses, however, such incidents send a potent message to taxpayers: comply, or the Gestapo may soon be pounding on your door.

Members of Congress, including Republicans, have been conspicuously uninterested in curtailing IRS abuses. The agency recently received funding to add five thousand new agents and auditors, even as it was forced to acknowledge that 368 agents were illegally scouring the returns of American citizens. (Only five were eventually fired.) The IRS work force is now up to 115,000, more snoops than are employed by the Environmental Protection Agency, the Occupational Safety and Health Administration, the Food and Drug Administration, and the Drug Enforcement Administration combined. Since 1985 Congress has doubled the IRS budget to $8 billion. The agency is one of Uncle Sam's fastest-growing non-entitlement programs. The latest indignity: the agency has announced, as the *Wall Street Journal* put it, "super tough IRS audits in 1995 and 1996."

The intrusiveness of the tax system is just one of its defects. Its absurd complexity is another, spawning an entire industry of tax attorneys and accountants who earn their livelihoods looking for loopholes. Even the people who write the laws rely on these professionals to prepare their returns. Dan Pilla, author of the new book *Fire the IRS*, reports that "60 per cent of the members of the House Ways and Means and Senate Finance Committees do not prepare their own returns." In 1992 "Loophole" Lloyd Bentsen, then chairman of the Senate Finance Committee and perhaps the single most influential architect of the modern-day tax structure, used a professional tax preparer because, he said, "my return is a complicated one."

What about the rest of us? Pilla discovered that in 1991 "about 70 per cent of the tax returns filed with tax preparers were for citizens making less than $50,000." Americans pay some $30 billion for the services of tax accountants and preparers.

But be warned: using a professional tax preparer by no means guarantees that your taxes will be calculated correct-



"We heard your ship came in. We're here to dock it."

ly. In 1992 *Money* magazine gave 48 accountants a financial profile of the magazine's typical reader and asked them to prepare a hypothetical tax return. Not only did each of them come up with a different answer, but the computed tax liabilities ranged from $16,219 to $46,564 – the higher figure nearly three times the lower. Will Rogers once quipped that "the income tax has made more liars out of people than the game of golf." Indeed, the massive ambiguities in the Internal Revenue Code subject even the most conscientious tax filer to the charge of being a tax cheat.

Furthermore, the Internal Revenue Code is forever getting less user friendly, despite countless good-faith efforts by Congress at tax simplification. The original 1040 form was a model of simplicity: four pages in all, including the instructions. The *New York Times* printed the form in its entirety on a single newspaper page. Today, the *Times* would have to devote several editions to reprinting the four thousand pages of tax forms and instructions. In 1914 there were 14 pages of federal tax law to implement the newly enacted income tax; by 1954 the page count had grown to 984; by 1994 it was 9,400. Shirley Peterson, IRS commissioner in 1992, laments that tax-law changes have become so commonplace that on several occasions Congress has rewritten the law "before the IRS even had time to reprogram its computers from the previous tax reform."

"When men get in the habit of helping themselves to the property of others, they cannot be easily cured of it."

New York Times (1909)

This complexity takes a toll. According to official estimates, in 1990 American individuals and businesses spent more than five billion man-hours computing their taxes. George Mason University economist Walter Williams calculates that this was more mann-hours than were used to build every car, van, and truck in the United States last year. These wasted man-hours alone represent a dead loss to the economy of some $200 billion. (For comparison, the income tax collects about $700 billion in revenue a year.) If converting to a simple sales-tax system merely cut compliance costs in half, it would generate savings in excess of $1,000 per family – more money than is offered in all the tax cuts promised by the Contract with America.

PRODUCTIVITY BOOST

BUT the major economic benefit from the sales-tax alternative (or from a flat tax, for that matter) would come from eliminating the punitive treatment of savings, investment, and capital formation – the essential building blocks of a prosperous economy. In a Cato Institute report, Boston University economist Laurence Kotlikoff estimates the impact of a revenue-neutral replacement of the income tax with a retail sales tax of 16 to 18 per cent. Kotlikoff finds that such a plan would:

1) raise the national savings rate to two and a half times its current level;

2) increase the capital stock by 8 per cent; and

3) raise income and output by almost $500 billion a year, or about $5,000 per family.

To address the fear that Congress might resurrect the income tax after the sales tax was installed, the federal taxing apparatus should be almost entirely dismantled, with responsibility for collecting the sales tax left to the states (a minimal burden, since almost all fifty already collect a state sales tax). A national sales tax can easily be made non-regressive. The first $5,000 of purchases per person could be exempt from the tax; every American would thus get a refund check for $200 each quarter. A family of four with an income of $20,000 would therefore pay no tax. Of course, taxes could be deferred through savings, but since all income is eventually consumed (or else there would be no reason to earn it), it would never fully escape taxation.

Finally, there is the practical problem of evasion under a sales-tax system. However, the IRS admits that roughly $100 billion of income tax is unpaid each year. If retailers were compensated for the cost of collecting the federal sales tax, leakage might not be any worse than under the current system.

Back in 1909, when the Sixteenth Amendment creating the income tax was being debated, the *New York Times* protested: "When men get in the habit of helping themselves to the property of others, they cannot be easily cured of it." Our experience with the income tax since then has fully confirmed that warning. In April Bill Archer will commence an unprecedented set of hearings on the feasibility of abolishing the income tax. This is the first step in the process of liberating America from an eighty-year national mistake.

THE FEDERAL INCOME TAX, THEN & NOW

	1914	1994
Taxes Paid*	$6.7 bil.	$683.4 bil.
Per-Capita Taxes*	$69	$2,622
Individual Filers	360,000	113,829,000
% Population Filing	0.5%	45%
IRS Budget*	$110 mil.	$7.1 bil.
IRS Employees	4,000	110,000
Pages of Tax Law	14	9,400
Pages of IRS Forms	4	4,000
Top Rate	7%	40%
Median Family's Rate	0%	28%

* 1994 dollars

Compiled by the Cato Institute from various sources

770-J Sycamore Ave. #158
Vista, CA 92083
June 15, 1995

Mr. Phillip Moseley, Chairman
Ways & Means Committee
U.S. House of Representatives
Washington, D.C.

Dear Congressman Moseley:

I believe that the income tax which is the fairest for all Americans is the flat income tax.

And I do not believe that it should exclude the poor, unless we agree to exclude police and legal protection for them also. They should understand that taxes are a necessary part of the life of a country. Of course it isn't necessary to actively enforce the law if they don't pay. It takes time for the realization to sink in.

As to the amount, I'm sure that 10% is enough. Why should the government ask more than God? That will be enough to cover the proper duties of our government, namely: to protect American citizens from foreign and domestic enemies (but NOT FROM THEMSELVES), to provide a valid and trustworthy money, based on gold and silver (NOT CREDIT OR FIAT), to regulate interstate commerce and to raise revenue.

The remainder, which will be necessary to eliminate the deficit, should be raised by Congress. This big(?) problem can be quickly reduced by eliminating all programs not mentioned in the original Constitution, especially those having to do with promoting the "general welfare." These words have been corrupted by the no good freeloaders among us who haven't found the strength to turn to God for help. They were never meant by our forefathers to promote socialism. The Congressmen who play their god lead them on to a final disaster. Why should we go along?

Sincerely,

Robert Morrissey

Robert Morrissey

TESTIMONY SUBMITTED BY MICHAEL E. BRUNNER
EXECUTIVE VICE PRESIDENT
NATIONAL TELEPHONE COOPERATIVE ASSOCIATION
REGARDING REPLACING THE CURRENT INCOME TAX CODE
U.S. HOUSE WAYS AND MEANS COMMITTEE
JUNE 22, 1995

Thank you Mr. Chairman for allowing me the opportunity to submit for the record some observations made by National Telephone Cooperative Association (NTCA) with respect to various proposals to replace the current income tax system with a fairer, simpler, and more transparent tax system.

Americans today are frustrated about their individual economic situations and the stress it puts on their wallets. The complexities of filing annual tax forms are overburdensome, tedious and excessively costly for most businesses, full or part-time workers, small business owners, or American consumers. Beyond the border, however, a critical detriment to the economy is a major reason for the abandonment of the current system. The principle detriment is that the current federal tax system discourages savings and investment. The situation is exacerbated for rural workers, businesses, and consumers.

According to several studies, the U.S. ranks last among industrial nations in the percentage of gross domestic product devoted to investment. To address this critical problem, varying proposals for replacing today's complicated tax system have surfaced over the years and have gained in popularity as the 104th Congress has progressed.

The purpose of my testimony is not to suggest that one particular replacement proposal surpasses any other in design or practical application -- that is a decision for you the Congress in conjunction with the Administration, to determine. Rather I would like to point out that each of the proposals NTCA has reviewed thus far, fail to adequately recognize the significance of investment in one critical part of the country, that being rural America. Rural areas, with their lower growth rates, are not natural attractions for investment today and would conceivably be less so under a system that eliminates specific incentives for such investment. As an example, I illustrate the case of the tax treatment under which rural telephone cooperatives currently operate.

S. 722, the "USA Tax Relief Act of 1995", as introduced by Senators Nunn and Domenici, offers the most detailed explanation of how cooperatively organized businesses would be treated under a replacement system. First, the exemption afforded a qualifying telephone cooperative under section 501(c)(12) of the current code would be eliminated. Alternative proposals, while not specific, suggest the same. Of even greater concern however, is the fact that S. 722 would only permit telephone cooperatives to exclude from gross income those patronage dividends that are allocated each year in cash or property. My thesis is that whatever form tax simplification takes, it should preserve the ability of telephone cooperatives to raise capital through their "capital credit" systems in order to continue developing telecommunications infrastructure which in turn results in substantial economic development.

<u>The duty "to serve all" persists</u>

The National Telephone Cooperative Association represents nearly 250 rural cooperative telephone systems who have been active leaders in promoting economic development in their respective rural communities. These telephone cooperatives serve from fewer than 100 consumers to more than 50,000. They employ from 2 to several hundred individuals. They often provide the only local telephone service in areas as large as an entire state.

NTCA member telephone systems, like most of the country's independent local exchange carriers, evolved during the early part of this century to serve low

density, high cost areas that larger commercial companies found unattractive for investment. Congress granted telephone cooperatives an exemption from federal income tax in 1916. Today these systems continue to ensure that every farm and home in rural localities receives the same quality service as that provided to those residing in urban sectors of our country. The challenge is not easily met. In fact, to date, while rural telephone subscribers consist of a mere 4.3 percent of the nation's total number of telephone customers, the areas served by independent telcos account for 40 percent of the nation's geographic area. In a vacuum, this equation equals costly phone service for rural consumers. Fortunately, support programs and additional safeguards have been established over the years to ensure rural telephone service is affordable.

As you are aware, deregulatory telecommunications legislation is currently being considered by Congress. This legislation nevertheless recognizes that rural telcos are charged and will continue to be charged with universal service obligations. Fulfillment of these obligations in a period of rapidly changing technology will require continuous capital formation.

The basis for capital retention by telephone cooperatives

An important principle for the provision of telephone service in these rural, high cost areas, is that capital credits, or the margins of operation that remain after a cooperative has paid its business expenses, constitute, as a legal requirement, a contribution of capital to the cooperative. It is well recognized in law that this method of capital formation is vitally important to the progression of advanced services in rural communities.

The telephone industry is undergoing rapid changes as technology continues to expand and develop. It is paramount that Congress understand the initiatives that are being undertaken by rural utilities and how the retention of capital enables these initiatives to take root. Various community development projects have been initiated under the leadership of the local telcos. These projects create jobs, raise the standard of living and provide security for rural families. These families, like families in all parts of the county, desire to be productive members of society. That is why rural telcos have forged relationships with higher learning institutions for the purpose of delivering course materials not otherwise available in local school curriculum. That is why local telcos have constructed video conferencing sites that enable local leaders to reach out to their counterparts all across the country to share ideas and solve problems. Even more exciting is the rapidly developing state of the art technology used to link teaching hospitals with local clinics where rural patients can receive care without having to travel the distances they were once accustomed to.

In the provision of these services, cost remains the principal hurdle. The investment in infrastructure for these types of services is made possible only through the ability to retain capital. Pursuant to statute and the by-laws of individual telephone cooperatives, the current treatment of capital credits enables local telephone cooperatives to reinvest in the future on a continual basis.

Conclusion

A low rate flat tax on all forms of business entities with an unlimited deduction for capital investment, is in theory a good concept. However, initiatives aiding in rural economic development should be guaranteed special attention. Just as S. 722 retains current law treatment of the home mortgage deduction and charitable giving, and creates a post secondary education deduction all in the name of the long term gains these investment provide the nation, so should investment in rural infrastructure and communities. It is precisely for this reason why cooperatively structured business arrangements operating in rural areas warrant preferenced tax treatment in our tax system. Rural America will be threatened if infrastructure growth is not properly reinforced by safeguards similar to those outlined in the current Internal Revenue Code.

June 8, 1995

Committee on the Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515-6348

Dear Members of the Ways and Means Committee:

I believe that the tax system of our country should be changed by substituting a national sales tax for the income tax system. The IRS, with its dysfunctional bureaucracy and invasive tactics should be entirely abolished and be replaced by a simple collection agency.

A national sales tax would, first, stop penalizing those who are financially successful. Under the present system, those who succeed in business are actually penalized, and hence goods cost more and the job base erodes. Second, a sales tax would distribute the tax burden more evenly among all income groups, in order to prevent the poor from being unfairly disadvantaged, certain basic goods and services, such as rent and food, could be exempted from the sales tax. Third, a national sales tax would be simple, paperless, and record-less. Many records are now kept just to satisfy the IRS.

Thank you for considering my concerns. Please relieve our tax burdens.

Sincerely,

James A. Norfeld

114 Oak Street
Petaluma, CA 94952

ENCL. 6 COPIES

29 May, 1995
1530 N. 115th
Seattle, Wa 98133

Philip D. Bosley, Chief of Staff
Ways & Means Committee
Longworth Building
Washington D. C. 20515

Dear Mr. Bosley,

I believe that the tax code of the United States of America should be totally changed .

The tax system is not fair. It currently penalizes people who wish to work long and hard by making them pay more of their money than those who do not work as hard.Too much social engineering is done with the tax system. It is not fair to give a tax brake (Clinton's New Plan) for sending your child to college to people earning $95,000, but not to parents earning $102,000. Why should parents sending their children to college get tax breaks, but families whose children become mechanics or electricians do not get tax breaks?

Compliance is too expensive. It costs over 1 Billion dollars to comply and this does not take into account the time it takes individuals to gather their tax information.

A National Consumption tax would be most fair, but a National Flat Tax on income would also be preferrable to the current system.

Sincerely,

Nancy L. Niles

Nancy L Niles

June 8, 1995

Phillip D. Mosley
Chief of Staff
Committee of Ways and Means
U. S. House of Representatives
1102 Longworth House Boulevard
Washington, D.C. 20515

The Honorable Phillip Mosley:

Your are right, the current income tax system needs to be revamped. My solution is as follows:

CONSUMER TAX

Every purchase excluding food and medicines have a consumer tax of 7% at time of purchase.

In doing this you would encourage people to save and also to donate to charities.

This would also eliminate the business loop-holes and all would be paying according to their consumption, private, business or government. Yes, this would include all purchases, excluding food and medicines, by the government. When I say every purchase excluding food and medicines I mean EVERY PURCHASE. This would also eliminate a passel of IRS employees saving billions of $$.

I pray this solution or one very similar will be adopted as soon as possible.

Thank you for your time.

Very truly yours,

Patricia A. O'Brien
Rt 4 Box 4495
Prosser, WA 99350

cc: file
Congressman "Doc" Hastings
Senator Slade Gorton

INDIANA UNIVERSITY

SCHOOL OF LAW
BLOOMINGTON

June 20, 1995

Honorable Bill Archer, Chairman
Ways and Means Committee
Room 1102
Longworth Building
Washington DC 20515

Dear Mr. Archer:

I enclose two chapters from my book manuscript. It will be published in a few months. Tne tentative title is, "Why We Should Abolish the Income Tax: A Guide to the Proposals."

Please enter these in the record to accompany the printed record to the hearings on June 6-8, 1995, before your committee.

I enclose a copy of my vitae.

Sincerely,

William W. Oliver
Professor Emeritus of Law

Third Street and
Indiana Avenue
Bloomington, Indiana
47405-1001

Fax: 812-855-0555

Chapter 21

Draft 6/20/95

A National Sales Tax to Replace the Income Tax

1. We need to flee from the complex, controversy-generating income tax to a simple tax, and the sales tax is a simple, broad-based tax. It is computed transaction by transaction; not on a total of many transactions over a period of time. Modern cash registers compute sales tax on each transaction and total the tax over a period of time, such as a day. This means the cost to the retail merchant will be minimal. Everyone pays it and it is progressive since the rich spend more on consumption than the poor.

2. The income tax takes away from business and investors', funds which can be spent by them more productively than by the Government, which, to a large degree, is unproductive and counter-productive.

3. The income tax imposes huge compliance costs on the private sector and abolition will lead to even more improvement in economic performance than that which followed the 1981 Reagan tax cut.

4. The market values of stock are largely based on after-income tax earnings; abolition of the income tax will increase the market value of stocks. Those increases in the value of stocks will increase the net worth of individual stockholders, pension funds holding stock (and thus increase the security of pension recipients both current and future), endowment funds of non-profit organizations, and others. This increase in net worths would be conducive to new ventures in the private sector, the real source of

wealth in our economy.

5. We would replace a tax on investment, with one on consumption.

6. We have a meager savings rate and largely rely on foreign sources to fund our budget deficits and trade deficits. Now the savers face two taxes: one on the income saved, and another on the interest, dividends, or other income received on the savings. Abolishing the income tax will increase savings, and help avoid the disaster which will ultimately come from the combination of budget deficits, trade deficits, and meager savings.

7. The host of people who are cheating on the income tax or winning at playing the audit lottery, would pay the sales tax on their consumption.

A study done by John H. Qualls, Ph.D., at Washington University in St. Louis concluded that a national sales tax at a rate of 17% could replace the revenue presently raised by the income tax. That may sound high, but remember take home incomes go up immediately through elimination of withholding of income tax and payment of estimated income tax.

Here is a summary of the Qualls study:

> The replacement of the current U.S. individual and corporate income taxes by a national sales tax would result in faster economic growth, higher levels of employment, more business investment, higher productivity growth, and an increase in the private savings rate.
>
> These results were obtained from an econometric simulation using a variation of the Washington University Macroeconomic Model (WUMM), available commercially from Laurence H. Meyer and Associates (LHM&A), a St. Louis-based economic consulting and forecasting firm.
>
> A one-for-one replacement of the personal and corporate income taxes with a national sales tax results in a

reallocation of GNP away from consumption and toward investment. The investment share of GNP rises two percentage points (from 17.1% to 19.1%) with the introduction of a national sales tax.

The private savings rate (total of personal and business savings) rises from 15.4% up to 18.1% after the introduction of a national sales tax.

Real business investment is from 19 to 25 percent higher with a national sales tax. In effect, businesses use the extra cash flow resulting from the elimination of the income tax to invest in plant and equipment.

The higher level of capital stock results in more employment. The number of new jobs generated by the national sales tax reaches 900,000 by 2000 and 1,600,000 by the year 2010.

Because of the increase in business investment, real GNP grows at a faster rate after introduction of a national sales tax. Although the annual growth rate differential seems small, at 0.2%, it results in a significantly higher level of real GNP by the year 2010 -- up 4.1%. This amounts to a difference of over $1,500 (in constant 1990 dollars) for every person of working age in the country, or over $3,100 for a family with two working-age adults.

The national sales tax is <u>not</u> inflationary. Although the price of goods (including the tax) would reflect a one-time price increase, the rate of increase in prices after that would actually be lower by 0.2% per year. Thus, sustained inflation would <u>drop</u> after introduction of the sales tax and abolishment of the income tax.

In short, implementation of a national sales tax would go a long way toward rectifying the U.S.'s decline in international competitiveness.

Another study by Laurence J. Kotlikoff, Professor of Economics at Boston University (<u>The Economic Impact of Replacing Federal Income Taxes with a National Sales Tax</u>), corroborates the conclusions of the Qualls study. This study was sponsored by the Cato Institute and released in 1993. It concludes that the abolition of the federal income tax and replacement with a national

sales tax will increase savings and hence available capital, and increase wages in real terms.

For businesses, cash flow will increase from the disappearance of federal income tax payments and the end of the huge unproductive cost of income tax compliance. The added available cash will make funds available for increased investment in plant, equipment and working capital. Since the federal income tax is a cost which must be recovered through sales prices high enough to achieve an adequate profit margin, abolition of the federal income tax should (through the competitive process) decrease prices to consumers, tending to offset the national sales addition to the cost of retail purchases (also offset for the consumer by the end of withholding of income tax and the payment of estimated income tax). Export prices can be decreased to reflect the abolition of the federal income tax and the resultant elimination of the huge costs of compliance. The sales tax will not apply to export sales. The resultant improvement in our international competitive position should decrease our trade deficit, and perhaps even eliminate it.

For individuals, the end of income tax withholding and payment of estimated tax will occur simultaneously with the imposition of the national sales tax. But the motivation for savings is substantially increased; the saver will no longer have the income on the savings reduced by the federal income tax The present situation with savings covering only a small part of our two deficits (trade and budget) and relying on foreign sources to cover the rest of those deficits means that our country is vulnerable to

a loss of confidence in the United States by those outside our borders. Increased savings by our people is a vital goal; substituting a national sales tax for the federal income tax may be our salvation by increasing savings.

To avoid the sales tax being a burden on low-income persons, there will need to be a refund of standard amounts of sales tax to such persons. There will need to be strict safeguards. Don't forget that the I.R.S. has made "refunds" to prison inmates based upon phony withholding forms; as well as the fraud involving the earned income credit (for example, reporting non-existent earnings to get the refund). The working poor on their own mostly do not understand this refundable credit and don't claim it; sharpies claim it for them, and probably get much of the refunds, which they don't report as income.

Excise taxes can be used to satisfy the widespread desire to do something to people who "have too much money." For instance, an excise tax on advertising on the broadcast or telecast of professional sports can reduce the excessive salaries there. While the top rates under the estate and gift tax should be reduced, and relief should be given for family businesses which stay in the family, the estate and gift tax will remain. Excise taxes can be used to inhibit the officers of publicly owned corporations from getting excessive compensation, thereby breaching their fiduciary duty to the stockholders.

Chapter 18

SUMMARY: WHY THE INCOME TAX SHOULD BE ABOLISHED

Draft 6/21/95

1. Payne's Costly Returns alone is sufficient reason to abolish the income tax. That tax, which costs the society and economy 65% of the revenue raised, is intolerable.

2. Congress' pre-1995 record shows that an income tax can be a dangerous instrument in its hands: Marriage Penalty, Percentage Depletion, 1993 Clinton Tax Act, rules on Charitable Deferred Giving, etc.

3. An income tax is unfair in a country with chronic inflation.

4. Complexity and other factors make fair treatment of all taxpayers under the income tax unachievable.

5. There are signs the income tax is breaking down: extensive cheating, the audit lottery, massive non-filing, protesters, an increasing backlog of uncollected assessments, etc.

6. Discriminations exist under the income tax which cannot all be eliminated short of abolition of the income tax.

The Process

Achieving abolition of the income tax will require dedication. Those who understand the problems of the income tax, must show an intensity of effort. Absent some strong mitigating circumstance, vote against every Congressional incumbent who will not support abolition of the income tax, and write and tell them so. Join organizations such as Citizens for an Alternative Tax System and the National Taxpayers Union.

Opposition will be encountered. There is an income tax industry with many persons engaged. These 65% direct and indirect costs resulting from our present federal tax system is putting lots of money in the pockets of many people.

Tax attorneys and tax accountants may mostly oppose abolition of the income tax. They shouldn't, for they know how awful the income tax is, and in a country short on intelligent, well-educated people there will be many other opportunities for them. Tax accountants, freed of the burden of coping with an ever changing, complicated income tax, can do more adequate work on coventional accounting. This will permit them to better assist managers of businesses in making decisions.

Some arguments in opposition have some apparent merit. For instance, the income tax can be said to favor charitable giving, but with the Reagan income tax cuts, charitable giving increased substantially. I.R.A.s combined with the income tax can be used to encourage saving; but abolition of the income tax and replacement with a national sales tax will increase savings much more.

Those in the municipal bond industry and some in local and state government will oppose the abolition of the income tax (under which interest on municipal bonds is free from income tax). Abolition will end the ability of those governments to borrow at interest rates below market. Also such bonds outstanding will tend to drop in market value. But we must look to the overall good of the country. The loss to slaveowners didn't stop us from enacting the 13th Amendment and freeing the slaves.

Abolition of the income tax will make the United States a tax have for foreign capital. At present, in lieu of the income tax, there is a thirty (30) percent withholding tax on nonresident aliens on investment income, such as interest and dividends, from U.S. sources. This has been modified by a treaty with some countries. That withholding will cease with the abolition of the income tax.

If Clinton is no longer president after January 20, 1997, the erosion of confidence abroad in our country should start reversing. With no income tax, capital from abroad will flow into the United States. Combined with increased domestic savings, increased available capital will cause interest rates to drop. Indeed, the price of municipal bonds may increase because the interest rates on those bonds will be above the interest rates on newly issued federal and corporate bonds.

Some in the life insurance industry will want to cling on to the income tax, because the tax-free build-up of cash surrender value can be used to sell life insurance as a tax shelter. But they will be misguided. The unique nature of life insurance will cause that industry to get its share of increased savings after the abolition of the income tax.

The arguments of those who want to hold onto the income tax for some advantage they have under it, are in effect asking to continue a discrimination in their favor.

GEORGE A. PALM
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CERTIFIED FLOOR INSPECTIONS
CARPET & RESILIENT

June 9, 1995

Mr. Phillip Mosely
U.S. House Ways & Means Committee
1102 Longworth Building
Washington DC 20515

Dear Sir:

I am writing because Mike Reagan said that if I sent you six copies of this letter it would be duly submitted for committee consideration.

Pertaining to new tax legislation I believe the I.R.S. should be mightily diminished by (1) either adopting Dick Armey's Flat Tax Proposal or (2) adopting a National Sales Tax,either of which will eliminate our present Income Tax.

Machinery to collect a National Sales Tax is in place now in all or almost all states. I want no part of any value added tax.

Eliminate double taxation - this taxes both corporations and the dividends they pay. Eliminate the Capital Gains Tax.

Add up the grand total of goods and services purchased or the total of income received to determine what tax income is needed and set the flat tax rate or the sales tax rate accordingly.

Let's establish an honest tax system free from lobbyists. We can call it the "Bill of Rights II".

Sincerely

George A. Palm
P.O. Box 545
Ludington, MI 49431-0545

Copy: Congressman Pete Hoekstra
Senator Spence Abraham
Senator Carl Levin

STATEMENT FOR THE RECORD CONCERNING CONGRESSMAN ARCHER'S HEARING ON JUNE 6, 1995 ON REPLACING THE FEDERAL INCOME TAX

Dear Congressman Archer:

Please consider the following in your deliberations:

1. The two primary motivating factors behind the increase in the number and complexity of the provisions in the Internal Revenue Code are:

(A) Transactions are far more complicated than they used to be and the Code has to be periodically changed to reflect same.

(B) Since approximately 1974, many of the changes in the Revenue Code and, over the past decade increasingly so, have been revenue driven. In other words, the real problem is that Congress is spending far too much money and has to invent ever more complicated ways to raise more money. For instance, take a look at the S.S.I. program. Note the provision which allows an immigrant, after being here for only five (5) years (it used to be three years) and who has never made a contribution to the system to receive S.S.I. payments. This is clearly abusive. Another issue to look at concerning Social Security is the fact that when the program was enacted, life expectancy in this country was age 62. Social Security payments did not kick in until age 65. The current program makes no sense from any equitable point of view and the only thing that is standing in the way of change is Congress' fear of the elderly vote. Congress is underestimating the elderly of this country. If properly explained, they would agree to financial responsibility and equity in the Social Security system. The Food Stamp program should also be scrutinized. The federal government is spending $26 billion a year on food stamps. It does not take a rocket scientist to realize that this is $2,600 a year for each of 10 million families of four individuals. This is 40 million people. This number clearly suggests massive fraud -- perhaps as much as fifty percent of the amount expended.

As a tax attorney who has specialized in civil and criminal tax litigation, I can assure you that the biggest burden on American individuals and American business is EMPLOYMENT TAXES. Employment taxes do not come out of your pocket after you determine whether or not you have a profit. Employment taxes come out of your pocket on an on-going basis regardless of whether your business is profitable. Rate increases over the last decade have made employment taxes even more burdensome. In addition, I have seen many businesses go out of business due to a re-characterization of independent contractors as employees. Part of the problem here is that federal law concerning the independent contractors/employee issue does not take into consideration that when an independent contractor is recast as an employee, there are severe, collateral economic consequences. They include, but are not limited to, a minimum wage and overtime investigation by the Wage & Hour Division of the Labor Department; an audit by the Workers' Compensation insurance carrier; and, an audit by the State Unemployment Compensation bureau. Hundreds, if not thousands, of businesses are being put out of business every year and Congress has done absolutely nothing to solve the problem. (Section 530 of the Revenue Act of 1978 has not solved the problem. The Internal Revenue Service still examines the business; and, the burden of proof and resources required to invoke Section 530 of the Revenue Act of 1978 are both excessive.)

2. Before you throw the baby out with the bath water with respect to the Internal Revenue Code. Please also consider the following points:

(A) If there is no tax on any interest or dividend; and, state and local political entities have to borrow money on par with

businesses, the cost of their borrowing will increase dramatically. The focus, thus far, on, in essence, eliminating the municipal bond market by not taxing all interest and dividends, has been on investors. While this is very important, since most of those investors are elderly people who have worked very hard to acquire the wealth to buy municipal bonds, everyone seems to be ignoring the fact that the cost of borrowing money to state and local political entities will increase dramatically. This will, undoubtedly, result in increased taxes at the state and local level.

(B) When most people buy a house, they examine their cash flow, taking into consideration any tax benefit, and make a decision on what house they can afford in accordance with same. If the mortgage interest deduction is eliminated, many people will find themselves in the position of not having sufficient cash flow, after taxes, to pay their mortgage. This could result in tens of thousands of foreclosures all over the country and the resulting personal bankruptcies. (As the passing of the 1986 Internal Revenue Code showed, when changes occur too rapidly in the tax system, it can result in a financial catastrophe. It has been well established that the changes in the Internal Revenue Code with respect to real estate significantly contributed to the collapse of values in real estate and the resulting savings and loan crisis.)

(C) If you eliminate the charitable deduction under Section 170 of the Internal Revenue Code, charities will be severely impacted.

(D) Individuals and companies have established retirement plans -- whether pension plans, IRA's, or other varieties. If all interest and dividends are not going to be taxed, does this mean that all of the accumulated income inside all retirement plans would not be taxed under a proposed change? While it is standard "Congress speak" to talk about transition rules, it is suggested that the complexities of the transition rules necessary to have any sort of equity in this area would be beyond human comprehension.

(E) For individuals subject to the 39.6% marginal tax rate, the tax is already a "flat tax." This is due to the limitations on itemized deductions contained in Section 68 of the Code and the phasement of deductions for personal exemptions set forth in Section 151 of the Code.

(F) Some businesses operate on a very slim profit margin. For instance, assume a business which has gross revenues of $100 million. Also assume that the cost of goods sold for the business is $99 million. This leaves income, without considering other expenses, of $1 million. If there was a "flat tax" of 14%, the business would be hit with a $14 million tax bill when it only had a profit of $1 million.

(G) Assume an independent contractor sales person receives gross income (gross revenues) of $150,000 per year. Out of this amount, the sales person pays all of his or her expenses in connection with all of his or her business activity. After paying all ordinary and necessary expenses, the sales person is left with $65,000 per year. A gross receipts tax of 14% on gross income of $150,000 would create a tax of $21,000. $21,000 subtracted from $65,000 leaves $44,000.

3. There are a number of things wrong with the laws of taxation in this country. The main things wrong, however, are not being addressed. From my point of view as someone who has been involved with civil and criminal tax controversy work since 1977 and has taught tax litigation and procedure since 1981; and is, therefore, someone who has seen most of the glitches in the system, they are as follows:

(A) Congress does not make technical corrections on a timely basis.

(B) Congress changes the tax law too frequently without sufficient thought and planning. This results in insufficient time for anyone, whether taxpayer or the Internal Revenue Service, to absorb the changes and properly plan and/or administer them. This also results in more glitches that need more technical corrections which Congress does not address.

Robert E. Panoff, (Current Chair of the Tax Section of the Florida Bar [this statement is not in my official capacity]; and, Adjunct Professor of Tax Litigation and Procedure University of Miami School of Law Masters in Tax Program.)
Suite 106
9400 South Dadeland Boulevard
Miami, FL 33156
Telephone: (305) 670-6547
May 18, 1995

June 7, 1995

Honorable Rep. Bill Archer
U. S. House of Representatives
Washington, D. C. 20510

Honorable Rep. Archer:

I picked up Pittsburgh Post Gazette dated today (June 7th, 1995), and read the headline "House opens debate on end to income tax". The side box had a quotation "Our challenge is no less than pull the current income tax code out by its roots and throw it away so it can never grow back". Based on my analyses of behaviors of many individuals over more than two decades and a lot of other analyses and writings, it struck me that this is a statement by an individual who has a lot of Ego (my idea is better) and lives on Jealousy or Hatred of the current tax system. However, I later on found out that it was a statement made by you opening the hearings on the current income tax system - I was just shocked to read it!

The current income tax system could have been simple if we had considered that there is a need to tax all income at the same rate after some basic deductions and avoided changes to it over the past thirty years in form of various kind of "credits and deductions". For example, Pennsylvania has a relatively simple income tax system. I had outlined a simplified system to Senator Harris Wofford in a letter dated April 3, 1992 (more than three years ago) - a copy is attached herewith - it is similar to the one proposed by Hon. Richard Armey.

The concept of taxing income is fundamentally more sound than the National Sales Tax or the Value Added Tax or any other concept. NST or VAT are MORE difficult to administer. In countries where the Sales Tax is the major source of revenue, over a period of time people learn to avoid paying taxes and slowly create a parallel economy - which leads to a creation of an underground economy. Similar thing can happen with the value added tax - where the businesses can keep books in a way where they minimize the taxes they pay and the government will need more agents to monitor the accounting practices of the "businesses".

A national sales tax (especially any thing more than 1%) is a VERY bad idea, because it will force people to pay taxes whenever they buy some thing even if they are not employed. For example, the elderly living on social security will have to pay a tax when they buy something for their grandchildren. Further, the "sales tax" will figure in every buying decision leading to a refrain in purchasing decisions every time - and thus leading to "recession" or a constant burden on the free economy. There are MANY other drawbacks with the concept of National Sales Tax as well as Value Added Taxes. Further, there is no guarantee that the system will NOT grow given the politics that is played in State Capitals or in Washington.

Therefore, the income tax concept is the best among many and there is need for the government to collect some taxes to maintain the minimum operations necessary in today's World - we just cannot avoid some taxes.

Bal Patil

Bal Patil

cc: United We Stand, USA Today, NBC News.
AARP

April 03, 1992 (follows up July 17, 1992)

Honorable Senator Wofford:

Here is an idea which can help a lot of families and large sections of our population. There may be extraordinary benefits to productivity of our economy and and the people at large. The thinking has been developed long ago, separate letters have been written and there is no reason for Republicans to play politics with it (As far as I can tell). The thinking looks at all the people in this nation as ONE HOMOGENOUS GROUP to be served.

The people who invest money for capital gains do not invest it for TAX attractiveness but to make a lot of money (get higher return than the banks or CDs etc. etc.) so they should be more than willing to pay AT LEAST 20% in taxes (to pay for the Government Services such as protection, defense, free enterprise system, administration etc. etc. etc. etc.). All we need is following items for deductions (Home Building and AUTOMOTIVE being primemovers of American Economy)

Total Income : Includes Wages, Tips, Salaries, Dividends, Interest, Capital Gains etc. etc. etc. etc. etc.

Deductions :

1. First 20,000 dollars tax exempt ... needed to pay for food, clothing, shelter, utilities, shoes, rent car to look for job, brush teeth, buy cough medicine etc. etc.

2.	HOME MORTGAGE INTEREST	Maximum Limit of	$ 20,000
3.	REAL ESTATE TAXES	Maximum Limit of	$ 10,000
4.	IRA FOR INDIVIDUALS	$2,000 per adult	
5.	AUTO INTEREST OR LEASE	Maximum Limit of	$ 6,000

All the limits to be indexed for Inflation. THE TAXABLE INCOME will be reduced by actual amounts of items (1+2+3+4+5). The ADJUSTED INCOME TO BE TAXED at a rate of 20% (based on Federal Income data available to me) and (my calculations) do not show any increase in deficits.

CHARITABLE DEDUCTIONS are not included...the ability to deduct it on a TAX FORM should not be the motivator ... the American people are really good at heart and we should encourage GIVING, SHARING etc. as a normal moral activity of all people including the HIGH INCOME people. I think such a bill, with absolutely no other complications, will simplify the life for many people.

DO THE THINGS which are good for PEOPLE AT LARGE and all of you in Congress and Senate can look forward to getting re-elected (to serve people).

Bal Patil

Balaji V. Patil
117 Crestwood Drive
Sarver, Pa. 16055

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Statement of Fortescue W. Hopkins, Director, The Patrick Henry PAC(VA)

AMENDMENT XXIX
THE TAX AND SPEND MAGNA CARTA

Section 1. The sixteenth article of amendment to the Constitution is hereby repealed.

Section 2. The fourth clause of Section 9 of Article I of the Constitution is hereby repealed and the third clause of Section 2 of Article 1 of the Constitution is hereby amended by eliminating the language "***and direct taxes***" contained therein.

Section 3. Except for the words "***The Congress shall have Power***", the first clause of Section 8 of Article I of the Constitution, including all legislation enacted pursuant thereto, is, hereby repealed effective as of the beginning of the calendar year following the adoption of this amendment and is replaced with the following language:

"Section 8. *The Congress shall have Power* To Lay an annual non-discriminatory, geographically and intrinsically uniform, flat rate income tax on the annual net income of all individuals in each of the several States, the District of Columbia and all Territories of the United States, only for the purpose of providing the revenue necessary to pay all debts heretofore incurred, to pay the costs of the Legislative, Executive and Judicial Branches of Government, as set forth in Articles I,II, and III of the Constitution and to carry out the powers specifically enumerated in this amendment and now expressly granted to Congress in Article 1, Section 8, Clauses 2 to 18, inclusive, of the Constitution, subject, however, to the following conditions:

A. "individuals" are defined to include all citizens of the United States and all non-citizens who have been residents of the United States for at least six months.

B. The "annual net income" of an individual is defined to include the receipt of anything of value, within one calendar year, from any and all sources, whatsoever, without exception, including interest received on obligations of any State or municipality therein, less cost(adjusted for annual inflation) or expenses related to any value received, less a carryover of any net loss from a prior tax year and shall be deemed to include the proportionate share of annual loss or the undistributed annual net income of any equity type entity(Corporation, Partnership,etc.,) in which an individual has an equity interest. For purposes of this amendment, any non-equity entity shall be deemed an "individual" but, for purposes of computing annual net income shall be allowed a deduction for any income distributed in the calendar year.

C. The term "receipt of anything of value", shall be interpreted as broadly, as possible, and shall include, for example, the cost of any benefit to or expenditure made for the benefit of any individual, except between husband and wife, regardless of the source of such benefit or expenditure; provided, however, that the cost of reasonable educational, medical and living expenses provided to an individual who is physically disabled or under the age of 22, by a parent or grandparent shall not be deemed a "receipt of anything of value to that individual.

D. The "flat rate income tax", except as above provided, shall not, in the slightest degree, be discriminatory or intended to achieve a non-revenue related objective, whether or not such objective is otherwise permitted under this Constitution and no other exemptions, exclusions, tax credits or non-expense related deductions shall be permitted in computing "annual net income" and tax due thereon.

E. Each individual and/or parent or person with custody of a child under the age of 18 shall prepare and file on or before April 15 of each calendar year with the State , District or Territory of residence a one page income tax return disclosing "annual net income" for the preceding calendar year and report and pay such income tax as may be due to the Local Commissioner of Revenue or to such bank or agency as the State, District or Territory of residence may designate.

F. The local Commissioner of Revenue of each jurisdiction shall collect, determine and, if necessary, litigate any dispute concerning the correct amount of income tax due in the local civil and common-law court in the vicinity of the residence of the individual; provided, however, that no presumption of correctness will attach to the State's, District or Territories' determination of additional tax due and that the question of what constitutes a correct "annual net income" and/or "tax" will be determined as a "matter of fact" and not subject to any law or precedent and such individual will be entitled to a jury trial[1] with respect to any such dispute where the amount in controversy is at least $200.00.

G. Interest at a rate double the Federal discount rate will be payable on any late payment of income tax. The penalty for negligent failure to pay tax and/or negligent incorrect tax will be an additional 10% of the tax determined to be due. The penalty for willful failure and/or willfully false tax return shall be 100% of the tax ultimately determined to be due. On or before June 30th of each calendar year, each State, District or Territory shall remit to the United States Treasury all interest and income taxes collected ; but shall retain all penalties for its own use.

. I. On or before April 1 of each calendar year , the US Supreme Court shall establish the "***flat rate***" of this tax on individual annual net income in accordance with the following formula:

R = (X+Y) x 100/Z = _____%

WHERE:

X = Prior Calendar year's total Federal Expenditures.

Y = Ten Percent (10%) of the Total Federal Debt as of 12/31/ of the prior calendar year.

Z = Prior Calendar year's total Federal Income Tax (Which for the first year, after the adoption of this amendment , will be an estimated amount)."

J. The Federal Government may maintain an agency to monitor the performance of the various States in the collection and the determination of this tax and if not satisfied with the performance of a certain State, it may file suit in the Federal courts to mandate a more reasonable compliance with this amendment and ask for an appropriate sanction[2] for the failure of any State to reasonably comply with its responsibilities under this amendment."

CONCLUSION

As a separate amendment, it would also be appropriate to propose an additional amendment, as follows:

"No State shall have the power to impose any form of Tax, Impost, Duty or Excise, except for a local non-discriminatory property tax and except for a flat rate individual income tax on "individual net income" as provided for the United States of America."

As you can see it is proposed to eliminate all Excise taxes(Federal & State), the reason being: (1) Indirect Excise Taxes do not promote ***Individual Political Responsibility*** and amount to a blank check which the politician uses to buy votes with and (2) Unfairly exacts from lower income persons a higher percentage of tax relative to income than from persons with higher incomes..

Also, all Federal duties and imposts are eliminated for the reason that an import duty to protect a farm or manufactured product, etc. is, in effect, an indirect tax on citizens that might otherwise pay less for a certain product.

Also, all Trade should be ***"FREE TRADE OR NO TRADE".*** There is no valid reason why we should not inform the rest of the world of this condition for trade with the largest and richest free trading area in the world, America. Again import duties do not promote ***"INDIVIDUAL POLITICAL RESPONSIBILITY"*** which is the indispensable ***"KEY"*** to ***"INDIVIDUAL ECONOMIC OPPORTUNITY".***

As you will have noticed, this proposed amendment to Section 8, eliminates completely the General welfare clause which, of course, has been improperly construed by the Supreme Court to give Congress an unlimited power to spend, mandate and control.

This amendment prohibits Social Security Taxes, which, if not, in fact, an unconstitutional discriminatory income tax, forces a person to contribute to an insurance program, where he may receive nothing if he dies early, clearly in violation of the "taking" clause of the 5th Amendment.

Also, this amendment eliminates corporate income taxes, but, instead, taxes the individual equity holder. Corporations do not pay taxes and do not vote. Only individuals do, so why tax corporations?

A completely non-discriminatory flat tax , without exclusions or exemptions is certainly equal and, most certainly, is what the framers of our Constitution intended when they used the word "*"UNIFORM"*. Our greatest Supreme Court Justice was ***Stephen Field***, who, with reference to a "$4000.00 exclusion from income tax said in ***Pollock v. Farmers Loan and Trust Co.(1895):***

> "Here I close my opinion. I could not say less in view of questions of such gravity that go down to the very foundation of the Government. If the provisions of the constitution can be set aside by an act of congress, where is the course of usurpation to end? ***The present assault upon capital is but the beginning. It will be but the stepping -stone to others, larger and more sweeping, till our political contests will become a war of the poor against the rich,-a war constantly growing in intensity and bitterness. "If the court sanctions the power of discriminating taxation and nullifies the uniformity mandate of the constitution," as said by one who has been a student all his life of our institutions, "it will surely mark the hour when the sure decadence of our present government will commence". If the purely arbitrary limitation of four thousand dollars in the present law can be sustained, none having less than that amount of income being assessed or taxed for support of the government, the limitation of future congresses, may be fixed at a much larger sum, at five or twenty thousand dollars, [3] parties possessing an income of that amount alone being bound to bear the burdens of government;"***

The last few sentences of Walter K. Tuller's great book: "***THE TAXING POWER/STATE INCOME TAXES***(Callaghan & Co. 1937) bears repeating:

> ***"IF THE COURTS PERMIT THOSE IN CONTROL OF THE EXECUTIVE AND LEGISLATIVE BRANCHES OF GOVERNMENT TO TAX WITHOUT DUE REGARD TO CONSTITUTIONAL LIMITATIONS, PARTICULARLY TO IMPOSE DISCRIMINATORY TAXES, CONSTITUTIONAL LIBERTY IS DEAD, WHATEVER FORMS MAY SURVIVE. THE GOVERNMENT WILL BE, IN FACT, ABSOLUTE. HERE LIES OUR GREATEST AND MOST IMMEDIATE DANGER. THE TIDE TODAY IS SETTING TOWARD THAT SHORE. THE ONLY HOPE LIES IN REVITALIZING THE OATH, SOLEMNLY TAKEN BY EVERY JUDGE OF EVERY COURT, TO MAINTAIN AND DEFEND THE CONSTITUTION OF THE UNITED STATES."***

It is obvious to the undersigned that, as of 1995, the ***"tide has set"*** and that the most important question remains: WILL ***DICK ARMEY, BILL ARCHER*** OR ANYONE ELSE BE ABLE TO EXPLAIN TO THE AMERICAN PEOPLE THE PROBLEM WITH AND THE SOLUTION TO "***DISCRIMINATORY TAXATION***" ?

When you read Henry Mayer's biography of Patrick Henry, "***A SON OF THUNDER***"(University Press of Virginia), it becomes quite clear that it was mostly the common people who backed the resistance to the Crown, and not the landed "***aristocrats***" who preferred the "***status quo***".

The "***COLLECTIVIZATION***" of America will continue unabated unless all "***AMERICANS***" are informed of and understand the dangers of the ever increasing power of the centralized government and are willing to act to compel State Legislators to curtail this power by the only possible means: "***CONSTITUTIONAL AMENDMENTS", proposed and passed by the States.*** The recent "***Williamsburg Resolves***" suggests that many State Governors are willing to take such action and to advise the American people. Lets support them.

The foregoing proposed amendment will be resisted as to complex and that "***REDISTRIBUTION AND THE WELFARE STATE***" should not be so hastily and completely eliminated. As a beginning, at least, the American people should act now to compel the following amendment:

THE TAX MAGNA CARTA

"THE CONGRESS SHALL ENACT NO TAX, DUTY, IMPOST, EXCISE, OR OTHER REQUIRED PAYMENT THAT IS, IN THE SLIGHTEST DEGREE, DISCRIMINATORY OR INTENDED TO ACHIEVE A NON-REVENUE RELATED OBJECTIVE, WHETHER OF NOT SUCH OBJECTIVE IS, OTHERWISE, PERMITTED UNDER THIS CONSTITUTION."[4]

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1 It is noted that the elimination of the Jury trial with respect to **"Stamp Taxes"** prompted the VA House of Burgesses **to approve of Patrick Henry's "Stamp Tax Resolutions" which led to increasing resistance to the Crown and, ultimately, to the Revolutionary War.**

2 The appropriate sanction suggested by Patrick Henry for the non-performance of a State in collecting such taxes would be for the Federal Government to then take over the collection duties.

3 It is noted that without repealing social security taxes and federal excise taxes, Dick Armeys ""\FREEDOM AND FAIRNESS RESTORATION ACT would exclude $5300.00 for dependents and $26,200.00 for married filing jointly for Wages, Salary and Pensions. Is there any doubt whether the " **sure decadence**" of our present government has arrived?

4 To the same effect, see Statements of Fortescue W. Hopkins, Hearings on "TAX REFORM AND DEFICIT REDUCTION, Sept. 1984, Serial 98-97, Pages 575-579 and Hearings on "COMPREHENSIVE TAX REFORM", July 31, 1985, RECORD SUBMISSIONS, Part 9 of 9, Serial 99-49, at pages 8613-8620. There was no response to these Statements. However, this time may be different if THE PATRICK HENRY PAC persuades all State Legislators to read the "TAX AND SPEND MAGNA CARTA" and propose a Constitutional Amendment to that effect.

Karolyn A. Phanauf
5802 Sutters Lane
Bloomfield Hills, MI 48301

Congressman Ways & Means

✓ Why do we need children to get a tax break ??? ($500?)

✓ Why can't kids eat a P.B.J. like my 6 kids did when they were in school? (Parents are lazy) They want to let government feed them!

✓ Cut the welfare to under 18 girls

✓ Feed the babies – that's all

✓ Abortion is not a government decision – it's private – Government out of Abortion – Now

✓ Term limits don't upset me

✓ Don't cut Social Security til you cut Congressional BIG Pensions

✓ government pensions to High!

✓ $123,804 Annually - Thomas Foley

✓ $110,538 Annually - Robert Michel

✓ $96,426 Annually - Rostenkowski

✓ Then you tax my little Social Security pension

It isn't fair!!! Disgusting

✓ I was behind a lady buying a stack of 8 T-Bone steaks, pop + potato chips —

With food stamps!

✓ I'm a pensioner & haven't bought a T-Bone in years

✓ She was driving a nice car too - ($20,000 plus)

✓ A man bought 1 lemon @ 15¢ with food stamp coupon - pocketed the cash

he was in front of me @ the market

Probably went for drugs or booze!

✓ Tax Cut please ! for everyone
(I don't have kids anymore)
H. R. 8 – yes!

✓ The Republicans got it right !
Keep on going

✓ Bonier is a mitcase –
embarrassing to Michigan

✓ Gephart lies, just like
Clinton !

✓ The children are not going to
starve –

✓ Who feeds them on week-ends

✓ Who feeds them on Summer
Vacations

✓ The Democrats are scare
mongering –

Really riled in Michigan

Karolyn A. Phanaul
5802 Sutters Lane
Bloomfield Hills, MI 48301

NO!

Do not change

VJ-DAY

Don't insult our fighting forces

Japan started that war not us — Clinton You weren't here then — V-J Day was a wonderful celebration!

You make me angry in Michigan

Mr. Chairman and members of the Committee:

My name is Daniel J. Pilla. I am a tax litigation consultant from St. Paul, Minnesota. I have been in the business of defending taxpayers against IRS actions for some 20 years. My work focuses on the areas of IRS abuse prevention and cure, taxpayers' rights issues and problems resolution. I have written a total of eight (8) IRS defense self-help books and hundreds of articles and special reports on the issue. Additionally, I edit two nationally circulated newsletters. My writings have been featured in Money Magazine, Tribute Magazine, Reason Magazine, Family Circle Magazine, The Freeman Magazine, and dozens of other financial newsletters and publications.

I am co-founder and executive director of the Tax Freedom Institute (TFI). TFI is a national association of tax professionals who defend citizens against IRS abuse. The organization consists of prominent attorneys, accountants and enrolled agents.

This statement is submitted on behalf of myself in my individual capacity, on behalf of the Tax Freedom Institute, and on behalf of every American business and individual taxpayer.

In the span of my career, I have seen every kind of tax case you can imagine, and many cases you could not imagine. My experience with the IRS has brought me to the conclusion that our current income tax system, which is dependent upon the IRS for enforcement, is the worst possible way to administer a tax system.

My experiences with the IRS reveal that the agency regularly uses tactics of bluff and intimidation, misinformation and disinformation, and in many cases, outright lies to citizens concerning taxpayers' rights and the limitations of the agency. Through my work, I see a continuing parade of glaring examples where IRS revenue agents and revenue officers boldly lie to citizens, refuse to explain taxpayers' rights, and twist the tax law and regulations solely for the purpose of collecting more money.

Unfortunately, many citizens are ignorant of their rights, and of the agency's limitations. As a result, they end up faced with tremendous assessments of tax, interest and penalties against them which too often, are simply wrong.

Through the years, we have seen an explosion of penalty assessments and computer generated notices. At the same time, we have seen a decline in the quality of IRS performance, both in the areas of taxpayers assistance and audit results.

These claims, and others, are fully documented in a report I wrote for the Cato Institute, entitled, *Why You Can't Trust the IRS*. Policy Analysis No. 222, April 15, 1995 (Cato Institute - 202-842-0200). The report examines several areas of tax law administration with a view toward answering the question whether or not the IRS performs its various tasks properly.

The findings may be summarized as follows:

1. The quality of IRS' taxpayer assistance toll-free help service has been steadily declining. While it is true the accuracy of its answers has increased over the years, taxpayers have a steadily declining capacity to get assistance. Whereas, in the 1993 filing season, taxpayers had a 1 in 3 chance of getting their questions answered by the IRS, in 1994, their chances fell to 1 in 4. In February of 1995, the GAO reported that the accessibility of the

system fell to the deplorable level of just 13 percent. See, *IRS' Fiscal Year 1996 Budget Request and the 1995 Filing Season*, GAO/T-GGD-95-97, page 4.

2. Evidence reveals the IRS has increased computer generated notices by 1300 percent over the period from 1988 to 1991. Computer notices account for billions of dollars annually in adjustments to taxpayers' accounts. For example, in 1993, the IRS mailed a total of 60 million notices to taxpayers, making adjustments totaling some $192 billion. However, the fact is that numerous GAO studies show that IRS notices are wrong about half the time. In 1988, the GAO first released a report showing an error rate of 48 percent. Subsequent examinations have been conducted nearly every year since. While the IRS is plainly aware of this fact, it has done virtually nothing to correct the problem. Thus, the agency continues to make unwarranted demands for billions in revenue from millions of citizens every year.

At the same time, the notices themselves are woefully inadequate to communicate what it is the IRS is seeking. In a December, 1994 report, the GAO examined IRS notices, not from an accuracy standpoint, but merely from an understandibility standpoint. GAO found that 31 of the most common 47 notices used by IRS -- 66 percent -- used language that was unclear, used inconsistent terminology, contained an illogical presentation of ideas, and provided insufficient information and guidance to the taxpayer. See, *IRS Notices Can be Improved*, GAO/GGD-95-6, page 8.

3. The IRS consistently makes improper penalty assessments on a wholesale level, amounting to billions in assessments which are not legitimately due. In 1980, the IRS assessed a total of 19.6 million penalties against individuals and businesses. After a decade-long process of tax simplification, one would think penalty assessments would have declined. However, by 1987, the year following massive tax reform, assessments rose to 27 million penalties, and by 1993, 32.97 million penalties were assessed against individuals and businesses.

The evidence indicates that such penalties are simply wrong anywhere between 40 and 50 percent of the time. The IRS' data on penalty cancellation reveals this truth. Yet, because the IRS disseminates incorrect and incomplete information on the penalty cancellation process, many citizens do not attempt to undertake the cancellation process. They wind up paying penalties and interest which they simply do not owe.

4. The IRS is consistently incorrect with the results of the face-to-face audits it performs. About one to two percent of all tax returns filed undergo face-to-face examination. The average audit results in an additional tax and penalty assessment of about $5,000. This number doubles after IRS adds penalties. However, the data shows these audits are incorrect about 50 percent of the time. In fact, a GAO report on the tax burden, released on December 9, 1994, showed that one of the major problems businesses face in dealing with the IRS is the fact that IRS tax auditors lack sufficient knowledge of the tax code to do an accurate or effective job in tax law administration. See, *Tax Compliance Burden Faced by Business Taxpayers*, GAO/T-GGD-95-42, page 3.

5. The IRS' periodic Customer Satisfaction Survey shows that the public's perception of IRS performance is steadily dropping. The survey shows declining confidence in the agency's ability to administer the tax law correctly, answer taxpayer questions accurately, maintain high standards of integrity, keep taxpayer information confidential, and be courteous to taxpayers. The public's composite assessment of IRS' conduct dropped from 6.42

in 1992, to just 5.88 in 1993. This is to say, 41.2 percent of the time, the public feels it was wronged, cheated or otherwise inadequately served by the IRS.

6. The IRS has announced plans laying the ground work for a highly invasive, broad based information gathering program which smacks of Big Brotherism like nothing else. On December 20, 1994, the agency announced plans to introduce a system of recordkeeping that would give it access to every public and private data base in the nation.

In addition, an incredibly invasive audit program has just recently been announced. The program is the District Office Research and Analysis Program (DORA). IRS has termed this the "life-style audit." Under this audit, IRS will not be interested in the entries on your tax return. Rather, it will examine your life-style in hopes of ascertaining whether your life-style is consistent with the income claimed in your return. Included on the list of items to be reviewed are: your home, furniture, fixtures, clothing, jewelry, toys, recreational vehicles, trips and vacations, weddings of your children, business licenses you hold, all real estate holdings, use of credit, and on and on.

Amazingly, these life-style audits are to be conducted by the same tax auditors who have little understanding of the tax code and are mistaken in their audit results half the time.

7. The data shows the IRS regularly and systematically submits incorrect information to Congress concerning the effectiveness of its enforcement programs. While the IRS continues to request of Congress more money, equipment and manpower, it simultaneously fails or refuses to provide accurate reports to Congress on the impact these enforcement programs have on revenue collection.

At the heart of this problem is the $23 billion Tax Systems Modernization program (TSM) which IRS has been engaged in for the last five years. IRS' financial reports to Congress have been so deficient with regard to this program, the GAO recently placed TSM on its list of "high risk" government programs. See, *IRS' Fiscal Year 1996 Budget Request and the 1995 Filing Season*, GAO/T-GGD-95-97, pages 8 and 9.

8. As if all this is not sufficient cause for one to question the continued existence of the IRS and the income system, the GAO's two audits of the IRS' own financial statements show the agency itself cannot do what it asks every taxpayer to do. The evidence shows that the IRS is unable to account for 64 percent of its operating budget, significantly overstated its accounts receivables ledger, and falsified significant records of its accounting activities. While the IRS has made repeated promises and assurances that it will correct the problem, the GAO recently noted it continues to have no confidence in IRS' financial statements, because they still are not "accurate, reliable or consistent." See, *Tax Compliance Initiatives and Delinquent Taxes*, GAO/T-GGD-95-74, February 1, 1995.

In Conclusion, I submit that a tax system consisting of 17,000 pages of law and regulation nobody understands is not suitable for a free society. Similarly, a federal agency which cannot adequately maintain its own accounting ledgers is poorly suited to police individual and business taxpayers.

The tax system of a free society must necessarily release the American people from the burdens of compliance and the hassle of dealing with an error-prone enforcement agency. Tax law enforcement is too important for anything less. The potential for enforcement abuse is too great to allow a government agency to

continue to wield the power of the IRS, given its lack of accountability and incapacity to manage its own affairs.

I therefore submit that we must eliminate the income tax system and the agency which administers it. I submit the only reasonable replacement to the system we now have is a national retail sales tax. *By no means* should such a tax be enacted in addition to any of the taxes we now have. Rather, it should *replace* all current income and payroll tax levies. I support a national retail sales tax because in my opinion, it serves both the government's need to raise revenue to support its legitimate functions, while at the same time, presents the least amount of personal invasion and economic distortion of any other form of taxation.

Most importantly, the national sales tax could eliminate the IRS, and with that, we could eliminate the hassle, anxiety, cost and in some cases, outright tragedy of dealing with an error-prone government agency which literally wields the power of financial life and death over every citizen.

San Clemente, California
June 3, 1995

House of Representatives
Ways and Means Committee
Washington, D.C. 20515

To: Members of the Committee

Your committee will be holding hearings on tax matters in the very near future. I wish to offer this letter as my contribution to your deliberations.

The Federal income tax should be abolished because it is both unfair and incomprehensible. There is no way to "fine tune" this tax to make it equitable and a flat rate tax has many of the same objections in that it would continue to allow the Internal Revenue Service to oversee its administration and collection. The present income tax is unacceptable because:

1. Both payroll and estimated taxes paid quarterly deprive the taxpayer of his right to use his money as he sees fit during the year before taxes are actually due.

2. After income has been taxed the remainder continues to be taxed. Some of these taxes are; Property, sales, gas, utility, etc. etc.

A National Sales Tax would probably be the fairest method of taxation if consideration is first given to the fact that in almost all states a sales tax is already imposed. In California we pay over seven per cent sales tax and are facing an election this month to raise the sales tax an additional one-half per cent in Orange County.

A National Sales Tax should be low and taxpayers should have assurance that once imposed it would not be raised arbitrarily except in cases that are clearly spelled out and cannot be "interpreted" to mean something not originally intended.

May success crown your efforts in a total revision of the onerous tax situation.

Sincerely,

Gloria M. Portner

Gloria M. Portner

129 Avenida San Dimas
San Clemente, CA. 92672

5/31/95

Michael Post
6091 Barbados Ave.
Cypress, Ca. 90630
(714)897-0018

Honorable Bill Archer
Chairman, House Ways & Means Committee
House Of Representatives
Washington D.C.

Dear Sir:

I am writing to urge you to adopt a Flat Tax. I believe a Consumption Tax will too easily lend itself to being hiked in the future (not unlike the sales taxes in many staes, or the gasoline tax), and may have other unintended and undesirable negative effects on our economy. I believe a Flat Tax, paid monthly, or quarterly, by citizens will be the most effective instrument for ensuring an efficient and fiscally responsible government. By overhauling the current horrendous tax system, including eliminating the tax on interest derived from one's savings and investments, and having all of us pay the same tax rate, you would spark a boom in the savings rate, the economy, and the spirit of this nation.

I greatly appreciate your taking my views into consideration as you commence with your desperately needed reform of our current tax system. I also want you to know how much I admire your articulation, leadership and courage in undertaking this Great Work of dismantling the IRS, and enacting a tax that is simple and fair to all, and which encourages the prosperity of the citizens of this country, rather than one which robs us of any hope of prosperity. May God Bless You in this Work!

Sincerely,

Michael Post

P.S.: I would appreciate your circulating a copy of this letter to each of the members of your Tax Sub-Committee. (6 Copies attached.)

Peter W. Powell
3315 Grand Prix Dr.
Sebring, FL 33872

May 25, 1995

Dear Sir,

I am happy to hear that someone in the government wants to hear and will actually listen to want the governed have to say. In reference to taxes, I think like most people who I come into contact with. Taxes give government an excuse to take 60% of my hard earned money and blow it on something anyone with an I.Q. of 75 wouldn't even consider worthwhile.

I am really not interested in any flat tax, I would still be paying more than I should have to pay. With no deductions I would end up paying as much or more than I pay now. The wealthy would still be getting all the break, so would the leisurely poor.

I would like to see a tax that everyone pays the same. It is my belief that the 1% tax that I have heard and read about would be the way to go. If I have to be taxed, why not tax what I spend, not what I make. Everybody would pay the same, there will be no exemptions or exceptions, that is what makes this fair tax system.

It would also raise far more money than the present system does. It has been estimated that at least 400 trillion dollars changes hands in the course of one year. 1% of this amount is almost double or present budget. Under the old system the consumer paid the bulk of all sales tax, but under 1% tax everytime a transaction is made 1% tax is paid. This is the only tax that is not only fair to all, but would raise the money for all those pork projects that Washington is so fond of.

Lastly, it would rid the American people of the I.R.S. Maybe with the I.R.S. out of the way congress would undertake the job they were sent there to do. Like protecting the CONSTITUTION.

Sincerely,

Peter W. Powell

Peter W. Powell

703 Sutter Street
Folsom, CA 95630
June 8, 1995

Chief of Staff
House Ways and Means Committee
1102 Longworth House office Building
Washington DC 20515

Mr. Moseley

Am writing concerning the discussion on the income tax reform hearings conducted by Congressman Archer, and am following instructions given by Mike Reagan from the Mike Reagan talk-show in order to have my views registered before June 22. This includes 6 copies.

Fist I start with the premise that we shouldn't have a federal income tax at all. There are Constitutional questions about that and from what I understand, Congressman Archer would like to repeal the 16th Amendment. I can go for that.

But, since we're going to have an income tax whether we want one or not, I wish to state my views on which one we should have. I like Congressman Armey's plan-a flat tax of around 17% with no federal tax below an income level of 36,000 dollars or something like that. I would make only one revision to that, lower the income limit to 30,000 dollars and the income tax rate to a flat 13%. I haven't run the numbers of course, but I think the government could get plenty of revenue with a 13% flat tax. This due to the multiplication effect once one gets past 10%. The multiplication effect is faster after the first multiple of 10. That's why banks never give interest rates past that number, and charge interest as high as they can on their loans...more money! Simple!

Don't get involved in that consumption tax. I know a lot of people around here like it. Most I've heard on the talk-show-circuit who like it are liberals. I often wondered why. I think I've figured it out. They think a lot of underground money will get taxed that way. And it's the liberal way to want to screw everybody. But it's a plan frought with danger, and it will generate more paperwork than anyone ever thought about, Because they keep argueing that it will have to be fine-tuned. Any time you talk about fine-tuning, something akin to a paper-work

jungle emerges.

Secondly, a lot of people think that will do away with the IRS. Well, the IRS will be with us always, no matter which plan is adopted. But if we can defang the gestapo like tactics of the IRS and put it back into its proper role-that is, simply to be numbers crunchers, then we'll have accomplished sometiing. The flat tax accomplishes that just as well.

Thirdly, I've always maintained that you want to keep the tax system away from the consumption side of the economy and place it on the money made, not on production. You get into a consumption tax and it would very easily fall over into a value-added tax. That's what they have in Europe. That's why it's so expensive to live in Europe. It burdens business by making them tax-collectors for the government more so than they already are, and that would be adrag on the economy. In addition, such a tax would be a small disaster for us on foreign markets. If you think we can't compete globally now, just wait until the consumption tax takes effect.

Lastly, the consumption tax is less equitable on a state-to-state basis. For instance, we out here in California have the highest rated tax system in the country, with a sales tax of 7.5%. Counties add on their %'s and we have an overall average rate of 7.75% sales tax. Add a 16% national sales tax to that and you have 23.5% sales tax plus 11% state income tax, et-al, you get the point. While just to the north, Oregon has no sales tax. There would be massive dislocations in buying patters, probably driving many businesses into bankruptcy.

Addendum: No matter what plan is devised, the federal insurance system must be reformed along with it. I'm including a pay stub from my last check. If you'll notice, I had no federal tax witheld. But over 65 dollars taken out in federal and state insurance programs premiums. That's on one partime check. 77? dollars total. Something's got to be done about that.

Thanks for including my letter

Sincerely

James A Rhodes

James a Rhodes

PAYROLL

EMPLOYEE'S NAME: RHODES, JAMES M/2

SOCIAL SECURITY #: [redacted]

PAY PERIOD ENDING: 5-31-95

OTHER: 94.25 HRS X 5.00

GROSS EARNINGS: $472.50

LESS FED. TAX: 0

SOC. SEC. TAX: 29.30

STATE TAX: 0

DIS INSUR: 4.72

F.I.C.A. 35.91 MEDICARE 6.85

ADVANCE: 0

TOTAL DEDUCTIONS 76.78

NET EARNINGS: 395.72

REMARKS:

EMPLOYEE S SIGNATURE: _____ DATE PAID: _____

Gary and Janette Roulston

June 16, 1995

Honorable Bill Archer, Chairman
Ways & Means Commitee
U.S. House of Representatives
Longworth House Office Building, Room 1102
Washington, D.C. 20515

Dear Representative Archer:

I am writing in regards to the debate to change the tax system of the United States of America.

My name is Gary L. Roulston and my wife and I reside at 7803-B Jefferson Place Blvd., Baton Rouge, LA 70809. I am a 48 year old decorated Vietnam veteran who loves his country and understands the duties and responsibilities of an American citizen.

I acknowledge the need to financially support the operation of my Government, according to Article XVI *"to collect taxes on my income"* so it may carry out its functions according to the Constitution of the United States. We must protect our shores and provide necessary infrastructure for daily functions. But the time has come to say to my government *" STOP! You have exceeded the amounts due you and your actions have now become abusive and oppressive!"*. On April 17, 1995, the Federal Government, by the authority of the present tax laws, demanded 1/3 of my income. Combined with my state and local taxes, our government obligation was 50% of our yearly income. If Thomas Jefferson were alive today, he would swear that King George was again on his throne. Jefferson complained that the King had *"erected a multitude of new offices and sent hither swarms of officers to harass our people and to eat out our substance"*. Similar harassment exists today through the current tax system, a system so complicated that even tax professionals don't understand it.

The amount of taxes that Americans are compelled to pay is outrageous and must be changed! The Bible tells me that I owe God 10% of what we earn to support his bidding. Why does my government demand more of me than Almighty God? I will tell you why. To perpetuate the *"fairness doctrine of the liberal agenda,"* i.e., to support the existance and expansion of the welfare state and to continue its *"liberal blitzkrieg"* of war on the classes. This is a contemptuous attempt to level the playing field as it sees it. It is wrong.

I want to applaud you and the many representatives and senators, regardless of party, that have brought this matter to the forefront. It is long overdue. I feel that for the first time in my life, real fairness in taxation of the citizenry is being seriously discussed. I welcome an opportunity to comment on the consideration of a new tax system and particularly the flat tax.

Of the two types of tax presently being discussed, I feel a flat tax would be preferable to the consumption tax. I especially like the flat tax plan of Representative Armey. My choice is predicated on two things. First, the flat tax is fair and simple. The very poor who make nothing would owe nothing. Working Americans would pay only 17% on what they make over the basic exempt amount. The playing field would *really* be level. Second, the flat tax would not necessitate the repealing of the XVI amendment. If a consumption tax were enacted, I feel a repealment would be necessary to avoid the possibility of a double taxation set in motion by future politicians. I know they would try to find a way to do it. I also believe a consumption tax could require intensive record keeping.

Thank you for your attention to my letter. You may enter this correspondence into the Congressional Record as a letter of support for your action on behalf of me and my family. May God grant our representatives and senators the wisdom of Solomon in addressing this and all matters of the people. God bless America and God bless you.

Sincerely,

Gary Roulston

Gary L. Roulston

7803-B Jefferson Place Blvd. • Baton Rouge, LA 70809 • (504) 925-5366

DAVID SACHS
1155 AVENUE OF THE AMERICAS
NEW YORK, NEW YORK 10036

May 26,1995

Mr. Phillip D. Moseley, Chief of Staff
Committee on Ways and Means
U. S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Mr. Moseley:

In connection with the hearings on tax reform scheduled for June 6 to 8, 1995, I am submitting for the record of the hearings a copy of my article on that subject recently published in Tax Notes (vol. 66, no. 6, Feb. 6, 1995). Brief summaries of my qualifications and my proposals are set forth in the box at the beginning of the article.

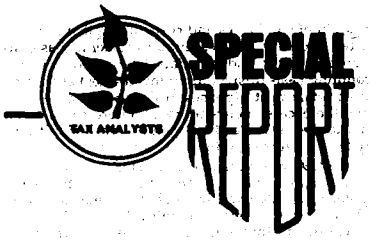
I should point out that my proposals would vastly simplify the collection of income taxes from both individuals and businesses, while relying on concepts most of which are not novel. Most individuals would be freed from having to deal with the IRS at all, and would pay substantially reduced tax rates, the bulk of which, however, could be graduated if desired. Based on data published by the Bureau of Economic Analysis, personal income tax revenues could be maintained at current law levels, even without taking into account the major savings in tax compliance costs for both government and taxpayers. (See example at end of page 867.)

This is the kind of non-gimmicky tax reform that individuals and businesses have been waiting for and voting for, and that they deserve to get.

Sincerely yours,

David Sachs

Encl: 6 copies



VARIATIONS ON A THEME BY DICK ARMEY — A FRAMEWORK FOR REAL TAX SIMPLIFICATION

by David Sachs

I. Introduction

Pleas for simplification of the federal income tax laws have been prevalent for many years, even during times when tax laws were considerably less complex than they are now.[1] The annual massive "reforms" and revisions of the Internal Revenue Code over the past 20 years, interspersed with comparably intricate technical corrections, have resulted in a broad-based recognition, by government officials as well as tax practitioners and educators, of the need for simplification.[2] Nevertheless, tax legislation continues to generate greater complexity almost on an annual basis. Until 1994, serious suggestions for simplification of the income tax focused merely on identifying and improving the most acute problem areas, such as penalties[3] and pensions.[4] Simultaneously, much attention has been addressed to issues such as revision of Subchapter C (governing corporate reorganizations) and integration of corporate and personal income taxation. In both areas, current law, while far from perfect, is relatively well-known and adequate. There is little doubt that any revision of Subchapter C or integration will introduce

[1] *E.g.*, Paul, "Simplification of Federal Tax Laws," 29 *Cornell L. Q.* 285 (1944); Surrey, "Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail," 34 *Law & Contemp. Probs.* 673 (1969); Bittker, "Tax Reform and Tax Simplification," 29 *U. Miami L. Rev.* 1 (1974).

[2] For example, an invitational conference on "Reduction of Income Tax Complexity" ("simplification" was apparently viewed as an oxymoron), sponsored by the Section of Taxation of the ABA and the Tax Division of the AICPA on January 11 and 12, 1990, included as speakers a stellar roster of 38 current and former government officials, economists, tax practitioners, and tax educators and a participating audience of approximately 185 "conferees." *See* AICPA/ABA, *Proceedings of the Invitational Conference on Reduction of Income Tax Complexity* (hereinafter "Proceedings"), II-B-1 through II-B-3, II-C-1 through II-C-12 (1990). No tax law changes resulted from this conference.

[3] Title VII, Subtitle G (sections 7701-7743) of the Omnibus Budget Reconciliation Act of 1989 (Pub. L. No. 101-239) revamped the complex and sometimes conflicting civil penalty provisions.

[4] N.Y. State Bar Ass'n, Special Comm. on Pension Simplification, "A Process Awry: A Call for Simplification and Rationalization of the Federal Pension Laws," 8 *Am. J. Tax Pol'y* 75 (1989).

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greater complexity, at least in the sense of requiring application of many new concepts.

At the risk of oversimplifying the causes of the seemingly inexorable trend toward complexity, it is suggested that this trend is attributable to a convenient synthesis of the pragmatic need for constantly increasing federal revenues with the theoretical doctrine that the purpose of the income tax is to tax "correct" economic income and the corollary notion that "correct" economic income is susceptible of statutory definition if one tries hard enough.[5] As long as these two factors continue to control the structure of the income tax law, complexity will continue to be unavoidable, all good intentions to the contrary notwithstanding. And since there is no realistic possibility that the need for increasing revenue will dissipate, it is the concept that "correct" economic income must be taxed that must be modified to achieve real simplification. It is submitted that the purpose of the income tax today should not be to tax "correct" income, but rather to allocate in a relatively simple and reasonably fair manner part of the costs of government among the persons and entities that the government benefits. If one can accept this proposition, it follows that it should not matter whether all items of income are precisely determined and taxed, provided that the overall tax allocation is reasonable and as simple as practicable, though perhaps not perfect.

II. The Armey Flat Tax Proposal

On June 16, 1994, Rep. Richard Armey, R-Texas, introduced H.R. 4585,[6] the "Freedom and Fairness Restoration Act of 1994." The bill provides for both income tax simplification and severe spending restraints on the federal government.

The tax portion of the bill is indeed simple.[7] For individuals, it provides for taxation *only* of earned income (retaining the current exclusion of foreign earned income) at the rate of 20 percent for the first two years and 17 percent thereafter. There are standard deductions ranging from $12,350 for separate filers to $24,700 for joint returns. Dependents qualify for $5,000 deductions. These deductions are indexed for inflation. Withholding taxes on wages are repealed. Armey visualizes a postcard-sized individual income tax return.

For businesses (regardless of form of organization), there is imposed a tax on the business at the same 20-percent rate, reducing to 17 percent after two years. The tax base is gross income, excluding investment income, less three deductions: business inputs, compensation of employees and costs of tangible personal and real property. Business inputs are defined as costs of goods, services, and materials determined on a cash accounting basis (disregarding inventories) and travel and entertainment expenses. If deductions exceed income, the excess, increased by an interest rate factor equal to the year-end three-month Treasury Bill rate, may be carried over to the succeeding year.

Since 1994 was a major congressional election year, the Armey proposal, put forth by the chair of the House Republican Conference, inevitably became caught up in the intense pre-election political battles. Conservative commentators lauded the flat-tax proposal;[8] Democrats condemned it, referring only to the individual income tax portion. The business tax proposal was virtually ignored, presumably because it was not of relevance to the average voter.

Supporters of the Armey bill contended that it would promote saving, capital investment, and employment. The principal substantive criticisms of the individual income tax portion of the bill were that it would produce too great a reduction in revenue and too much benefit for higher-income individuals, especially the "coupon clippers." Putting partisan considerations aside, there is still some merit in these objections. They are addressed and remedied in the proposals presented below.

The principal vice of the Armey business tax proposal is that it retains, though in a changed format, the current requirement that businesses compute taxable income under a different regime from what they use for normal accounting purposes. It exacerbates this problem by establishing a new set of taxable-income-determining definitions that, no doubt, will lead to years of litigation over their application to the myriad types of business enterprises. These difficulties are also addressed and remedied in the following proposals.

III. Variations on the Armey Theme — Summary

In keeping with the foregoing precepts, it is proposed that the federal income tax be revised (1) to tax corporations and other business interests on their book income, preferably without adjustment, and (2) to tax individuals mainly by a withholding system imposed on the principal classes of income.

These proposals will be discussed in greater detail below. However, it is not the intention of this commentary to provide an all-inclusive plan for complete implementation of the suggested tax structure. Obviously, considerable further study will be necessary, particularly with respect to categories of persons that are now subject to special tax regimes, such as insurance companies, cooperatives, and tax-exempt entities. Procedural provisions will have to be carefully examined

[5]For brief discussions of the impact on tax legislation of the so-called Haig-Simons economists' definition of income, see Hickman, Comment on "The Role of the Treasury Department in Reducing Tax Complexity," Proceedings, I-E-1, I-E-3; McLure, "The Budget Process and Tax Simplification/Complication," *id.* I-A-1, I-A-12 through I-A-13.

[6]103d Cong., 2d Sess. (1994).

[7]The tax portion of the bill occupies only about 6 of its 50 pages; the remaining 44 pages deal with the spending restraints. The latter provisions are outside the scope of this commentary.

[8]In New Jersey the Republican candidate for the Senate, Garabed Haytaian, running against incumbent Frank Lautenberg, included a slightly modified version of the Armey proposal as a major plank in his platform. Haytaian lost the election.

to determine whether there should be additions, deletions, or modifications.

IV. Corporations

A. Significance of Book Income

The book income of corporations (as disclosed by their financial statements) is relied on by government regulators, shareholders, prospective investors, lenders, and other interested persons for virtually all purposes except taxation. Certified financial statements are generally considered adequate to meet the rigorous disclosure requirements of the securities laws. While not all financial statements are certified, they are accepted as valid bases for evaluating corporate performance, although they may not state economic income "correctly." They should also be acceptable as a means of allocating corporate income tax liabilities. For this purpose, book income does not need to be absolutely correct, but only reasonably comparable on a relative basis. In other words, is it not reasonable for a corporation with book income of $10,000,000 to pay five times the tax of one with book income of $2,000,000?

Is it not reasonable for a corporation with book income of $10,000,000 to pay five times the tax of one with book income of $2,000,000?

There is no inherent reason why this format would not be as fair as the current taxing system. For a short while (1987-89), book income (50 percent thereof) was utilized as one of the measures of corporate alternative minimum tax.[9] Criticism of that element of the AMT centered on the additional complexity resulting from the addition of a third alternative basis for taxation[10] and transitional problems.[11] My proposal, of course, does not involve any alternative bases but rather adopts the basic, existing financial records as the corporate tax base. Transitional issues are unlikely to arise because the new system, in not seeking to define "correct" income, can accommodate some short-run duplications or omissions.

B. Evaluation of the Proposal

It is unclear whether the aggregate tax base under the proposed corporate tax system would differ substantially from the current tax base. In 1994, the Internal Revenue Service reported aggregate corporate taxable income of $366.4 billion in 1990, and $350 billion in 1991.[12] For the same two years, the Bureau of Economic Analysis of the Department of Commerce (the BEA) currently reported respective aggregate corporate profits before tax of $304.7 billion[13] and $334.7 billion,[14] before any adjustments could have been made by reference to tax return data. Thus, assuming that the BEA statistics more closely approximate aggregate book income than do the IRS data, deviation of book income from IRS taxable income (-17 percent in 1990 and -4 percent in 1991) does not appear to be sufficient to justify the retention of a separately defined, exceedingly complex system for calculating income only for tax purposes. Probably all that would be needed is a slight adjustment in the tax rate to compensate for any difference in the tax bases and the identical tax revenues could be produced. Since the major corporations report their book income quarterly, the government would have a more accurate and up-to-date basis for projecting corporate tax revenues than it now has.

It might be argued that financial accounting is biased in favor of balance sheet conservatism (that is, minimizing net assets). Even conceding that, it should not have a significant adverse effect on the relative amounts of reported income. More troublesome is the possibility that corporations will intentionally bias their accounting practices to minimize taxable book income. This problem now exists in the computation of taxable income under the Internal Revenue Code, and it will have to be met with similar deterrents, including IRS audits and penalties. To the extent that certified accounting statements are involved, there would be the added element (not now existing) of the independent review by the certifying accountants.[15] Certification could be encouraged by giving certified financial statements the benefit of favorable presumptions, possibly together with penalties (like the current substantial authority and preparer penalties) for taxpayers and accountants who intentionally deviate from generally accepted accounting principles for the purpose of tax avoidance.

It is recognized that there are varying accounting principles that are viewed as generally acceptable, although the range of acceptable principles is being narrowed.[16] This problem of selective use of favorable accounting principles could be largely ameliorated by imposing, from the outset, a mandatory conformity requirement that would preclude any change in prior accounting for any item without IRS approval. The IRS maintains that it currently has this authority,[17] although there is some judicial precedent to the con-

[9] IRC section 56(f) (1986).

[10] Anthony & Dilley, "The Tax Pressure on Financial Reporting," 66 *Taxes* 466, 472 (1988).

[11] Brown, "Corporate Alternative Minimum Tax," 45 *NYU Ann. Inst. on Fed. Tax'n* 7-1, 7-29 (1987).

[12] IRS, Pub. 1136, *SOI Bulletin*, Summer 1994, Fig. 1 at 22 (1994).

[13] U.S. Dep't of Commerce, Bureau of Economic Analysis, *Surv. of Current Bus.*, V. 71, No. 7, Table 1.14 at 7 (July 1991).

[14] U.S. Dep't of Commerce, Bureau of Economic Analysis, *Surv. of Current Bus.*, V. 72, No. 7, Table 1.14 at 54 (July 1992).

[15] IRS data indicate that $347.2 billion (94.8 percent) of the $366.4 billion in taxable income reported in 1990 was earned by corporations with assets of $1,000,000 or more. IRS, Pub. 16, *Statistics of Income*, 1990 Corporation Income Tax Returns, Table 4 at 37 (1993). Such corporations should be able to bear the cost of certified financials.

[16] P. Delaney, J. Adler, B. Epstein and M. Foran, *GAAP, Interpretation and Application* 550 (1989).

[17] *See* Treas. reg. section 1.446-1(e)(2).

trary.[18] In addition, in the case of public corporations, there would be the countervailing incentive favoring the reporting of increased book income (to say nothing of securities law restraints) to offset any tendency to overutilize accounting principles that reduce income.[19]

IRS audit attention would have to be focused on nonpublicly owned corporations, particularly those that have no certified financial statements.

IRS audit attention would have to be focused on nonpublicly owned corporations, particularly those that have no certified financial statements, to confirm that book income is being fairly reported.

C. Application of the Proposal

Under my proposal, corporations that are subject to tax at corporate rates[20] (i.e., C corporations) would be taxable based upon their income as determined for financial accounting purposes. This would simply be their "bottom-line" net income, adjusted only to eliminate the provision for federal income taxes. The financial statement fiscal year would be used as the taxable year.

A number of consequences, mostly self-evident, would follow from this proposal. The income of all consolidated corporations, including foreign subsidiaries, would be taxable. Foreign income taxes would become deductions rather than credits. No other credits would be available. No income would be exempt from tax or subject to special treatment. In other words, dividends from unconsolidated corporations, municipal bond interest[21] and capital gains would be fully taxable. Conversely, deductions would be available for accruable expenses and liabilities, and the much-debated *General Utilities* doctrine that no gain is taxable to a corporation upon distribution of appreciated property to shareholders would be reinstated. There would be no loss (or other) carryovers or carrybacks, though cumulative corrections of current book income, when appropriate under generally accepted accounting principles, would be taken into account. Consideration would have to be given to the treatment of items that are normally dealt with in footnotes to financial statements, though the presumption would favor disregarding them.

Corporate structural changes would be nontaxable when book income is not affected (e.g., where pooling is permitted). Amortization of goodwill and negative goodwill would be taken into account. Dividends would continue not to be deductible, thus preserving the distinction between debt and equity. However, recent financial developments suggest that the tendency toward overleveraging may no longer be a serious threat to the tax base. In any event, the book-income proposal would merely perpetuate and not exacerbate this problem.

Foreign corporations engaged in business in the United States would be taxable on the book income of their United States branch or facility, subject, of course, to any treaty restrictions. The treatment of S corporations would continue as at present, except that book income would be allocated to the individual shareholders.

No doubt the exceedingly varied nature of business corporations would in some instances result in what some would consider improper taxation. However, some aberrations of this sort should be deemed an acceptable price to pay for the substantial simplification involved. It would, of course, be possible to "adjust" book income (such as by the exclusion of municipal bond interest) to take care of perceived improprieties either in favor of or against the taxpayer, and the pressure to do so would be great if the system were adopted. But, once started, such adjustments would quickly become the rule, rather than the exception, and the benefit of utilizing book income would be lost. For this reason adjustments would have to be kept to a minimum, and preferably avoided entirely. The new system should be given a test period of at least three years with no or minimum adjustments.

V. Individuals and Passthrough Entities

A. Application of the Proposal

Individuals who are not engaged in business (other than the performance of personal services)[22] would be subject to withholding taxes at fixed rates (which in some cases could be graduated) on the following categories of income:

(1) Compensation, including pensions and compensatory annuities;

(2) Interest, including original issue discount and the interest element of financial annuities but excluding municipal bond interest;

(3) Dividends;

(4) Rents and royalties;

(5) Alimony; and

(6) Casino and lottery winnings.

Pass-through entities (partnerships, trusts, and estates) *that are not engaged in business* would pass through the net balances of such classes of income after

[18] *E.g., Gimbel Bros. v. United States*, 535 F.2d 14 (Ct. Cl. 1976); *Beacon Publishing Co. v. Commissioner*, 218 F.2d 697 (10th Cir. 1955).

[19] Corporations having assets of $50 million or more, which are likely to be public corporations, reported 84.3 percent of aggregate corporate taxable income in 1990. *See IRS*, Pub. 16, *Statistics of Income, supra* note 15.

[20] IRC section 11 (1986).

[21] The United States Supreme Court has made clear that there is no constitutional impediment to inclusion of municipal bond interest in the tax base. *See South Carolina v. Baker*, 485 U.S. 505, *reh'g denied* 486 U.S. 1062 (1988).

[22] Such individuals constituted approximately 80 percent of individual return filers in 1990 and 1991. *IRS*, Pub. 1304, *Statistics of Income*, 1991 Individual Income Tax Returns, Table A at 2 (1994).

withholding, either by the payer of the income to the pass-through entity or by the entity if, for some reason, the payer has not withheld. The basic concept would be that such pass-through entities would be subject to one level of withholding on the designated classes of income, so it would make no difference whether or not they distributed their income.

As mentioned, withholding on certain categories of income, such as compensation, could be at graduated tax rates. Governmental payments, such as unemployment compensation and Social Security benefits, could be exempted or taxed, as deemed appropriate. Withholding on original issue discount and financial annuities would be applicable to the amounts accruable by the payers as annual deductions for book purposes, whether or not distributed. This would require the payers to make advance payments of the withholding tax in cases where payment of the discount or annuity is deferred, but such advance payment requirement could be taken into account by the payer in establishing the interest rate and other terms of the obligation. Alimony withholding should be designed to pass through proportionately to the recipient the effect of taxes paid on the income of the payer. This could be accomplished by allowing credits on the withholding tax return to be filed by the payer for taxes paid with respect to the portion of the payer's income paid as alimony.

Foreign persons (including corporations) not engaged in business in the United States would likewise be subject to withholding tax on the same categories of income, much as they are under current law and taking treaties into account.

B. Business Income

Individuals, trusts, and estates engaged in business would, in addition to the withholding tax on the designated classes of income, be taxable on a tax return basis and at rates not exceeding corporate rates upon the net book income of the business, including their shares of business income earned through pass-through entities (e.g., partnerships, S corporations). The pass-through entities themselves would continue to be exempt from taxation on business income, but would be required to file information returns reflecting their book income and its allocation among owners, and to withhold on the categories of nonbusiness income subject to withholding if such withholding has not previously occurred. To avoid distortions of normal pass-through-entity business and investment activities, the classes of income subject to withholding (and related expenses) would be excluded from business income of pass-through entities.

Similar treatment would be applicable to foreign individuals and foreign pass-through entities engaged in business in the United States, subject to treaties.

C. General Effect of the Proposal

The effect of these proposals with respect to individuals and pass-through entities would be to eliminate all credits and all deductions not allowable in determining business book income. Capital gain included in business book income would be taxable. Nonbusiness capital gains would not be taxed. Except for possible withholding tax returns, no tax returns would have to be filed by individuals and pass-through entities that have no business income.

Tax rates could, and probably would, differ with respect to the different classes of income, taking into account fairness and revenue requirements.[23] To the extent rates are graduated on a particular category of income, such as compensation, the effect of joint return or head-of-household rates could be provided.

D. Evaluation of the Proposal

The BEA recently published a reconciliation of its estimates of adjusted gross income compared with adjusted gross income reported by the IRS for the years 1990 and 1991.[24] Two significant facts may be gleaned from the BEA study. First, the initial five categories of income designated above for withholding taxation plus business income constituted at least the following percentages of aggregate adjusted gross personal income reported in the study:

	BEA Adj. Gross Income	IRS Adj. Gross Income
1990	95.6%	94.3%
1991	95.8%	94.5%

This indicates that very little income (about 5 percent) would be untaxed under my proposal. Second, the study indicated that there was a noncompliance gap of about 11.6 percent in both 1990 and 1991 between the adjusted gross income reported by the IRS and the reconciled adjusted gross income determined by the BEA. (This gap does not include unreported capital gains or illegal income.) If the gap could be closed by operation of the withholding and book income system, the already small diminution of the personal tax base by my proposal would be more than fully offset.

The following example shows how the proposal might apply to aggregate adjusted gross income, as determined by the BEA for 1991:

Category of Income	Amount of AGI (bill.)	Assumed Tax Rate	Tax (bill.)
Compensation	$2,793.7	12%[25]	$335.2
Bus. income	343.9	15%	51.6
Dividends	128.3	10%	12.8
Rent	28.2	5%	1.4
Interest	229.8	10%	23.0
Pensions and Annuities	241.4	10%	24.1
Total Tax			$448.1

[23]See example, in part V.D., *infra*.

[24]U.S. Dep't of Commerce, Bureau of Economic Analysis, Relationship Between Personal Income and Adjusted Gross Income, 1990-91, *Surv. of Current Bus.*, V. 73, No. 11 at 68-71 (Nov. 1993).

[25]The 12-percent assumed tax rate on compensation is an average rate; lower-income individuals would be taxed at a lesser rate and higher-income individuals at a greater rate.

For purposes of comparison, the reported federal receipts from individual income taxes in 1991 was $448.4 billion.[26] If higher or graduated rates were imposed on business income, other rates could be reduced or tax revenues increased, or both. The foregoing comparison, of course, ignores the very substantial reduction in costs to both taxpayers and the government from the proposed simplification.

E. Withholding From Dividends and Interest

It is recognized that there was an unsuccessful attempt in 1982 to impose a 10-percent withholding tax on dividends and interest.[27] This tax was repealed in 1983 before it came into effect,[28] as a result of an intensive lobbying campaign sponsored by financial institutions that did not wish to undertake the substantial bookkeeping burden (nor, perhaps, to discourage business from customers who may not have been reporting their interest or dividends). However, the publicly stated objection to withholding was the adverse effect withholding would have on the small investors (the "widows and orphans") who would have no ultimate tax liability. Ironically, the repeal was accompanied by elaborate information reporting requirements that were virtually as cumbersome to the financial community and almost as damaging to noncompliance as withholding would have been. Now that the reporting procedure is in place and fully operational, the additional requirement of withholding should not be a significant additional burden to the financial community.

In any event, current data processing systems of both the IRS and private business should be able to cope with the withholding, and should be able to provide an efficiently functioning system for not withholding on persons entitled to exemption by reason of having low income or otherwise. For example, the IRS could adapt its backup withholding procedures[29] to certify exemption claims by taxpayers. As a fail-safe, the IRS could also provide a "quickie" refund procedure for improperly withheld funds.

F. Possible Additional Variations

It would be possible to permit or require the filing of returns to provide for certain objectives deemed to be meritorious, such as the allowance of foreign tax credits (or other credits), the application of graduated tax rates to income other than compensation, or the taxation of classes of income not readily susceptible of withholding. The obvious problem with departures such as these from the basic withholding concept is that, like modifications to business book income, they are likely to proliferate to the point where they would defeat the simplification objective. If such proliferation could be avoided, one or two special exceptions (such as the graduated taxation of interest and dividends) could be accommodated.

[26] IRS, Pub. 1304, *Statistics of Income*, *supra* note 22.

[27] Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, sections 301-308 (repealed 1983).

[28] Interest and Dividend Tax Compliance Act of 1983, Pub. L. No. 98-67, section 102 (1983).

[29] *See* IRC section 3406 (1986).

VI. Conclusions

Some may have the instinctive reaction that the proposals presented above represent too fundamental a change in the system for taxing income. But this is not really the case. The proposals merely expand the application of concepts that, as previously noted, have been adopted by Congress in the past. More importantly, they utilize data and procedures (book income and withholding) that are well-established and readily available with relatively little modification. And most importantly, a change in the system is vital to assure continued effective functioning of the voluntary compliance concept.

Another possible approach for evaluating the proposals, commonly used in connection with proposed tax legislation, would be to calculate whether the evaluator is advantaged or disadvantaged by the contemplated change and to support or oppose it accordingly. It is hoped that this testing procedure will not be applied (though it may result in a majority of approvals). Rather, it is suggested that one should consider whether the business community and the general public would view the new system as a significant improvement over the old and at least as fair, if not more fair.

It is submitted that most people would view with approval the allocation of the business tax burden in the manner proposed.

It is submitted that most people would view with approval the allocation of the business tax burden in the manner proposed. Business people are accustomed to relying on financial statements and should be most pleased to have to produce only one income statement and to analyze only one set of financial data in making management decisions. And the general public would probably view book income as less artificial a measure than taxable income (as currently determined).

As for the exclusive reliance on withholding for nonbusiness taxation, this would make it less feasible to graduate the rates of taxation. But if, as seems likely, an acceptable range of rates could be applied to compensation and other rates could be made low enough, the overall arrangement should meet with public endorsement, particularly since for most taxpayers the very costly (both in time and money) annual April 15 ritual would be eliminated. The de facto exemption of unconventional categories of income should not result in any serious distortions since all the principal types of income would be taxed.

The focus of this discussion has been on the simplification benefits to taxpayers. There would also be considerable benefits to the legislative and executive branches of government, in the elimination of periodic (sometimes annual) marathon sessions for tax "reforms" and the resulting need for ever increasing regulation projects, form changes and taxpayer education. Withholding would also reduce collection costs and collection failures. The audit function would have

to continue in the business return and withholding compliance areas. The judicial branch of the government might also benefit from a reduced number of tax controversies.

The adoption of these proposals would, of course, also require a revision of the functions of the tax practitioner. Those who are not accountants would have to familiarize themselves with accounting principles (as tax accountants have been required to familiarize themselves with legal concepts). However, the inherent complexity and variety of taxpayer activities would, no doubt, continue to generate issues requiring expert assistance. Experience has demonstrated that even seemingly elementary forms of taxation, such as stamp taxes and transfer taxes, raise challenging questions.

The principal benefit to be expected from the instant proposals would be the elimination of many (or most) unnecessary complexities that provide merely a marginal benefit or no benefit at all to the ultimate governmental objective of collecting revenue.

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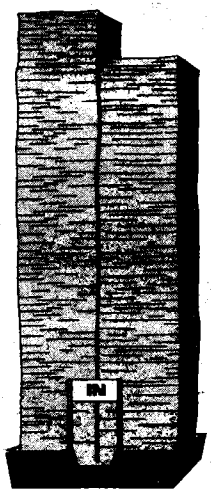

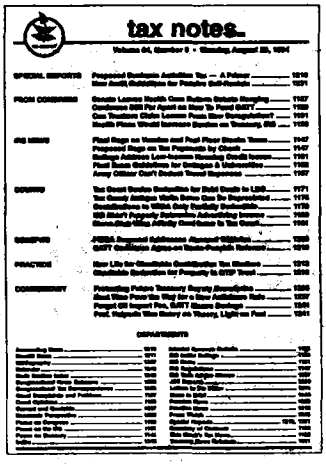

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159-94

Linda Sanders
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May 19, 1995

Phillip Moseley,
Chief of Staff
Committee on Ways and Means
US House of Representatives
1102 Longworth House Office Building
Washington DC 20515

DATES OF HEARINGS: June 6, 7 and 8, 1995
RE: Federal Income Tax - Congressman Bill Archer

STATEMENT FOR A CONSUMPTION TAX

Conclusion: Why ignore the Truth and attempt to placate the American people with a different version of the same illegal tax - as a flat tax would be? Enact a lawful, Constitutional Excise tax (consumption tax) and respect the limitations of the Constitution, which forbids a tax on labor at Article I Section 10. Otherwise, you will still have an underground rebellion and a climate of discontent and non production. Any tax which taxes labor WILL NOT result in a productive economy - as is proven by socialist economies worldwide. Just because "they" do it doesn't mean we should abandon America's way as provided by the Constitution.

It is a fact that the provisions of the Internal Revenue Code are not working. Nothing has been so effective as the "Code" in alienating the American people from their government, tearing down morale and pride in the "American way" and creating hatred for government agencies because of the brutal way the IRS has collected taxes, most often outside the laws that govern collection.

The reason for this does not lay entirely on the fact that the tax imposed began at about 3% in 1913 and crept up to a back breaking 33% as time went on. The main reason that voluntary cooperation has diminished over the years is because many Americans began researching the tax laws, to find out how to deal with taxation that had become so oppressive - and discovered some disturbing facts. While Americans had been led to believe that Congress had 'sold out' the American people with the 16th Amendment, in spite of the fact that the organic Constitution protected against a "capitation" tax, at Article I Section 10 - the opposite was true. The 16th Amendment did not "amend" the organic Constitution by imposing a "capitation" tax on labor - it only amended the taxing provisions granted by the Constitution to the extent that no apportionment was required when taxing "income" which has been defined as "profit and gain" by the Supreme Court. No where did the 16th Amendment impose a tax on labor. This fact is supported by Supreme Court decisions including,

Lucas v Earl, 281 US 111 which states,

> "The claim that salaries, wages and compensation for personal services are to be taxed as an entirety and therefore must be returned by the individual who has performed the services which produced the

> gain is without support either in the language of the Act or in the decisions of the courts construing it.
> ...It is to be noted that by the language of the Act it is not salaries, wages or compensation for personal service that are to be included in gross income. That which is to be included is gains, profits and income DERIVED from salaries, wages or compensation for personal service."

In Connor v US, 303 F. Supp 1187, the court held,

> "[under 61A of the Code] ...If there is not gain there is not income, Congress has taxed income and not compensation...There must be gain before there is "income" within the 16th Amendment."

And finally, that it has been held that the 16th Amendment did not violate the guarantee of Article 1 Section 10, [no capitation taxes] is clearly stated in several Supreme Court decisions,

Stanton v Baltic Mining, 240 US 103, "...the 16th Amendment conferred no new power of taxation...."

Peck & CO. v Lowe, 247 US 165, "[the 16th Amendment]...does not extend the taxing power to new or excepted subjects...".

Brushaber v Union Pacific RR, 240 US 1, "...the Amendment contains nothing repudiating or challenging the ruling in the Pollack case...".

Lastly, the 16th Amendment has no enabling clause, as do the other amendments, because it doesn't need enforcing - it grants no new powers or authority that already didn't exist in the organic Constitution.

Too many Americans, in their indignation that the quality of life in America was rapidly deteriorating by excessive taxation of labor, began studying the law. For many, it became a spiritual quest - for which there is no better motivation for steadfast adherence to a principle.

No power of government, through legislation or brute force, can force a spiritually motivated entity to "comply".

Investigation into Supreme Court decisions - along with investigation into the actual Code and Regulations - revealed that there is no tax on labor for those who prefer to remain outside the jurisdiction of the federal government - which jurisdiction cannot be conferred absent a waiver of the protections of the Constitution - which Americans are refusing to waive. This is proven by the fact that the term "United States" is conspicuously defined in the Tax Code (and the Social Security Act) several different ways - sometimes it includes the "several states" or "the 50 states" and sometimes it doesn't.

FACT 1: Too many Americans have discovered that the Income Tax Code does not extend into the 50 Republics - it could not without violating the Constitution.
While the tax code has been written in such a way that it is confusing, ambiguous and and grammatically obscene - some researchers have finally - after 70 years, deciphered it. This has been accomplished by resorting to the original Acts of Congress published in the Statutes at Large - whereby the mysterious, "anyone liable" is identified.

The IRS has been telling suspicious Americans that they are liable under the code pursuant to Sections 6001, 6011 and 6012. However these sections refer to "every person liable", "any person made liable" and "every individual having gross income....", later restricted to "effectively connected with the "United States". Sections 6001 and 6011 can be dispensed with as not identifying the "one liable" - and therefore having no effect upon anyone, but Section 6012 makes something/someone liable if they have gross income. Gross income is identified in 61 A of the code as being "derived from" everything - including the tooth fairy. Since "income" has been identified as "profit and gain severed from capital" then it does not mean the actual capital. 61A describes many types of sources of capital. As soon as the capital is used to make profit - say on the stock market - the profit is now taxable gross income. This is perfectly fair and Constitutional.
However, the Americans have been pillaged and plundered by the IRS who conveniently ignore the term "derived from" when placing THEIR OWN interpretation on the law. Unfortunately, the courts, which many Americans no longer have respect for, have turned a blind eye to this "custom and practice" to misapply the law as enacted - in complete violation of the organic Constitution, because Americans have waived the protections of the Constitution - unknowingly - by voluntarily signing into the "custom and practice" of tax on labor with W2 Forms and expectation of Social Security benefits.

Americans see their error, perpetrated upon them by ignorance, fraud and temporary crisis, and no longer will participate. [Incidently, the crisis to which I refer could not have occurred if the Federal Reserve board had not been given control over "money" unbacked by gold - but this is an issue that is separate from the issue herein].

FACT 2: Because United States is a "Republic" as guaranteed by the Constitution at Article 4 Section 4, the federal government is limited in their jurisdiction. Indeed, the federal government has very limited powers, pursuant to the Constitution at Article I Section 8. The purpose of a "federal" government was just to provide for foreign relations, self defense, international relations and commerce. Indeed, it's legislative powers were limited to "10 miles square". Somehow, however, this power slowly increased and crept into the 50 Republics - destroying the type of government guaranteed by the Constitution. While there is some confusion over just HOW the government did this - during the Roosevelt era - much suspicion is raised by the fact that the jurisdiction revealed by the type of flag displayed in the courtrooms and in federal buildings is that of admiralty/military/commerce. A simple look into Title 4, Sections 1 and 2 confirms that the national flag of the Republic does NOT provide for the military gold fringe. So why is such flag displayed? [To suggest that the gold fringe is used "indoors" is inconsistent with the fact that many schools and federal agencies use unfringed flags indoors. It is also inconsistent with the fact that Army Regulations 840-10 state that to use a fringed flag in <u>other</u> than a military jurisdiction is disrespectful and a violation of such regulations.]

For this reason, there has been an outcry from the people to their Representatives to reclaim their state's sovereign independent status as a Republic with "10th Amendment" movements. In Colorado, this outcry was met by the passing of HJR 94-1035 - known as the "10th Amendment Bill".

SUMMARY

<u>THE PEOPLE WANT THE "REPUBLIC" BACK AND UNTIL THEY GET IT -THEIR ONLY MEANS OF EXPRESSING DISSATISFACTION IS BY GOING UNDERGROUND" AND INTO THEIR OWN "JURISDICTION" SEPARATE FROM THE FEDERAL GOVERNMENT. TAXES WILL NOT BE PAID VOLUNTARILY WITHOUT THE FEDERAL GOVERNMENT'S ADHERENCE TO THE CONSTITUTION. IT IS A UNIVERSAL LAW THAT THE POWER ALWAYS, ULTIMATELY, REMAINS WITH THE PEOPLE.</u>

The scam is up. And the only way to bring all Americans back into the fold is to return this country to a Republic of 50 sovereign countries, (as the several states are referred to in 28 USC 297) with adherence to the Constitution. It is the Constitution which sets this land apart - from all other lands with their socialist taxes - and Americans will not sit by and watch America become just another unproductive, socialist, welfare state.

A lawful, constitutional consumption tax - rather than a flat tax on labor which will take no time to increase again to impossible burdens - would inspire people to once again, be productive - rather than encourage welfare - and the spending power would increase - fueling a booming economy because the take home pay of every American would increase dramatically. More important, loyalty and respect for the American government would be reborn - which is the foundation to this country's power.

Respectfully, all of the undersigned Americans,

Linda Sanders Littleton, Colorado
Charles M. Meyers Littleton Colorado
Richard Comer, Colo Sp, Colorado Republic
[illegible] Hartley Evans, Colorado Republic
William Campbell Littleton, Colorado
Barry Smith Ft. Collins, Colorado
Bradley Carlson Arvada Colorado
Robert Gibson Englewood Colorado
Steven W. Young Littleton, Colorado
Douglas Sanders Denver
James M Davis Lakewood, Colorado
Barbara Robinson, Arvada, Colorado
Jeffrey Bridges Lakewood, Co.
Kevin Williams, Thornton, Co
Randy Cummins Denver, Co.
Kirk McKuen Colorado Springs Co
Mary Arlington Parker Colorado

Alvin K. Sanford
Mt. Clemens, Mich.
June 12, 1995

Phillip E. Mosely
Chief of Staff, Ways & Means Comm.
1102 Longworth House Off. Bldg.
Washington, D.C. 20515

Dear Mr. Mosely:

I want to be heard on the tax code.

$4½ Trillion debt. Let's not pass it on to our children. 260 million U.S. citizens each share a government debt of $17,837. If we would each pay our share, we will each save $1,386 per year for ever and ever in interest on our national debt alone. In 13 years and 4 months each of us will have saved an equivalent return of all our money. Let's pay it now. We can't wait 7 years to make our first payment on our national debt. In 7 years (2002) our national debt will increase exponentially to $8.4 trillion. Then each U.S. citizen will share $32,300 debt ($64,600 per couple) costing each citizen $2,423.00 per year just for interest on the National Debt. I want to hear all congressional members make our National Debt a political issue and inform all their constituents of a plan beginning immediately to set aside funds in a lock box for this purpose.

Let's all agree to eliminate the debt by these articles:
Article 1. Reduce succeeding appropriations by 10% of current spending, and please no exceptions. Command strict compliance from all administrative departments and agencies.
Article 2. Cut out waste and pork barrel spending. Only spend our money on things we need the government to do for us, like protecting us and our homes and build safe roads for us.
Article 3. No more grants or loans to foreign countries until the budget is balanced and we have a surplus.
Article 4. Each U.S. citizen to be assessed to pay an equitable share of the National Debt.

When all citizens become fully aware of perils facing our economy, I'm sure they will support congressional members who vote for these articles.

I admit my letter may be considered political incorrect, but is factually correct within a 5% margin for error.

I want to hear that Congress is working on a plan to immediately start collecting funds and place in a lock box paying off the National Debt.

Sincerely,
Alvin K. Sanford
Alvin K. Sanford
37255 Charter Oaks Blvd.
Clinton Twp. MI. 48036-2412
Phone (810) 468-9769

6 cys enc.
cy to Michael Reagan

P.S. Republicans balance the budget in 7 years
Democrates say 10 years.
I say do it now (this year)

NASARIO SANTOS
2780 N. PLACITA MIA
TUCSON, AZ 85749

June 13, 1995

Honorable Bill Archer
Chairman: House Ways and Means Committee & Members
1102 Longworth House Office Building
Washington, DC 20515

RE: Federal Income Tax

Honorable Bill Archer:

Concerning Federal Income Tax, I would like to contribute the following opinions and requests to help you in your decisions in this debate. I will strive to make it as concise as possible. First of all, I believe that the primary purpose of the 16th Amendment was to clarify to everyone, once and for all, that Congress always had the power to levy a federal income tax on those employees, as presently defined in Section 3401(C) of the IRS Code, which are:

A - A Corporation.

B - A person who lives in a US Territory.

C - An elected government official.

But, not to include the common US citizen. The fact that the US citizen is exempt from such a tax, is perhaps, why the Supreme Court ruled it un-constitutional. That ruling was back during the US Civil War. The Committees' debate needs to delve into why the common citizen is being forced to pay this Federal Income Tax now.

The crux of the matter is that the common citizen has the sovereign right to the fruit of his labor and the Government nor anyone else has any business inquiring what or how his honest wages were earned, for purposes of taxation. My personal experience with the Internal Revenue Service conflicts with our Constitution and its own regulations. Approximately, about 1984 - 1989, I had my employer: The Kroger Company, 701 Gellhorn, Houston, TX 77001 stop withholding Federal Income Taxes from my wages. I accomplished this legally by submitting a different W-4 with my employer. The W-4 form used was filled out with all the required information. However, the exempt box was checked and my signature was omitted. It is my understanding, that according to the Internal Revenue Service, when I sign a W-4 form, I am voluntarily submitted myself to the Federal Income Tax by becoming an "Employee" as defined in Section 3401(C) - IRS Code. Furthermore, my signature also authorizes my employer to withhold Federal Income Tax from my wages, voluntarily on my part.

My Employer, The Kroger Company, honored by W-4 the way I legally filled it out. Consequently, during those years mentioned, (1984-1989) no Federal Income Tax was withheld from my wages.

It was during that time, I wrote a letter to Representative (Republican) Jack Fields concerning this matter. I questioned him on the legality of my stance. He, in turn, wrote to you, Mr. Chairman, to get your opinion. The response I received was positive. Mr. Fields also wrote a letter to my employer explaining to The Kroger Company that, "The only responsibility they had towards my Federal Income Tax was to honor my W-4 the way I filled it out." The Kroger Company honored my newly filled W-4. Consequently, about 1984-1989, no income tax was withheld from my wages. I needed to do this to be able to support my family financially. Mr. Fields further explained that his office would be available fir I had difficulties with the IRS. For the record, I sincerely thank him for such a generous offer of support.

My "Sweet Taste of Freedom" was short-lived. I, among many others, was laid off from work. When I went with a different employer, my financial state was better, so I volunteered to have Federal Income Taxes withheld, again in 1989. It was not until 1991 that the Internal Revenue Service contacted me. They wanted to collect taxes for those past years of 1984-1989. The tax was $22,000 with interest compounded daily. Now, I am paying monthly a total of $279.00; and the IRS debt is $110,000 with no end in sight!!

Like many other citizens, the IRS has a lien on my property and wages and like so many others, bankruptcy is our only solution. We, and our private debtors, have been greatly wronged by this tax system. I, therefore, request that a National Sales Tax on consumption be considered. This is the only fair Federal Tax that I can see for all. I request that the present income tax system be abolished and amnesty for debts to that system should also be given.

In closing, I request that my letter be included on record in this Historical debate on Federal Income Tax.

Thank you for your time and cooperation. I would like to say that I admire the Constitutional spirit given this Committee and 104th Congress. It rivals the spirit of our Founding Fathers. I pray for God speed and that you give a good fight in this debate.

Constitutionally Yours,

Nasario Santos

NASARIO SANTOS

NS:ph

To: Mr. Phillip Mosely
House Ways and Means

From: Gordon Shearer

Dear Mr. Mosely,

I heard on the radio that I should write to you regarding income taxes and the IRS. After doing quite a bit of research including going through the United States Code, I am in favor of abolishing the IRS, its heavy-handed extortion of good Americans, and the fear that goes with it

For one thing, nowhere do I find in the code (USC) that we are liable to pay income taxes as individuals (non-corporations), although we do pay anyway because we're afraid if we didnt. Also, I think a national sales tax is the way to go - at least it would be lawful and it would certainly be more fair! Even a flat tax would be unlawful and unfair. Please institute the national sales tax!!

Gordon R Shearer
6402 S. Xenon Ct
Littleton CO 80127

STATEMENT OF HAROLD I. APOLINSKY ON BEHALF OF
THE SMALL BUSINESS COUNCIL OF AMERICA

BEFORE THE COMMITTEE ON WAYS AND MEANS

ON ESTATE, GIFT AND GENERATION-SKIPPING TAX REFORM

June 8, 1995

Mr. Chairman and Members of the Committee, I am Harold I. Apolinsky, Past Chair of the Small Business Council of America (SBCA) and currently Vice President - Legislation. I am also a practicing tax attorney (over 30 years) who specializes in estate planning and probate. For over 18 years, I have taught estate planning and estate, gift and generation-skipping taxation as my avocation to law school seniors at both the University of Alabama School of Law in Tuscaloosa, Alabama and the Cumberland School of Law in Birmingham, Alabama. I am here to present our views on estate, gift and generation-skipping taxes.

SBCA is a national nonprofit organization which represents the interests of privately-held and family-owned businesses on federal tax, health care and employee benefit matters. The SBCA, through its members, represents well over 20,000 enterprises in retail, manufacturing and service industries, which enterprises represent or sponsor over two hundred thousand qualified retirement and welfare plans, and employ over 1,500,000 employees.

The time has come for Congress to repeal the estate, gift and generation-skipping taxes.

An estate tax due nine months after death is imposed on the transfer to children or other heirs of the taxable estate of every decedent who is a citizen or resident of the United States ($600,000 of assets are exempt). The graduated estate tax rates begin effectively at 37% and increase to a maximum rate of 55% (see Exhibit "A" for how the tax is calculated). Taxes on bequests to spouses may be deferred until the last-to-die of husband and wife.

A gift tax is levied on taxable gifts (excluding $10,000 per donee per year) as a back-stop to the estate taxes. The graduate rates are the same. (The $600,000 exempt amount may be used during life for gifts or at death.)

An extra, flat 55% generation-skipping tax is imposed on gifts or bequests to grandchildren ($1,000,000 is exempt).

The 1995 White House Conference on Small Business recommended as its 4th priority eliminating estate and gift taxes. Legislation has been introduced in prior years to accomplish this (Exhibit "B" attached).

With a new entrepreneurial voter wave shifting control of both the House and Senate to Republicans, it is time to repeal these transfer taxes. President Clinton has expressed the desire to retain and increase jobs. Repeal would do this!

- Only 30% of family business make it through the second generation. Seventy percent (70%) do not. Only 13% make it through the third generation. Eighty-Seven (87%) do not. The primary cause of the demise of family businesses, after the death of the founder and the founder's spouse, is the 55% estate tax. It is hard for the successful business to afford enough life insurance. (Premiums are not deductible and deplete working capital.)

- A recent study by Prince and Associates (research company) for National Life of Vermont reviewed the history of 749 family businesses which failed within three years after the death of the founder. The Prince study reinforced and supported the conclusion

of the deadly effect of estate taxes. The businesses could not continue as a result of the tax drain on working capital needed to effectively compete and cover errors in judgment made by new and younger management. Jobs were lost in the communities.

- The estate and gift tax took its present form primarily in the early 30's. The express purpose was to "break-up wealth". Is this consistent with a free enterprise economic system and a very competitive world economy? In 1992, the estate, gift and generation-skipping taxes accounted for only 1.1% of revenue. For 1995, the figure is closer to 0.8%. The expenses of administering this system and loss of jobs probably offset 75% or more of the revenue when you factor in IRS, Treasury and costs of litigation.

- Independent analyses reveal that, were these transfer taxes repealed, the Nation's GDP level of employment and capital formations would increase substantially. According to one study, repealing these taxes would increase GDP from 1993 to the year 2000 by over $79 billion, create 228,000 new jobs and increase capital by $639 billion. (Fiscal Associates, Inc. -- Federal Transfer Taxation: A Study in Social Cost).

- The transfer tax provisions represent 82 pages of the Internal Revenue Code and 289 pages of Regulations issued by the Internal Revenue. The transfer tax system forces many estates, the Internal Revenue Service, and the Department of Justice to expend funds in court. The number of transfer tax cases now total 10,247 representing some 13,050 pages of the Commerce Clearing House Tax Publication.

- Australia repealed their estate and gift tax laws in 1977. It was felt that these transfer taxes were an inhibitor on the growth of family businesses. The legislative body of Australia sought more jobs which they believed would come if family businesses grew larger and were not caused to sell, downsize, or liquidate at the death of the founder to pay estate taxes.

- The President has expressed concern about children inheriting appreciated assets from deceased parents and selling them without paying income taxes on the profits. This is the result of the step-up in basis to the value as shown in the estate tax return. If the transfer tax laws were repealed, there would be no step-up in basis. At the time assets were sold, gain would be taxed and funds available to pay the tax. The fair market value of assets sold would be fixed.

- If you factor the significant expense in collecting these taxes, the income tax when assets were sold, and income taxes from jobs saved and provided, the repeal may be revenue neutral or revenue positive.

- Combined income and estate taxes frequently consume 75% or better of retirement plan accounts at death (see chart attached as Exhibit "C").

A very few of our most wealthy citizens have elected to give up their citizenship, become citizens of foreign countries, and avoid the 55% transfer taxes. The cover story of Forbes, November 21, 1994 (attached as Exhibit "D"), was devoted to "Expatriation -- As the Ultimate Estate Planning Technique." What a loss of available capital! These are the people who may give the most to charity and have the resources to seed new businesses.

This should be a wake-up call that this tax is no longer appropriate. We have the highest transfer taxes in the world. Instead of reacting to this by an "exit tax" -- Congress should step back, study the issue, and then repeal these taxes to promote jobs and the growth of family capital.

It is contrary to the best interest of my tax practice, my teaching, and my firm (we have 8 lawyers out of 94 doing estate planning, administration and probate) to urge repeal of these transfer taxes. It is the right thing to do to help grow family businesses and farms. provide jobs and capital and encourage the entrepreneurial spirit needed for small businesses to become large businesses and family businesses of all sizes to survive death.

EXHIBIT "A"

CALCULATION OF ESTATE TAXES

A. Gross Estate (fair market value at death of all assets, including real estate, stock, cash, life insurance, retirement accounts, etc.).

B. Deductions:

1. Debts and expenses.
2. Marital (assets left to spouse if citizen).
3. Charitable.

C. Taxable Estate.

D. Add Prior Taxable Gifts.

E. Total transfer to heirs (life and death).

F. Apply Rates: 18% to 55%.

G. Less credit ($192,800*)

H. Net tax (effective 37% to 55% [plus 5% for larger estates] due 9 months after death.

I. Extra 55% tax for bequests to grandchildren in excess of $1 million.

* This is tax on $600,000 taxable estate.

EXHIBIT "B"

PERTINENT LEGISLATION

A. Legislation was introduced in July 1993 (H.R. 2717) to repeal estate, gift and generation-skipping taxes.

B. Legislation was also introduced but not enacted in the 102nd Congress would have allowed heirs of small business owners to defer the estate tax owed on a farm or business until it was sold outside the family. In order to take advantage of this deferral, the following requirements would have to be met:

(1) The business must be worth less than $50 million.

(2) The business must comprise at least 40 percent of the decedent's estate.

(3) The person inheriting the business must have actively participated in the running of the business prior to the owner's death.

C. A provision in separate legislation also introduced in the 102nd Congress would have reduced the amount exempt from estate and gift taxes from $600,000 to $200,000. This provision of the bill was subsequently withdrawn.

D. Legislation introduced in the 103rd Congress included bills that would increase the estate and gift tax exemption to $770,000 plus cost-of-living adjustments (H.R. 567), $850,000 plus cost-of-living adjustments (H.R. 1475), $1 million (S. 531) and $1.2 million (H.R. 1110).

E. H.R. 784 was introduced on February 1, 1995 to repeal estate, gift and generation-skipping taxes. H.R. 1039 was introduced on February 27, 1995.

F. S. 628 was introduced on March 27, 1995 to repeal estate, gift and generation-skipping taxes.

EXHIBIT "C"

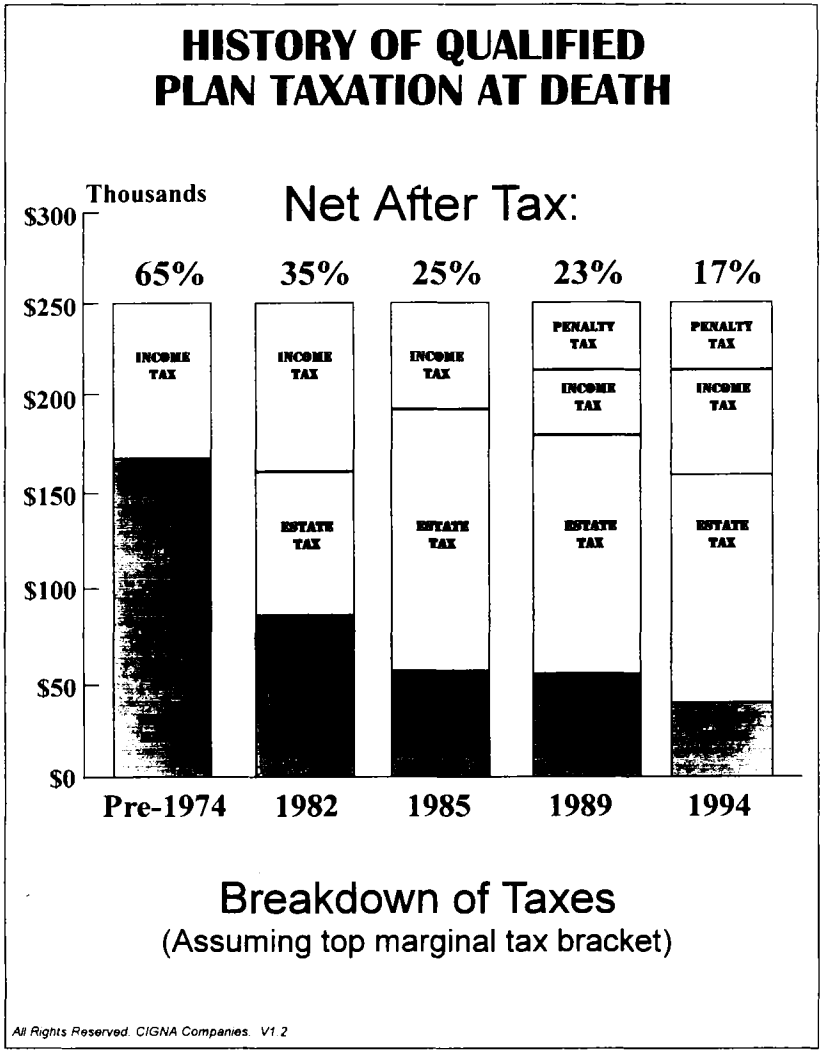

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EXHIBIT "D"

Many Americans are giving up their citizenship. Before condemning them, we might well ask ourselves whether the U.S. tax system isn't killing the goose that lays our golden eggs.

The new refugees

By Robert Lenzner and Philippe Mao

Michael Dingman may easily be able to pay for his new 15,000-square-foot home with the tax money he saved by giving up his American citizenship.

"Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant."

–Judge Learned Hand

"I TALK TO A new client interested in expatriating every week. Many people can't pay the federal tax rate and live in the style they want." So said Francis Mirabello, the head of the personal law department at the Philadelphia office of Morgan, Lewis & Bockius, speaking at a Bermuda conference on offshore money early this fall.

Expatriating? Give up U.S. citizenship? Who in his right mind would give up his U.S. citizenship? Lots of people. You could practically fill a Boeing 747 with well-heeled U.S. citizens who have taken on foreign citizenship rather than submit to what Learned Hand called "enforced exactions" at a level that amounts to virtual confiscation. The exodus may speed up under an Administration that campaigned for office on a tax-the-rich platform.

In 1981 Ronald Reagan lowered taxes. The following year not a single American gave up his citizenship. In 1993 the expatriate community grew by 306 names.

The expatriates of recent years have included:

Michael Dingman, chairman of Abex, and a Ford Motor director. Dingman is now a citizen of the Bahamas and lives there.

Billionaire John (Ippy) Dorrance III, an heir to the Campbell Soup fortune. Dorrance is now a citizen of Ireland and lives there as well as in the Bahamas and Devil's Tower, Wyo.

J. Mark Mobius, one of the most successful emerging market investment managers. Born a U.S. citizen, Mobius has the German citizenship of his ancestors and lives in Hong Kong and Singapore.

Mr. John Spenst
300 Plaza Alicante No. 4180
Garden Grove, CA 92640

300 Plaza Alicante #4180
Garden Grove, CA 92640

June 8, 1995

Mr. Philip Mosely
Chief of Staff, Ways and Means Committee
House of Representatives Office Building #1102
Washington, D.C. 20545

Revising the Tax System

Dear Mr. Mosely:

Please count this as a vote for the Consumption Tax - that is a national Sales Tax.

Of course nobody likes taxes, but some are worse than others. I think it is our objective to enact the tax that has the best hope of bringing in sufficient revenue with the least amount of damage.

Best of all would probably be if we learned to get along on import tariffs as we did from 1778 to 1913 - a short span of 125 years during which we grew from a clutch of freedom-seeking rebels to become a world-class nation. This tremendous spurt of growth was possible because profits were not taxed away, but were re-invested in the economy. However I don't expect to see it happen again, so I will have to vote for the Sales Tax as being the least obnoxious of what is available.

I want to thank you for your radio message. It is nice to know whom to write to. I understood you to say that you wanted responses in six copies, and I am obliging.

Also, I am enclosing an original letter and five copies from a friend, Mrs. Suzan Haxby, who also favors the Consumption Tax.

Please understand that this is not a sudden impulse with me. I have given the matter some serious thought. I am enclosing a photocopy of my letter of March 17 to my Representative, Congressman Robert K. Dornan, where I discuss different forms of taxation at some length. Please feel free to refer to the said letter, or to use in in any way that will help.

Again, thank you for giving me the opportunity to be heard.

Yours very truly,

John Spenst

John Spenst

JS/j

Howard P. Spracklen, P.E.

Electrical Engineering Consultant
21172 Aspen Ave.
Castro Valley, CA 94546
(510) 537-3250

June 8, 1995

Phillip Mosley, Chief of Staff
Committee on Ways and Means
US House of Representatives
1102 Longworth House Office Bldg.
Washington, D.C. 20515

Re: Income tax reforms.

The flat tax proposal would be a great improvement over the present system, however it would do nothing to reduce the huge cost of the IRS bureaucracy and its burden on businesses. (Estimated to be of the order of 500 billion dollars per year)

We feel that complete abolishment of the IRS replaced by a sales (consumption) tax would be a much better solution for the following reasons:

1. It would encourage savings, creating a large domestic capital pool.
2. Most states now have a sales tax system in place. Collection of the federal tax would have a minimal impact on the state systems.
3. It would bring in much more of the underground economy to the system.
4. People would be more aware of government costs and less likely to ask for more government services.
5. It would remove the unconstitutional provisions of the IRS wherein people are now found to be guilty until they can prove innocence.
6. An attempt to reconstruct the IRS would be like pruning a destructive weed. It will only grow back more-destructive than ever.

The argument that the tax would amount to double taxation on savings that have been taxed is valid, however in just a few years the savings in taxes on the interest on these accounts would make up for this loss.

Proposals for a value added tax would add to the complexities of the market place, and would hide the tax from the consumers. It has not worked well in the countries that have tried it.

Thank you for your consideration,

Myrtle T. Spracklen

Howard P. Spracklen

Howard & Myrtle Spracklen

STATEMENT OF CONGRESSMAN PETE STARK BEFORE THE WAYS AND MEANS COMMITTEE
June 8, 1995

A TAX CODE FOR THE FUTURE

Mr. Chairman, Members of the Committee.

This week we are examining major changes in our tax code aimed at replacing the income tax with a consumption tax. The main argument for making such a major change in how we tax is that it will improve the performance of the economy and raise our standard of living. I have my doubts about whether some current proposals will do that. But I do agree that we can improve future living standards with appropriate changes in the tax code. In particular, I urge the Committee to consider ways that we can collect more revenue from taxes on pollution and energy and less from taxes on labor and capital.

I am working on a bill, which I will present later this summer, that would gradually reduce corporate and individual income taxes and gradually increase taxes on pollution, excessive depletion of valuable natural resources, and inefficient production and consumption of energy. Over the longer term, these changes in the tax code would produce a healthier society and a more sustainable economy. In the near term they will shift taxes onto foreign oil producers and help reduce the $50 billion per year we spend on oil imports. In short, they would discourage harmful and wasteful economic activities and encourage beneficial and productive activities.

The goal of my plan is not to increase taxes. Every dollar of increased pollution and energy taxes we collect would be used to reduce income taxes. I would begin by cleaning up the existing tax code and removing current incentives that encourage excessive production and consumption of non-renewable natural resources or that encourage activities that pollute. We certainly should not be using our tax code to encourage such economically inefficient activities. By broadening the tax base we would be able to lower existing tax rates without sacrificing revenue. But my plan would go further and gradually phase in economically efficient pollution and energy taxes. Each dollar raised through these taxes would be used to reduce income taxes.

My plan is fully in the spirit of this week's hearings and it builds on the growing body of evidence that economic incentives can be used to achieve desirable social and economic goals. Many member of the Committee want to reduce or eliminate taxes on capital investment and savings and increase them on consumption. My proposal goes further and asks that we tax consumption of products that are non-renewable and that pollute the environment. We know that using taxes to change the economics of a product can work to achieve desired goals. The tax on CFC almost immediately brought new, non-ozone-layer-destroying chemicals to the marketplace. CFC production is way down, and there are reports that the ozone layer destruction may be moderating. The marketplace economics brought about by the tax increase is solving the problem without the need for a complicated administrative licensing process.

You may say, we've tried this before--and lost! Our experience with the BTU tax in 1993 is one that none of us wants to repeat. But the BTU proposal was a tax increase without offsetting tax reductions. My proposal would be simpler and revenue neutral. For every dollar of pain in higher pollution taxes, there would be a dollar gain in lower income and corporate profits taxes. The proposal would also be

a very gradual transition to avoid shock to any particular sector or region of the country--I am envisioning a twenty year transition. A long transition will give industry and labor plenty of time to move toward energy and anti-pollution efficiency, creating jobs in new products and processes before jobs are lost in energy production sectors.

Realistically, this transition to a more economically efficient and environmentally appropriate tax code would not result in the complete replacement of the income tax. After all, if the energy and pollution taxes work as intended to discourage inefficient and harmful activities the tax base should shrink! Nevertheless, we would have an income tax with a broader base and lower rates--the time honored goal of tax reform. We would also have a cleaner environment, a more sustainable economy, and a higher standard of living.

Although my proposal is revenue neutral and will raise average living standards, there will still be winners and losers and we will need to assist the transition. I would expand the earned income tax credit to offset any adverse impact on low-income families. Also, there will be regions of the country or particular industries--West Virginia comes to mind--that are so dependent on a particular product like coal that a gradually rising tax on it would depress the local economy. I believe that can be addressed by the inclusion of a Local Impact Trust Fund, in which revenues could be returned to localities that bear a heavier than average burden under this system, so that those local governments could also lower their taxes and attract new businesses. The Fund could also be targeted to particular industries to help them finance the move to cleaner, less-polluting production methods.

The Congressional majority is obviously very opposed to regulatory approaches to environmental improvement. The EPA and its command and control approach to improving the environment are under constant criticism. This bill is the answer: use economics--the price of products--to encourage recycling, the use of more efficient production processes, and conservation. When fully implemented, the economics of the tax changes will make the EPA and its regulatory bureaucracy virtually unnecessary. Those who pollute won't be able to compete with those who don't. Efficient, non-polluting cars will rule the marketplace. No one will build a house without the best of insulation. It won't take bureaucrats to make these changes--the economics and the marketplace will do it for us.

Mr. Chairman, the world needs to reduce the emission of pollutants and the destruction of non-renewable natural resources. America is by far the world's disproportionate consumer of energy and natural resources and should lead in this effort. As the century ends, we see how America's population has practically quadrupled from less than 70 million to over 260 million in the past 100 years. The world's population has soared from 1.6 billion to nearly 6 billion in this century. One can cite endless studies arguing whether there is over-population, whether there is a greenhouse effect, whether pollution is really a serious threat, whether we are really running out of various valuable minerals. But simple common sense tells us that we are burdening the environment and that future growth of the human race requires that we think of better ways to prevent pollution and ensure the recycling of precious and increasingly scare natural resources.

There are lots of worthy goals for a tax system. The first is to raise the money to run whatever size government the people want. Another is to ensure fairness in a society. Whether we need a tax code revolution to encourage more exports or to increase investment and productivity are interesting questions, which economists can argue about forever. But if you look at the pressures on the environment in the decades to come, I think the most useful and important change we can make would be to help steer, gradually, our economy to one which can survive in an increasingly fragile environment.

I think this is a change which, if people thought about it, would be widely supported and less controversial than almost any other approach. To repeat, I am currently drafting a model bill to achieve these goals. I would appreciate ideas, comments and concerns from you, the Committee, and the public in the weeks ahead.

Thank you.

JAY STARKMAN, P.C.
CERTIFIED PUBLIC ACCOUNTANT
2531 BRIARCLIFF ROAD
ATLANTA, GEORGIA 30329
404-636-1400 / FAX 636-1130

May 23, 1995

Mr. Phillip D. Moseley
Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Moseley:

Please add the enclosed article and my following comments on flat tax to the record for the hearing on fundamental tax reform.

A truly "flat" tax would raise inadequate revenues. Using exemptions, deductions and credits would accomplish through complexity that which is easier to accomplish through graduated rates. Originally, the income tax was supposed to be flat. It was the arguments of Rep. John Nance Garner which convinced the House to pass a graduated tax in 1913, and it wasn't until World War II that it applied to the masses.

Consider a three-prong approach to flat tax to raise adequate revenues through very low rates, free the vast majority from the annual drudgery and expense of reporting, and minimize disincentive economic effects.

First, institute a VAT at a low rate, as close to 10% as possible. At a low rate, taxation of savings under VAT which were previously subject to income tax would be minimized, and the transition to VAT would be simpler. Joel Slemrod has suggested that VAT could displace the income tax completely because of the structure of the U.S. economy. (See Joel B. Slemrod, "The Simplification Potential of Alternatives to the Income Tax", *Tax Notes*, February 27, 1995, pg. 1331.)

Second, institute a flat income tax with a high income threshold. Say, only those earning over $75,000 gross would be subject to income tax, at a 20% rate. Revenue from an income tax would allow a low VAT rate. The threshold should aim to exempt some 80% of the population from income tax.

Third, repeal the estate and gift tax, or reduce it to a very low 10% - 20% rate. Without an estate tax, repeal of step-up basis becomes viable, without endangering small business. A recent study by The Tax Foundation concluded that income tax rates would have to be nearly doubled to achieve the disincentive effects of the estate and gift tax. (See Patrick Fleenor and J.D. Foster, "An Analysis of the Disincentive Effects of the Estate Tax on Entrepreneurship", Tax Foundation Background Paper

#9, The Tax Foundation, June 1, 1994.) I'd prefer repeal because it's a very inefficient tax, comparing the disincentives and cost of estate tax planning and compliance to the revenues raised.

These changes would significantly reduce compliance costs. IRS could be down sized. Most people would no longer have to keep records and file annual income tax returns. Estate planning would become much simpler. Though consumption taxes are regressive, polls consistently rate sales tax as one of the fairest. Retention of an income tax would retain progressivity.

In all forums on simplifying taxes, the issue of wasteful government spending always arises. A simplified tax is possible, but note that Michigan's VAT is very complex. I have little faith that Congress would keeping it simple for long, or resist the temptation to raise rates or expand the tax base for some spending project.

Sincerely,

Jay Starkman

JS:abm:x
Enclosure

The Atlanta Journal / The Atlanta Constitution ▲▲ Wednesday, April 26, 1995 A15

IS A CONSUMPTION TAX THE ANSWER?

The idea of a flat tax may be simple, but its implementation is more difficult

By Jay Starkman

The Bible tells of taxation in the wilderness. God loved his people and wanted them counted. It was unseemly to count heads. So, Moses collected

a half-shekel from every man and counted the coins. Indeed, God loved his people so much, He had Moses count them three times during the first year after they left Egypt, collecting shekels each time.

This was a head tax. It is the simplest flat tax, unpopular in modern societies because it doesn't consider the ability to pay and raises insufficient revenue.

Every tax has two components: a tax rate and what is taxable. A flat tax means any tax system with only one tax rate and broad base. Most people are upset with the current income tax because rates are too high, the law is too complex and government spending is wasteful.

Progressive tax rates have always been intensely controversial. Proponents say more revenue can be raised when high earners pay tax at steeper rates. Recognizing ability to pay through other means requires deductions and credits which are more complex than progressive rates. If these mechanisms are not used, rates must be set low enough for the poorest taxpayers to afford, which may result in insufficient revenue.

Yet, federal tax revenues have remained constant — 18 percent to 19 percent of the gross domestic product for the past 40 years — whether the top rate was 92 percent or 28 percent. So, the net effect of tax law changes has been to redistribute income, add economic and social incentives or carve out an exception for a particular constituency. Not surprisingly, members of congressional tax-writing committees are among the top recipients of campaign contributions from special interests.

Out of 107 million individual income tax returns filed, only 31 million claim a deduction for home mortgage interest or for charitable contributions. Another 15 million claim an earned income tax credit. Emphasizing family values means tax breaks for having dependents and being married. How many of these should we keep in a "flat" tax?

There are harder questions: when, whether or not and how to tax capital gains, municipal bond interest, life insurance proceeds and gains on home sales. Some business expenses must be deductible, like the cost of goods purchased for resale. How about salaries, factory equipment, interest on business debt and employee health insurance?

In 1986, Congress "flattened" the tax to two rates — 15 percent and 28 percent — down from a top 50 percent rate. Nine years and 4,000 tax code changes later, we have five rates, with a top rate approaching 50 percent again.

It would be easier to create a flat "consumption tax," such as a national sales tax or value added tax, than a flat income tax. The biggest hurdle is avoiding double taxation. Those who paid income tax on their savings may again pay consumption tax when they spend their wealth.

Until this century, high tariffs were the major source of federal taxes. Because we imported most manufactured goods, tariffs worked like some of today's consumption tax proposals. The burden fell disproportionately on the poor because they spent a far higher percentage of their income on the affected goods than did the rich. Income tax was introduced to replace high tariffs and ease tax burdens on the poor.

The annual collection cost of the present income tax is estimated as high as $75 billion. Several less costly alternatives promising lower, simpler taxes have been proposed.

Finding one that is flat, fair and simple is difficult.

Jay Starkman, an Atlanta certified public accountant, is a member of the Tax Executive Committee of the American Institute of Certified Public Accountants. The views expressed are his own.

STATE FARM INSURANCE

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June 8, 1995

PHILIP D. MOSELY, CHIEF OF STAFF
HOUSE WAYS & MEANS COMMITTEE
U.S. HOUSE OF REPRESENTATIVES
HOUSE OFFICE BUILDING
1102 LONGWORTH
WASHINGTON, D.C. 20515

SUBJECT: TAX REFORM

DEAR MR MOSELY,

AS A CITIZEN AND AS A SMALL BUSINESS MAN, I CAN SUM UP MY FEELINGS REGARDING THE TAX SYSTEM IN 1 WORD, ENOUGH. IF I RAN MY HOME & BUSINESS WITH THE CRIMINAL INEFFICIENCIES OF THIS GOVERNMENT, I WOULD BE OUT OF BUSINESS AND/OR IN JAIL. SO MUCH FOR EMOTIONALISM.

THE ONLY SYSTEM OF REASONABLE FAIRNESS IS A SYSTEM BASED ON A NATIONAL TAX ON ALL SALES EXCLUDING, HOUSING, FOOD AND MEDICAL. THIS SYSTEM CAN BE STRUCTURED WITH LIMITED DEDUCTIONS FOR QUALIFIED LOW INCOME FAMILIES. THIS REVISION WOULD REQUIRE THE PASSAGE OF ADDITIONAL LEGISLATION, THE PURPOSE OF WHICH IS TO PROTECT TAXPAYERS FROM THE ARBITRARY WHIMS OF SELF INDULGENT POLITICIANS, WHO ASPIRE TO BUILD BUREAUCRACIES & PERSONAL FORTUNES FROM THE HARD WORK AND OTHERS. THE AMOUNT OF THE TAX SHOULD FALL BETWEEN 12% & 14% OF SALES. BASED ON THE AMOUNT OF FAT IN THE CURRENT QUESTIONABLE BUREAUCRACY, THERE WOULD BE SUFFICIENT MONEY TO FUND THE SYSTEM AND DURING DOWN TURNS, SUFFICIENT INCENTATIVE FOR THE FED TO JOIN THE REAL WORLD AND TIGHTEN GOVERNMENTS BLOATED BELT.

CORDIALLY,

CARL RATKUS

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June 8, 1995

THE HONORABLE PHILIP D MOSLEY
CHIEF OF STAFF
HOUSE WAYS AND MEANS COMMITTEE
US HOUSE OF REPRESENTATIVES
1102 LONGWORTH BUILDING
WASHINGTON, DC 20515

Dear Mr Mosley,

I am writing to you in support of a change in our current Federal tax code practice.

As a small business owner and employer in Spokane, WA., I find the current taxation system difficult to understand, too intrusive, and much too high in the percentages of tax a self employed individual must pay.

An overhaul of the monster that we have created over the last 40-50 years is long overdue and I support a move to the various flat tax proposals that your committee is preparing to review.

President Clinton surely shot himself in the foot for a re-election bid in 1996 by levying the largest taxation increase in U.S. history. Please don't make the same mistake and turn a deaf ear to the American public. We spoke as one voice back in November of 94 and now we look to you to see that the right choices are made.

Small businesses are at the core of the American success story. Isn't it about time that we begin to reward those individuals who embody the entrepenurial spirit that made this country the leader in the economic arena? Or, are we going to continue penalizing those individuals and their families with an archaic and inherently unfair system of taxation?

I hope that you accomplish what you set out to do in this committee session and that the common man is heard both loud and clear.

Sincerely,

Shawn McGuire
Agent - State Farm Insurance

PSYCHOLOGY OFFICES

1550 South 70th Street, Suite 100
Lincoln, Nebraska 68506-1576
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June 13, 1995

Honorable William Archer, Chairman
House Ways and Means Committee
United States House of Representatives
Washington, D.C. 20515

RE: Written Testimony

Dear Chairman Archer:

Attached please find a document which I am submitting as written testimony on the subject of the repeal of the current income tax and its replacement with another tax. I am not sure of the correct procedure for submitting testimony to a Congressional committee so am following the procedure for the Nebraska Legislature, which is to direct the correspondence to the Committee Chairman for distribution to the Members.

I cannot indicate too strongly my support for your efforts and that of the ranking minority member to end the income tax as presently structured and replace it, although I disagree with the specific proposals thus far discussed for replacements. I agree completely with the testimony given by Congressman Cox to the effect that Congress has demonstrated an inability to resist the temptation to abuse the Sixteenth Amendment. The Congress should send to the States, concurrently with the passage of replacement tax legislation, a Constitutional amendment significantly modifying or repealing the Sixteenth Amendment.

Congressman Cox is correct in asserting that the People will not trust the Congress at this point absent a commitment of at least this magnitude by Congress.

There are two ideas which I believe are novel in my views (in addition, of course, to my personal experiences). These are indicated with a ▸ on pages three and four. Much else is probably a modernization of the Federalist Papers, #21, Hamilton, at least in some respects.

Thank you for your consideration of my testimony.

Sincerely,

William R. Stone, Jr., Ph.D.
Clinical Psychologist

cc: Doug Bereuter, Bill Barrett, Jon Christensen

Testimony on Taxation to the House Ways and Means Committee

In 1993, fifty years after my own birth, my grandson was born. While he was born with air conditioning and a mother with a master's degree and other "advantages" of technological and societal progression, and I lived most of my childhood in poverty (we had an outhouse until I was in my teens), I felt sorry for him. I did not, as I had expected I might, envy him but was, instead reminded of the story of The Wolf and the Dog I learned as a child.

There was a hungry wolf who, in the early winter, chanced upon a ranch house with a dog. The hungry wolf was allowed by the dog to share his dinner. The wolf enquired how the dog came by food and was told the people supplied it. The dog further described his life and asked the wolf if he wanted to stay. The wolf initially agreed, but then noted the collar around the dog's neck and enquired about it. The dog assured him it was no problem, that he (the wolf) would have one, too, that it was merely where the chain was fastened. The wolf secured some further clarification and, at that point, decided some prices are too high to pay for security and departed.

The income tax is several links in the chain forged by Congress that binds my grandson. The end purpose of this testimony is to petition you to devise a means to remove these links from this chain.

The initial portion of my testimony indicates my position on the need to reform the tax structure. Second, my analysis of specific types of reform is outlined. Third, I provide a chronology of personal and business experiences with the Internal Revenue Service which provide a significant portion of the basis for my views. Fourth, I provide data on my own taxes for 1972 and 1992 for comparative purposes. My experiences demonstrate clearly why the substantial alteration or repeal of the Sixteenth amendment and a change to another tax structure is desirable.

Need For Reform

At one point the income tax was low and voluntary. As recently as 1967 the Commissioner of the Internal Revenue Service was able to truthfully write, "Ours is essentially a self assessment tax system where the citizen fills out the tax forms and sends in his proper tax. This is what distinguishes the American tax system and makes it a model for the rest of the world." Congruently, as a child the ordinary people around me talked about the need to pay their fair share. This was certainly my own attitude and approach through most of the years that I have been paying taxes. While I still wish to pay my fair share, since about the mid-1980's, however, my attitude towards the income tax has shifted. I no longer view the tax burden as a fair share; my motivation in paying taxes now is primarily my fear of imprisonment. While my own apparently outmoded code of honor is such that I do not cheat on my taxes, I do not find moral fault with the people who do cheat and I would certainly not report them for cheating. There are people who may be enemies of mine whom I suspect of cheating on their income taxes, but no one that I hate badly enough to expose to the IRS.

Taxes are necessary to support the government and each of us should voluntarily pay a fair share. One should not be left feeling, as I from time to time do, that in the difference between armed robbery and taxes is more nominal than actual. In both cases one surrenders money that one has

worked for against one's will upon the threat of force. It has only taken a few years for the Internal Revenue Service to get entirely out of hand and even if it were now returned to something like its original state it would only take a few more years to inevitably end up at this point. Congressman Cox is correct that this is not an acceptable solution.

There was a striking lack of reality contact by the Clinton Administration Treasury Secretary that appeared before your committee. The Clinton Administration as a whole seems to be operating in a world of kindly government where the phrase, "I'm from the Government and I'm here to help you", a phrase that elsewhere in America strikes fear in every heart, is taken as positive. Those of us subject to the Secretary's kindly ministrations are appalled by the entirely un-American way in which the Internal Revenue Service operates. The Secretary talks of tinkering around the fringes of the Code, leaving the income tax basically unaltered. Those subject to it have a uniformly different view.

The income tax is probably a major cause of the bloated and disproportionate size of the Federal government. Part of the reason for the bloating is that the withheld income tax makes paying taxes appear painless at the time of payment, which has enabled Congress to make a seemingly endless number of tax increases without inflicting the level of pain that would lead to a tax revolt. The budget had to get entirely out of hand, as at present, before the revolt came. We must not only eliminate this tax as currently structured but must eliminate the opportunity for this problem to re-occur. To this end, the replacement tax must necessarily be painful on an ongoing basis, providing a stimulus to the citizenry to track the expenditures and expansions of the Government. Clearly any tax reform will work much better if the Senate eventually manages to send the long overdue balanced budget amendment to the States.

Reform Proposals

My thoughts on taxation at all levels always began with the rather common sense view that ordinary individuals, who pay almost all of the taxes, must necessarily pay their taxes from their income; they have no other source. Practically speaking, therefore, all tax is in some sense an income tax and the Federal Tax Code needs to be structured with this fact in view. The notion of "property" tax is functionally absurd; property is not a negotiable instrument and cannot, therefore, be used as a form of payment. Neither is there an invariable relationship between property and income or wealth. Similarly, purchases provide no money to the buyer who pays the tax, but must necessarily come from the profits and/or income of individuals. But for the problem of the inability of Congress to comport itself appropriately, it would be my view that the ideal tax would be a flat tax on the income of individuals (not on corporations). Tax on corporations is nothing more than an indirect tax on the individuals who own stocks and receive dividends from the corporation. Corporate income tax is a double taxation removing a part of the income from shareholders before dividends are paid and taxing the remaining profit when paid as dividends to shareholders.

Income Taxes

The optimal income tax would have a large individual exemption adequate to cover actual

individual living expenses. Individuals should not have to pay taxes out of the money that they need for food, shelter, and medical care for themselves and their families. An individual exemption of at least $7,000 per person would be appropriate at this point in history. Beyond the base level, I would think that all genuine income, from whatever source derived, should be subjected to a flat tax rate.

While fairness dictates that income (above the base) of all individuals be taxed, it violates the basic concept of fairness to somehow argue that individuals with higher income should pay a higher rate. Clearly those with more income should pay higher taxes but this does not imply that the rate should be higher. No other exemptions should be allowed, although clearly there would need to be an adjustment for the inflationary portion of capital gains. After all, it seems clear that the primary source of inflation is a government whose expenditures routinely exceed its income, a government which has made a practice of monetizing debt through inflation.

Again, but for the inability of the Congress to comport itself appropriately, the flat tax of Mr. Armey, with one change, would perhaps be the optimal tax. The one revision would be the elimination of payroll withholding and the requirement of direct payment to the government of taxes by each individual taxpayer. Unfortunately, the proposal made by Congressman Armey leaves intact and unaltered the Internal Revenue Service with its un-American and intrusive characteristics.

▸ Perhaps the Sixteenth Amendment could be amended in a way which require simplicity of the tax code and makes payment of taxes painful. Perhaps the specification that a uniform rate be required and withheld tax eliminated could be written into an Amendment of the Sixteenth Amendment. If such language could be devised then the income tax would probably be preferable to a consumption tax.

Value Added Taxes

The value added taxes being discussed as most desirable because they are relatively painless and provide a broad, hard to evade base are unacceptable precisely because they are relatively painless and hard to evade. One of the things that has to be true in order to keep the taxes under control is that the tax must present an ongoing pain to the people paying it so that the taxpayers do not lose track of what they are paying. It is important that taxes be truly voluntary which is, of course, the case (as Hamilton points out) with a tax that is relatively easy to evade.

While a value added tax would, of course, at present, be much simpler than the current tax, it still provides a high level of paperwork for businesses. The other problem with the value added taxes, as discussed thus far in your hearings, is that they are scarcely likely to provide any improvement, within a few years, over the current morass of Federal laws, rules, and regulations. It might likely be initially a simpler structure, but I expect that the administration representative (while generally an individual out of contact with reality) is probably right that one would end up with just as much bureaucracy using a value added tax. The VAT is subject to the same abuses as the present income tax. Right away one gets into the problem of keeping track of the purchase and sale prices of products at multiple points during their development and execution.

Sales Taxes

Absent a Constitutional Amendment to the Sixteenth Amendment, but with its repeal, I am in favor of a sale's tax, to be collected by the States and forwarded to the Federal government. A Sales Tax would be painful and the fact that a sales tax inflicts ongoing pain is one of the benefits of a sales tax. Further, a Sales Tax would be difficult or impossible to apply to private transactions, making the Sales Tax fairly easily evaded. Easy evasion is also as an asset since this trait again limit the power of the Congress to levy rates of taxes that are incongruent with the rates of taxes that people are willing or can afford to pay. The case for a sales tax is made better than I can make it in the Federalist Papers, #21, Hamilton. The sales tax would allow the repeal of the Sixteenth Amendment and elimination of the IRS, making it immensely attractive to all who value Freedom.

The one drawback of sales taxes is the inherently regressive nature of the sales tax. While flat rates should not offend anyone's sense of fairness, it is wrong to require that people be compelled to pay tax with their grocery money or the money that they need to buy shelter or clothing for their children.

▸ While no solution to the regressive nature of the sales tax is perfect, perhaps a good solution would be for the Federal government to rebate to each citizen the tax on a certain base amount of income, probably at least $7,000 per year at present. This rebate could be given without concern as to whether the person actually had that much income. While one could require that an initial application be made for the rebate, one could perhaps simply generate rebates through the Social Security System. Rebate payments to each holder of a Social Security number could occur on a monthly basis and end at death. This would eliminate much of the regressive character and remove the hardship from individuals who are living month to month. After the first month they would have the money available at the beginning of the month.

The problem of providing rebates to individuals who are employed by the Federal government or are receiving Federal welfare benefits or are otherwise non productive could easily be dealt with by adjusting the rate of payment of such Federal benefits to a lower level to compensate for the rebate.

Personal Experiences

My personal experiences with the Internal Revenue Service (apart from the annual filing of returns based on hundreds of annual hours of record keeping), in their entirety, follow. The entire source of all of my business suffering is based on my professional occupation as a clinical psychologist. I have a small private practice and employ a single secretary and someone part-time to vacuum and clean the office. My expenses are those inherent in operating an office. In addition to my contacts with the Internal Revenue Service I must also, of course, interface with local property taxes, State income tax, State sales taxes, State unemployment taxes, Federal unemployment taxes, and various forms and filings in conjunction with these. Even at the State level the absurdity runs to the depth of having to have a "safety committee" to satisfy recent changes in Workman's Compensation laws. The aggregate of these governmental encounters

which makes the minimization of the government in my life a primary objective. The narrative which follows outlines contacts only with the Internal Revenue Service which has the distinction of being the most egregious entity involved but certainly not the only one.

First Substantive Encounter

Shortly after I went into practice full-time, I hired an employee and it was necessary for me to begin withholding tax. I contacted the Internal Revenue Service as to how this is done and was advised that I needed to use the tax tables and make deposits of the withheld amounts and employer contributions in an approved Federal Reserve bank. Skipping what now looks to me to be an appalling level of ignorance, I scouted around and found an approved Federal Reserve bank and opened an escrow account in it wherein I deposited the money withheld. At the end of the quarter, which was about when I found out what deposited with a Federal Reserve bank means, I filed the required 941 and sent the money in.

At that point the IRS contacted me to advise me of my error and to advise me further that I was going to be subject to a penalty and interest charge. I did not object to this, understanding that I had acted incorrectly, if innocently rather than malignantly as they seem to think. At any rate, I inquired what the penalty would be and was advised that they would be sending me a bill.

The bill did not arrive for a number of years. When it did arrive, it was approximately $125.00, $30.00 or so of it interest. I contacted the Internal Revenue Service by telephone since, in the intervening years, I had forgotten I was expecting something from them. They clarified for me what the bill was for and after reviewing my records I indicated to them what had happened and that I had at the time of the error agreed to pay the penalty but had never received a bill. They checked and verified that I had, in fact, never received a bill. The agent on the telephone gave me a figure (absent the subsequent interest), and indicated I need not pay the subsequent interest, and I sent the money to them. The reason that I had not sooner received a bill, I was told, was that they had forgotten to print a special bill and the computer program did not print automatic bills unless the amount was over $100.00.

A year or two later I again received a bill referencing this tax period for the unpaid interest along with a threatening letter. The amount was now down to about $25.00. I tried to contact the person I had dealt with before who was, of course, gone. I talked to his supervisor who advised me that he had not had the authority to make the agreement that he had made.

By this time, I had, of course, received a final warning notice from the Internal Revenue Service advising me that because of my severely delinquent behavior they were, with that letter, placing the agency in a position to seize (without further warning) all of my assets and freeze all of my accounts to secure the money that I was trying to cheat them out of and/or was allegedly refusing to pay.

At that point I, of course, paid the $25.00 and sent a letter telling them that I would like a receipt and that I thought it was too bad they could not keep their agreements.

I, of course, never received a receipt (the IRS does not do receipts). I did, however, over the next

two years receive (at random intervals) small checks referencing this tax period, which checks eventually exceeded the total amount that I had paid in. There was never any sensible explanation as to why I was getting these little checks.

Second Class of Substantive Encounters

Over the years that I have been in business, I have several times a year received notices from the IRS advising me that I have either overpaid or underpaid something or other by some small amount. I am typically unable to locate where they think the source of error is. At this point I, with terror in my heart, of course, pay any amount that they bill me that is not astronomical without even checking to see what it is.

When they send me a notice that I have overpaid and inquire whether I want a refund or not, I always indicate that I want the refund. This is then followed by a notice from them that the requested refund has been applied to my delinquent taxes and that no check will be forthcoming. I have yet to receive any indication of what the delinquent taxes are that these unexpected windfalls are being applied to. I will note the rate of these mystery notices has declined over the years.

Related Non-Encounter

In the early 1980's I incorporated my practice. The sole reason for this incorporation was to create a better situation tax-wise for managing my profits.

Third Substantive Encounter

A few years ago I received notice from the IRS that I had cheated on my taxes by selecting a lower of two rates as applying to my corporation. There is a lower rate for corporations where less than 95 percent of the activity is professional service, as is the case with my corporation. I contacted the Internal Revenue Service and advised them that I was qualified for the lower rate, that the corporation was engaged in property rental, office management, and other investments as well as providing professional services and that these far exceeded the 5 percent cutoff, and were, rather, more around 50 percent.

They promptly basically accused me of lying, of course, and demanded, in effect, documentation to prove I was not lying. They refused to specify what documentation would be acceptable with reference to the tax code. The tax code and regulations referenced by the IRS revealed, of course, no description of required documentation. I prepared documentation that demonstrated that the corporation took in half of its income from other than professional service sources. They, of course, determined that this was not adequate proof that the five percent of employee <u>time</u> requirement had been breached.

At some point in the discussion, I inquired of them how they had determined that I had deliberately cheated on this matter and/or what reason they had to think I was lying. I grew up, by the way, when a man's honor had some meaning and if I don't watch myself I'm prone to think you shouldn't accuse a man of lying without some pretty good reason, a concept alien to the IRS.

Their whole explanation was that it would be possible for me to lie so therefore they had concluded that I was.

At some point in the dispute I became aware that the regulation I was accused of cheating on had not actually been fully adopted by the Internal Revenue Service but was only a proposed regulation. I contacted my attorney, ignorantly thinking this fact might matter, and was advised that this did not make any difference. I was advised that the Federal courts allow the IRS to enforce draft regulations.

At some later point in the dispute I found out that the regulation I was accused of deliberately evading, violating, and cheating on had in fact not even been drafted at the time that I was filing the income tax return wherein I presumably deliberately lied and cheated. I, of course, contacted my attorney again, foolishly, only to find out that the fact that the regulation had not been drafted was no defense against a charge of deliberately cheating on it.

I secured a Federal Court date, eventually, and shortly before the matter was to go to court, the United States Attorney's office was in contact with my attorney indicating that my documentation was adequate legally and that the case should not have been carried forward and offering to settle. By that time I was out some significant amount in legal fees, of course, and had my attorney inquire as to whether they would pay her legal fees.

The informal feedback she got was that they would never, ever pay legal fees unless ordered to do so in court and, furthermore, if I pursued the matter in court to that end rather than settle then they had a number of other areas about my taxes that they were going to start looking into.

My mother did not raise a total idiot so I, of course, accepted their offer for a settlement with no taxes, penalty, or interest due, and a decree was issued by the court. I was only out the cost of defending myself in this case and a year or so of harassment by the Internal Revenue Service.

Fourth Substantive Encounter

Some years ago I filed my personal State and Federal income tax returns and, as luck would have it, that year received a small refund. The refund I received from the Federal government (not significant in size) I cashed and spent.

A couple of years later, I received a threatening letter from the Internal Revenue Service (any letter from IRS is a threat) advising me that I had not filed an income tax return for the year in question and insisting that it be filed. I, in fact, had filed and promptly sent them a copy of the return with an accompanying letter advising them that I had timely filed the return and had, in fact, received the refund and spent it. I suggested to them that perhaps they had lost some of their computer files and that if they had they might verify that I had filed by looking up the refund check.

I received back a letter with no acknowledgement of the content of my letter but rather advising me that my return (the recently sent copy) was incomplete in that it was not signed and that I could not get a refund unless I signed the return, and demanding that I submit a signed return.

I then made another photocopy of my file copy of the return and signed it and forwarded it to them with yet another letter indicating that while I had signed the copy of the return, I did not wish to receive another refund, that I had already received the refund.

I then received yet another hostile correspondence from them indicating that my return was still incorrect in that the return was not also signed by my wife and again demanding that I submit a return signed by both of us or we would not get the refund. There was again no acknowledgement of the fact that I had indicated having a refund and did not want another one.

At this point in the sequence I contacted Senator Exon, if my memory serves, with the matter indicating that I wanted to know if there was a limit to the number of times the law required the submission of the same return to the Internal Revenue Service and indicating that I could not seem to direct the attention of the IRS to the fact that I did not want a second refund. The feedback that I got from the Senator, as I recall, was to the effect that I had to comply with their demands and he really could not help me avoid receiving a refund unless I could show proof that I had received the refund. There did not seem to be a paper trail, so I submitted yet another return, this one signed by both my wife and I, and in due course received a second refund check.

Related Non-Encounter

At the present time I am, on the advise of my accountant for income tax purposes, now operating a second corporation. Although the matter of percentage of time spent in professional activities was adjudicated in a Federal court decision, my accountants are advising that the IRS practice is to wait a few years after losing such a case and then renewing the original complaint and repeating the inquisition. My accountants are advising me that I should operate the two activities under two separate corporations. This of course causes no small inconvenience for someone who cannot afford a full-time accountant but must, with the help of their secretary, do all of their own tax record keeping. Running books for two corporations is fairly entertaining when you do not have background in business administration but wasted your time studying psychology in graduate school.

Summary of Facts Learned

While these four encounters are the only unusual contacts I have had over quite a number of years, they, in total, occupied my time over a span of many years since a year or more of correspondence with the IRS on any matter is about typical.

During my encounters with the IRS, I have learned the following facts:

A. When challenged by the IRS, for whatever reason or for no reason at all, one is guilty until proven innocent.

B. Unless you pay money to go to court, it is functionally impossible to prove yourself innocent since the people you have to prove yourself innocent to are the same people who have tried and convicted you in some administrative process you did not attend.

C. The IRS, like other agencies, apparently, will admit no mistakes. A refund cannot be refused, for example.

D. One can be guilty of cheating on a rule that is not actually a rule and one can deliberately cheat on a regulation that has not yet been drafted. The no ex post facto law notation in the Constitution does not apply.

E. The IRS can seize all of your assets on a whim or in a non-dispute over $25.00.

F. In general, the Bill of Rights does not apply to IRS.

Stone Income - 1972 vs. 1992

Nineteen seventy-two and nineteen ninety-two were selected for comparison on my subjective feeling of similar effective income. The difference is that in nineteen seventy-two my income supported four people at this subjective level while only two were so supported by the nineteen ninety-two amount. The numbers are my personal (non-business) returns and demonstrate the bloating of Federal income tax, the bloating of State income tax secondary to it, and the need to also reform FICA.

	1972	% Increase	1992	Constant Dollars
Adjusted Gross	17,157	426	73,148	17,157
FIT	2,019	594	11,985	2,813
%	11.8		16.4	
FICA Base	9,000		N/A	
FICA (EMP)	468	1208	5,655	1,327
%	5.2		7.7	
SIT	303	1076	3,259	765
%	1.8		4.5	
Total Tax	2,790	749	20,899	4,905
%	16.3		28.6	
1992 Tax @ 1972 rate			11,123	
Difference			8,976	
Take Home	14,367	364	52,249	12,265

June 7, 1995

To Congress:

Get back to basic Republican form of government — PLEASE!

DON'T TAX LABOR OF AN INDIVIDUAL.

DON'T IMPOSE FLAT TAX ON THE LABOR OF AN INDIVIDUAL!

Go back to excises — collect revenue at the SOURCE!!

Impose a national sales tax if necessary.

Don't raise revenue then determine how to spend it. — RATHER, make a budget, then determine how to raise the revenue.

Richard L. Summer
4052 Chalfe Dr.
Garland, Texas 75043
(214) 278-1916

DALLAS COUNTY PRECINCT 2274

INCOME FROM WAGES

1. I INCUR A LOSS IF I DO NOT GET PAID FOR MY LABOR.

2. I AM COMPENSATED FOR MY LOSS WHEN I AM PAID FOR MY LABOR.

3. MY LABOR IS MY PROPERTY.
   a. "The property which every man has is his own labor, as it is the original foundation of all other property, so it is the most sacred and inviolable. Adam Smith's Wealth of Nations, BK.I, ch.10." Butchers Union Co. v. Cresent City Co., 111 US 746, 757 (1884) (Mr. Justice Fuller concurring).
   b. "Included in the right of personal liberty and the right of private property - partaking of the nature of each - is the right to make contracts for the acquisition of property. Chief among such contracts is that of personal employment, by which labor and other services are exchanged for money or other other forms of property. If this right be struck down or arbitrarily interfered with, there is a substantial impairment of liberty in the long-established constitutional sense. The right is as essential to the laborer as to the capitalist, to the poor as to the rich; for the vast majority of persons have no other honest way to begin to acquire property, save by working for money." Coppage v. Kansas, 35 S.Ct 240, 243 (1915)

4. "EXESS COMPENSATION" FOR LABOR IS INCOME.
   a. "Reasonable compensation for labor or services rendered is not profit." Laureldale v. Matthew, 345 Pa. 239, 47 A 2d 277 (1946)

5. I CANNOT RECEIVE "EXCESS INCOME" FOR MY OWN LABOR.
   a. "'Income' within the meaning of the 16th amendment and the revenue act, means 'gain' ... and in such connection 'gain' means 'profit' ... proceeding from property, severed from capital, however invested or employed, and coming in, received, or drawn by the taxpayer for this separate use, benefit or disposal. 'Income' is not a wage or compensation for any type of labor." Stapler v. United States, 12 F.Supp 737, 739
   b. "Compensation for labor is not income." Oliver v. Halstead, 86 SE 2d 858 (1955).

6. I CAN ONLY RECEIVE "EXCESS INCOME" FOR ANOTHER PERSONS LABOR.

   a. I CAN HIRE ANOTHER PERSON AND EMPLOY HIS LABOR.
   b. THE AMOUNT I AM PAID FOR ANOTHER PERSON'S LABOR THAT EXCEEDS THE AMOUNT THAT I PAY THE OTHER PERSON FOR HIS LABOR IS "EXCESS COMPENSATION."
   c. "Congress has taxed income, not compensation." Conner v. U.S., 303 F.Supp 1187.

Another attachment is being retained in the Committee files.

June 7, 1995

Committee on the Ways and Means
1102 Longworth House Office Building
Washington, DC 20515-6348

Dear Sirs:

It came to my attention recently that you are considering changes to our current methods of taxation. I would like to voice my support of a national sales tax as an alternative to our current use of the Internal Revenue Service.

It is my feeling that our current method of taxation is crippling. If you measure the strides I have made throughout my career by salary increases, I have been penalized rather than promoted thanks to higher taxation. As I strive to provide for myself and my family, my dollars are disappearing before my eyes.

I would much rather see a national sales tax based on the premise that the more you spend the more tax you put back into the system. This method would do away with the Internal Revenue Service and utilize the sales tax collection and payment procedures already in place.

By exempting basic living items from taxation this plan would also be more than fair to lower income families. Food, housing and medical related expenses would not be subject to taxation. Luxury items would be taxed accordingly.

I believe this opportunity to spend the full amount of money earned will encourage spending as well as allowing individuals to relieve mortgage, credit card and other debts. Once debts have been relieved the luxury of putting money into savings will increase, giving banks more money at their disposal for lending purposes. More money to lend would translate into more building and growth.

Sirs, I hope you find a way to make this happen.

Sincerely,

Joan Taramasso

Joan Taramasso

4104 Old Sonoma Road
Napa, CA 94559
707-257-7666

Copy 2 of 6

June 22, 1995

Mr. Phillip Moseley, Chief of Staff
House Ways and Means Committee
1102 Longworth House Office Building
Washington, DC 20515

Dear Sir:

On the Michael Reagan Radio Talk Show (June 8, 1995) I heard that your Committee is inviting citizens to send comments and suggestions on the various tax reform plans. I understood Mike to say that they should be sent in by June 27. However, when I called your office on June 20 to find out more about the procedure Walter (who was very helpful) told me that the target date was June 22!

So I worked night and day June 20-22 to finish this paper: "Qualities of Tax Plans". Hope it gets to you in time. Walter said hand-written copies are OK, so I hope you can read my left-handed, arthritic hand-scrit! If you will give me some extra time, I'll be glad to hire a typist (or word processor specialist, or whatever you call them these days) to get a printed copy.

Enclosed are the six copies that were requested by Walter. He said my report will be reproduced along with suggestions from other citizens. The record of the June 6-8 hearings will also be included. (They were excellent! I heard most on replays by C-SPAN 2.) He said the copies will be available in the late summer and will sell for about $10. Please send me one when ready.

Congratulations to you, your staff, Chairman Bill Archer and other members of the Committee for the excellent job you are doing on comprehensive tax reform. (Just wish you all had been in charge in 1986!) Thanks also for letting us plain but interested citizens participate.

Sincerely yours,

Sam Thompson III
UTEP P.O. Box 68306
El Paso, TX 79968-999

P.S. One of my hobbies is writing political lyrics. Enclosed is my creation of April 28, 1995: "The Ultimate Tax Reform" (to be sung to the tune of "America The Beautiful"). Thought you and the others might enjoy it.

THE ULTIMATE TAX REFORM
(Tune: "America The Beautiful")

1) We're hopeful now the income tax may be repealed at last
For many years the Supreme Court said it should not be passed
Repeal the Sixteenth Amendment, admit that it was wrong
And substitute the retail tax, to make our country strong.

2) An evil tool of socialists to redistribute wealth
The income tax is hazardous to economic health
It punishes successful work, incentives it devours
Discouraging the savings and investments that are ours.

3) When we abolish income tax, we won't need IRS
We'll dump their complex maze of rules and bureaucratic mess
No more invade our privacy, no guilt will be presumed
And end their mean Gestapo raids, such policies are doomed

4) The ultimate of tax reform -- a tax on retail sales
So all you earn you now can keep, no April 15th wails
You're only taxed on what you spend, at one low rate renown
Consumer votes scare Congressmen, that rate they will hold down.

5) Some liberals claim the retail tax will mostly hurt the poor
Until they're told a cash advance will ease the pain for sure.
The underground economy at last will pay their share
By buying goods and services, taxation will be fair.

6) Each local business will retain a portion of the haul
With such incentive to report, they won't hide sales at all
To local and state governments the revenues will flow
Then trickle up to federal -- they'll carefully spend our dough.

7) At last our great economy will back in freedom's glow
The saving and investment boom will help good business grow
We'll waste no time on long tax forms, productive work will rise
We'll have more jobs and higher pay -- the retail tax surprise.

Sam Thompson VII
April 28, 1995

QUALITIES OF TAX PLANS

A preliminary analysis of the current income tax system and seven proposed tax-reform plans based on twelve qualities defined for an ideal plan.

by
Sam Thompson III
UTEP P.O. Box 68306
El Paso, TX 79968-9991

June 22, 1995

Qualities of Tax Plans

Table 1 summarizes the twelve qualities of the ideal tax plan. They are based on my studies as an interested citizen of publications, television (C-SPAN, etc), and radio programs. Table 2 contains my preliminary ratings of qualities of the present income tax and the most prominent of the proposed reform plans. Many of the plans are in their formative stages and I have studied some of them more thoroughly than others. Nevertheless, my preliminary analysis may help to reject the inferior plans, and select and improve the better ones.

1.) Sufficient - An ideal tax plan will raise sufficient revenue to pay for legitimate government expenditures. Much of the current spending by the federal government is wasteful, counterproductive, and in some cases unconstitutional. Thus the level of sufficient revenue (and that part to be raised by taxation) will be significantly lower and cannot be determined accurately until the current budget reform process is completed. (If the ill-conceived "entitlement" programs such as Social Security, Medicare, and Medicaid can be privatized or phased out and replaced by targeted subsidies for the truly needy, the budget total may be brought down to a modest level.)

In the IRS booklet for 1994, the total Federal revenue for fiscal year 1993 was $1,154 billion and the total expenditures were $1,408 billion (deficit of $255 billion). Most reasonable people consider these figures to be astronomically high. About 51% of the revenue was raised by personal and corporate income taxes, excise taxes etc, or about $589 billion. To replace the current tax plan, a reform plan needs to raise revenue on this order of magnitude, or somewhat less if budget reform is successful. However, the static concept that a tax-reform plan must be "revenue neutral", that is raise the same amount as the current system, should be discarded.

Table 1 : Desirable Dozen Qualities of the Ideal Tax Plan

1.) Sufficient - Will raise sufficient revenue to pay for legitimate government expenditures.
2.) Undamaging - Will do minimum damage to the economy.
3.) Encouraging - Will encourage saving and investment
4.) Enforceable - Can be enforced without oppressive government intervention
5.) Simple - Can be paid simply and easily; avoidance is not worth the trouble
6.) Inexpensive - Can be enforced and paid at low cost.
7.) Understandable - Can be understood easily and is so obvious that all tax payers can be aware of the tax base, tax rate, and amount paid.
8.) Fair - Will be perceived as fair by most reasonable people; no escalating ("progressive") tax rates, no loopholes (no exemptions or deductions), no privileges (no credits). (Will help needy with subsidies.)
9.) Quick - Will be passed into law so rapidly, will be implemented so easily, and will be accepted so readily, that the transition time to change from the current system is minimal.
10.) Rigid - Will be so rigidly constructed that there is no room for political manipulation (vote buying, pork barreling, log rolling, etc); no longer use tax code for social engineering, only to raise revenue.
11.) Stable - Will be so well prepared that no other tax reform plan will pass for at least 30 years. (May have minor adjustments of tax rates.) With such long-term stability, individuals and businesses can do more accurate financial planning. (Still have unknown rate of inflation.)
12.) Liberating - Will result in abolition of the Internal Revenue Service and repeal of the 16th Amendment to the U.S. Constitution (which brought us the income tax in 1913).

Note: A unified (Federal, State, and Local) retail sales tax is the most ideal plan.

STIII
95.6.20

Table 2: Preliminary Ratings of Qualities of Current Income Tax and Proposed Reform Plans
5 = Excellent, 4 = Good, 3 = Fair, 2 = Poor, 1 = Lousy, 0 = Awful

	(1) Sufficient	(2) Undamaging	(3) Encouraging	(4) Enforceable	(5) Simple	(6) Inexpensive	(7) Understandable	(8) Fair	(9) Quick	(10) Rigid	(11) Stable	(12) Wheeling	NON-WEIGHTED TOTAL
1.) Current income tax (IRS)	4	2	1	1	0	0	0	0	5	0	0	0	13
2.) Progressive income tax (Kaptenoff)	3	3	1	2	1	1	1	0	2	0	0	0	14
3.) Consumed income tax (Nunn and Domenici)	3	3	3	2	1	1	1	2	4	0	0	0	20
4.) Flat rate tax on wage income (Armey)	3	4	4	3	3	3	3	3	4	3	3	2	38
5.) Flat income tax + VAT (Bradley)	4	2	2	2	2	2	1	1	2	1	1	0	20
6.) Value Added Tax (VAT) on wholesale and Retail Sales (Gibbons, others)	3	4	5	3	4	2	2	3	3	3	3	2	37
7.) National Retail Sales Tax (Nugent, others)	3	4	5	4	5	3	5	4	3	4	4	3	47
8.) Unified Retail Sales Tax (collected locally) (ST III)	3	4	5	5	5	5	5	5	2	5	5	5	54
													(max 60)

Notes: See Table 1 for explanation of qualities
See text for discussion of current income tax and proposed reform plans.
Non weighted total of ratings may not be an accurate appraisal because some qualities are more important than others. However, the relative ranking of ① No 8 - 54, ② No 7 - 47, ③ No. 4 - 38, ④ No. 6 - 37, ⑤ and ⑥ tie between No 3 and No 5 at 20, ⑦ No 2 - 14, and ⑧ No. 1 - 13, appears reasonable.

ST III
95.6.20

The current tax plan and all of the proposed reforms are capable of raising sufficient revenue if their rates are high enough. The current plan is rated as a 4 - Good (out of 5) because it does not raise enough revenue to eliminate the deficit. The reform plans that would continue to tax income (Nos 1-4) are rated 3 - Fair because they propose lower rates. However, as dynamic scoring becomes available they may indeed raise more revenue than the current system.

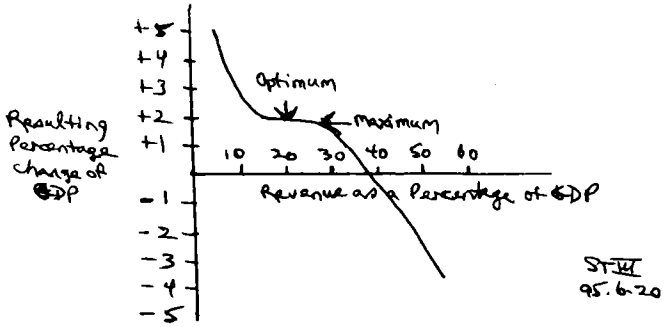
The reform plans that would change the tax base from income to consumption (Nos 6-8) are also tentatively rated 3 because they too aim for low rates. Total retail sales in the U.S. during 1993 are reported to have been 2.1 trillion. A consumption tax rate of 20% would have raised about 420 billion in 1993. To get to the 589 billion of the present system, the rate would have to have been 28%. Although these calculations are only crude approximations, they show that a consumption-based tax is in the ballpark when it comes to raising sufficient revenue. The plan suggested by ex-Governor Jerry Brown (D-CA) to combine a flat income tax and a VAT is rated as a 4 because it may raise as much or more revenue as the present system, but it should be rejected on other grounds.

2.) <u>Undamaging</u>. An ideal tax plan will do minimum damage to the economy. Any amount of revenue taken out of the economy by government will do proportional damage to it.

Combining 1.) and 2.), I submit that the most important goal of tax reform is to choose a plan that will raise sufficient revenue to pay for legitimate government expenditures but also will not do serious damage to the economy. If the economy is seriously damaged, most if not all of the people in the country will suffer.

Figure 1 is offered as a first step in the assessment of economic impacts. It is a preliminary chart showing a plot of total revenue (Federal, State, and Local) as a percentage of real Gross Domestic Product and the resulting change of GDP. A statistical analysis should be made to see what part of a change in GDP is the result of the change in total revenue. Also, the proper time lag should be determined.

Figure 1. Preliminary chart of total revenue (Federal, State, and Local) as a percentage of real Gross Domestic Product and the resulting percentage change of GDP. The maximum is the revenue percentage above which serious damage will be done to the economy. The optimum is the percentage at which the most revenue will be raised while doing the least damage to the economy (inflection point on curve).



The maximum is defined as the revenue percentage above which serious damage is done to the economy. The optimum is defined as the percentage at which the most revenue will be raised while doing the least damage to the economy. Intuitively, I believe that the maximum is around 30% (certainly 50% or above) and the optimum is around 20% (between 10 and 30%).

A select panel of experts, including professionals from both inside and outside of government, should plot such a general curve with appropriate documentation. They may also plot general curves to see if there are significant differences as to whether total revenue is collected from an income or consumption base, or is collected only by the Federal government or by State or Local governments.

Finally, they should plot specific curves for each of the tax reform proposals to see what rates will will result in maximum and optimum revenue percentages and comparison to those of the present system. (The revenue raised by the tax plan may be combined with revenue from other sources to determine the total.) Those proposals which have reasonable tax rates that will raise sufficient revenue at an optimum percentage of GDP may be selected; those which do not may be rejected.

In my preliminary ratings, I show the Flat Tax system as a 2-Poor regarding the quality of underwriting. The tax increase of 1993 is starting to have its effect after the normal two-year time lag. I judge that the Brown plan (No. 5) would not be much better. Those plans that will continue to tax income at escalating ("progressive") rates, No. 2 being proposed by House Minority Leader Richard Gephardt (D-MO) and No. 3 proposed by Senators Sam Nunn (D-GA) and Pete Domenici (R-NM), are rated as 3-Fair because they at least are proposing lower rates. The No. 4 plan submitted by House Majority Leader Richard Armey (R-TX), to tax only wage and pension income at a low flat rate of 17% (and exemptions of $13,100 for a single person, $36,800 for a married couple with two children), is given the best rating of 4-Good. The consumption tax plans, Nos. 6, 7, and 8 would have been rated as 5-excellent except for the fact that they will raise the cost of living for everyone, and even the elimination of income taxes and the integration of subsidiaries

for the ready may not affect the economic impact, so they are optimistically rated as 4-Good.

3.) Encouraging - An ideal tax plan will encourage saving and investment. Investment is the life blood of a growing economy, providing jobs and increasing the standard of living. Thus any improvement in this quality will help to offset any damage done by taxation (Quality No. 2).

In the current system, savings are taxed at a marginal rate up to 39.6% (some "%?"), and capital gains on investments held longer than one year are taxed at 28%. Because the USA has an abysmal savings and investment rate compared to other developed (and some developing) nations, I believe a rating of 1-Lousy is justified. It would be 0-Awful except for the fact that some reduction is given on capital gains taxes.

However, consider my personal situation. As I became a serious investor in mutual funds in the early 1980's, I got used to paying a capital gains tax on investments (outside of IRA's, 403b's, etc) of 14%. After the Tax Reform Act of 1986, my rate doubled to 28%. I consider that rate to be very high. Since then, I have been reluctant to invest in stock funds and have kept most of my nest egg in money market funds. I would guess there are millions of others like me. Thus the elimination of taxes on savings and investments should unleash a torrent of activity, including a significant input from foreigners, that an economic boom probably will result.

Because Gephardt is so committed to escalating ("progressive") rates and redistribution of wealth (and he says he is "not a socialist"!?), I doubt that his plan (No. 2) will give much encouragement to savings and investment, so I have given it also a rating of 1-Lousy. Because Brown has a similar political philosophy, I give his plan a slightly better 2-Poor because he implies a flat rate tax on savings and investments (however, he has spoken of a possible surtax additional rate on the "rich").

The consumed-income tax plan of Nunn and Domenici (No. 3) would subtract the amount put into savings and investment from total income and tax the remainder as a consumption equivalent. Because they keep savings and investment in the tax equation, and thus subject to federal abuse, I give that plan only a rating of 3-Fair. The much better Armey plan (No. 4) takes savings and investments

completely off the table, but the fact that he taxes any income at all allows for a return to taxes on savings and investments in the future, so I rate it as only a 4- Good.

All of the consumption tax plans (Nos. 6, 7, 8) are rated as 5- Excellent because they eliminate taxes on all income and thus greatly encourage savings and investments into the foreseeable future and maybe beyond. Hooray!

4.) Enforceable - An ideal tax plan can be enforced without oppressive government intervention. In fact, an ideal plan should be self-regulating with only a minimum of governmental spot-checking.

For many decades, there have been horror stories of abusive intervention, some armed and violent, by the Internal Revenue Service into businesses and personal lives. Even the initials, IRS, send shudders through all taxpayers. That is why the Chairman of the House Ways and Means Committee, Bill Archer (R-TX), is so determined in his drive to abolish the IRS. If anyone has any hope that the IRS can or will improve, they should read the recent report by Daniel J. Pilla, "Why You Can't Trust The IRS" (Cato Institute, Policy Analysis No. 222), with the timely date of April 15, 1995. Because I have been generally well treated by the IRS, I believe I am entitled to give the current tax system a generous rating of 1- Lousy in this category.

The Gephardt (No. 2) and Nunn-Domenici (No. 3) plans remain so dependent upon the IRS for enforcement I give them a rating of 2- Poor. The same is given to the Brown Plan (No. 5) because he depends on the IRS to collect both the income tax and the VAT. The Armey Plan (No. 4) is relatively simple, so enforcement by the IRS should be less involved; but the work remaining so it is given a 3- Fair. The Value-Added Tax (VAT) on wholesale and retail sales proposed by the Ranking Member of the House Ways and Means Committee, Sam Gibbons (D-FL), (No 6) is also given a 3 because at least two collections on each item of consumer goods or services must go to the IRS.

The National Retail Sales Tax (No.7) proposed by Senator Richard Lugar (R-IN) and others does what it says, but incredibly the payments are sent to the IRS, so I rate it only a 4-Good. For this and other reasons, I am compelled to introduce (hasn't anyone else?) the idea of a Unified Retail Sales Tax (No.8) in which all Federal, State, and Local sales taxes are combined into one rate, are collected by the local business and sent to the Local tax office (City, County, etc.). In my plan, the business would keep a portion of the collection, say 1 or 2%, to cover administrative costs plus a small profit, and may even be given the "float" while earning interest in a bank account before making quarterly payments to the tax office. Thus, each business would have a good incentive to report all sales and collect taxes on them, the system would be practically self regulating, and only rare spot checks would be needed by inspectors from the Local tax office (and they would be the friends and neighbors of the business people). At the Local Tax Office their share of the revenue would be retained and the remainder sent to the State Tax Office, which in turn would retain their share, and the remainder sent to the Federal Tax Office. In this age of computers and wire transfers, the time for the tax money to go from the business to the Federal Tax Office may be measured in nanoseconds. The Federal Tax inspectors may check on the State Offices, and the State Tax inspectors may check on the Local Tax Offices, but the latter would buffer the business people from both of the former. What could be more easily and pleasantly enforceable? So I give my plan a 5-Excellent!

5.) Simple - An ideal tax plan is so simple that the taxes can be paid simply and easily; avoidance is not worth the trouble. Because enforceability and simplicity of complicance are so closely related I give my plan (No 8) a 5 in this category also. I may be too generous in giving a 5 to the National Retail Sales Tax Plan (No.7); a business man who misses a quarterly tax payment to the IRS, has a helicopter land on his roof, and from it come jack-booted thugs who shoot up his storefront with AK-47's, may not think that plan is so simple!

Similarly, the VAT plan (No. 6) cannot be considered so simple if at least two business people, the wholesaler and the retailer, must send payments to the IRS, so it is rated 4. The addition of an income earner sending payments to the IRS further complicates the Brown Plan (No. 5), so it is rated only a 2.

At first glance, the post-card sized reporting form proposed in the Armey Plan (No. 4) appears to be the epitome of simplicity. But the worst feature of it is the that payments must be sent once per month with an annual return to make any adjustments. Sending over 13 postcards to the IRS per year cannot be considered simple and easy, and will drastically increase the potential for problems. The 3 rating could be raised to a 4 with only 1 report per year.

A spin-off from the Armey Plan, called "MC-Flat" by the Congressman (R-IA) who introduced it, is similar except it retains the deductions for mortgages (M) and charitable contributions (C). Such a move is politically popular, but it could wreck the tax-reform process. Restoring such goodies to the tax code would increase the complexity exponentially.

Several of the plans have proposed designating home ownership and other real estate as capital investments. Thus purchases and sales would not be taxed in those plans (at least Nos. 3, 4, 6, 7, and 8). As for charities, won't they be happy to know the contributions they receive are straight from the heart and are not the result of some tax-dodger playing games with the IRS?

The Nunn-Domenici Plan (3) involves so many complexities that it can hardly be called simple, so I rate it a 1-Lousy. The Gephardt Plan, which also will have several tax brackets, is also rated a 1. With over 17,000 pages of laws and regulations (Pilla, 1995, p. 2) the current IRS tax code is generously rated a 0-Awful! That is one reason why Chairman Bill Archer wants to "... tear up the present income tax system by its roots".

6) Inexpensive - An ideal tax plan can be enforced and paid at low cost. Inside the beltway of Washington, D.C., the operating budget of the IRS in 1993 at 7.07 billion doesn't sound like much, but it is an increase of 84% over 1986 (3.84 billion), and is expected to increase to 21 billion by 2002 (Pilla, 1995, p. 23). Incredibly,

the IRS could not account for $4.3 billion, or 64% of its operating budget when the Government Accounting Office tried to audit that agency's budget for 1992 (Pilla, 1995, p. 25). (If any of us taxpayers kept records like that, the IRS would throw us in the Federal Prison at Fort Leavenworth!) Even worse, the cost to all taxpayers, individuals and businesses to comply with the complex IRS code is $600 billion to $1 trillion annually, plus 6 billion hours in work time (Mr. Kurt Hauser, Wall Street Journal, May 14, 1993). All that to collect $800 billion in revenue (William Greer, Wall Street Journal, Feb. 11, 1993). Now is that expensive or what? How about another generous 0-Awful rating in this category for the current tax system.

With that deep attachment to the IRS, I doubt that the Gephardt (No. 2) and Nunn-Domenici (No. 3) plans are much better, so I rate both as a 1-Lousy. The Brown (No. 5) and Gibbons-VAT (No. 6) plans may be slightly better, so they are rated 2. The Armey (No. 3) and Luger (No. 7) plans have less to do with the IRS and the cost of compliance should be reduced, so they are rated as 3 (may be 4). In the Unified Retail Sales Tax Plan (No. 8), the cost of compliance for the consumer is practically zero, the cost to businesses to collect the tax is offset or better with the 1 to 2% fee, and only the expenses of the Local, State and Federal Tax Offices count toward the cost of enforcement. I believe another 5 rating is justified.

7.) Understandable - An ideal tax plan can be understood easily and is so obvious that all taxpayers can be aware of the tax base, tax rate, and amount paid.

The present tax code gets another generous 0-Awful rating, this time because it is not understandable. Each year from 198- to 1991, Money magazine proposed a hypothetical set of data about a typical family and sent it to 50 professionals, asking them to prepare a tax return. They received 50 different answers, none of them correct. Money also discovered that about 60% of the members of House Ways and Means and Senate Finance, the tax-writing committees do not prepare their own tax returns, but have their expert lawyers employed by the committees prepare their returns at taxpayer expense. (Our hero, Bill Archer, is a notable exception.) The IRS answers only about 63% of taxpayer questions correctly (Pilla, 1995, p. 5-7).

Anyone who has ever struggled with an IRS form and booklet more complicated than 1040 EZ should not expect the Gephardt (No. 2), Nunn-Domenici (No. 3), or Brown (No 5) plans to be much more understandable, so I rate them a 1- Lousy.

If a Value-Added Tax (No. 6) is passed, it may be poorly understood when first introduced. Although the tax is levied only on consumption goods and services, it is applied at both the wholesale and retail levels. For some manufactured goods, there may be several levels of taxation. For each level of taxation there would be some administrative cost, so the total price including the VAT may be higher to the consumer than if a single tax were levied at the retail level. In some countries, especially in Europe, the wholesale parts of the VAT are not shown so that much of the tax is hidden from the consumer. To avoid that problem, an American VAT could require that all levels of taxation be printed on the retail receipt, but at a higher cost. The Europeans also exempt some items from their VAT, such as food and medicine; such practice has produced a cumbersome nightmare of misunderstanding. Tax-reform insiders, especially those who favor the VAT, use the new buzz-word "border adjustable" to indicate that the tax may be imposed on imports and rebated on exports with the hope that the balance of international trade may be improved. (They like to point out gleefully that corporate taxes in the Armey plan are not border adjustable.) The VATs adopted by European countries have failed to improve their trade balances (Bruce Bartlett, Wall Street Journal, April 16, 1993). Because all this may not be as understandable, I rate No. 6 as a 2.

The worst thing about the VAT (or any other Federal consumption tax) is that it may be imposed in addition to the income tax, as in Europe. Thank goodness the "Hillary VAT" to finance her radical health-care reform plan never materialized. One of the real dangers of the Brown Plan (No. 5) is that it would introduce double-based Federal taxation on both income and consumption, perhaps starting at low rates but soon mushrooming as the politicians began trading with one then the other. The unwary citizen would have a doubly hard time understanding what is being taxed, what the rates are, and what the total amount of taxes is per year.

The Armey Plan (No. 4) with its relative simplicity should be generally understandable, especially the flat rate and the total tax. However, the tax base may not be so well understood. The plan is to tax individuals and families only on the income from wages, salaries, and pensions (not Social Security). Some may have to be taught carefully that income from savings and investments are not to be included on the postcard to the IRS (who may not give it back!). On the other hand, the more astute may understand the Armey Plan too well and begin taking their active salary in stock and changing their pensions into IRA's etc. That would help economic growth but could play hell with expected Federal revenues. I rate this plan a 3 in this category.

The National Retail Sales Tax by Lugar and others (No. 7) is more understandable and is top rated as a 5. On each receipt of a retail sale the rate and the amount of the Federal tax should be shown. The customer should clearly understand that the tax base is consumption. He or she may not understand the problems the store owner may have with reporting directly to the IRS.

The Unified Retail Sales Tax (No. 8) is equally understandable and is also rated as a 5. As with the National one, I expect the Federal tax rate to be shown on the receipt and to be the same across the nation. However I would hope and expect that each State and/or Locality would try to set a lower tax rate than its neighbor, which would help keep those rates down by competition. The different rates and amounts should be shown on the receipt. In many States, a combined State and Local sales tax is already in effect, thus the addition of the Federal would only add one more line to the receipt. The same is true with the National Plan. Thus the main difference in the two is that in the Unified Plan, the tax is sent to the Local Tax Office instead of the IRS. The customer may be very pleased when he or she understands that the tax money first goes to the tax office in the community.

Dick Armey's objection to a Federal sales tax is that he doesn't like the idea of forcing business people to be tax collectors for the Federal government. In those areas where there is no sales tax at the present time, the sudden introduction of a

Federal sales tax would be quite a shock. However, my proposal for a 1 or 2% portion of the total tax collection to be given to the business people, as well as the possibility of getting the "float" on the interest, should ease the pain considerably. For the many who are already used to a State and or local sales tax, there should be no problem.

8) Fair - An ideal tax plan will be perceived as fair by most reasonable people. There should be no escalating ("progressive") tax rates, no loopholes (no exemptions or deductions), and no privileges (no credits). The needy may be helped with subsidies on the spending side, but should not be used as an excuse to complicate and politicize the tax code on the revenue side.

For many decades, the liberal concept of fairness has gone practically unchallenged. It asserts that the "rich" (rarely defined) should pay escalating, "progressive" (toward what? - socialism?) rates on their taxes because they can afford it, because they don't need the money, because they didn't really earn it, because they are greedy (politics of envy), because they are too successful and need to be punished (zero sum fallacy), and probably some other "reasons" we haven't heard yet.

Many liberals are also extreme egalitarians. So why don't they insist that everyone pay the same amount in a per-capita tax? Don't they believe that everyone's life and liberty are worth the same and should be protected by government for an equal charge? Won't they at least compromise and agree that everyone pay the same rate in a flat tax (on income only)? Gephardt, Brown and others have said they are proposing a "flat tax" at one low rate for most people and then a higher rate or surcharge for the "rich"! Isn't that deceitful, trying to capitalize on the buzz word "flat tax" and then sneak in a "progressive" one?

After "soaking the rich", the liberal's next step in the "fairness" process is to take the tax dollar

and spread them among their bureaucratic buddies in the Federal government. Finally, they distribute the remainder to the "poor" (also rarely defined), which include welfare addicts (several generations on the dole), substance abusers (alcoholics and drug addicts), homeless (many are wandering schizophrenics turned out of mental hospitals), fatherless families (teenage mothers with several illegitimate children), etc., and some truly needy people. For many years, estimates indicate that out of each tax dollar designated for welfare, about 80 cents goes to the Federal bureaucratic overhead and only about 20 cents reaches the "poor" (so this "trickle down" economics?) And yet liberals scream the loudest when conservatives propose that Federal welfare programs be devolved back to the State governments where they can do a better job at less cost.

In regard to the tax code, the liberal concept of fairness demands that the "poor" be exempted from paying any taxes and that low income workers be given a tax credit. In recent years, they have promised (but not yet delivered) tax cuts for the "middle class" (whoever they are).

Even the social conservatives get into the act. They request tax deductions for families with children, home mortgage interest payments, charitable contributions, etc. Even a firm economic conservative like Jack Kemp proposes "enterprise zones" to encourage development within the devastated inner-city areas by giving tax breaks to businesses who locate there.

If we are ever to arrive at the ultimate tax reform -- abolition of the current income tax code, repeal of the 16th Amendment, dismantling of the IRS, and establishment of a simple Federal retail sales tax, we need to convince at least a majority of reasonable people that the strict economic conservative view

of fairness is correct. In most basic terms, to be fair to everyone in the country, the only purpose of the Federal tax code should be to raise revenue for legitimate government expenditures. Thus the code should be strictly an economic document, not a political or social one. Because a growing economy benefits everyone, only the minimum amount of necessary revenue should be extracted, because any amount of revenue taken from the economy will do damage to it. Also, to be completely fair, everyone should pay the same tax rate and no consumption items should be exempted (such as food or medicine.) A logical definition of fairness does not allow punishment of good, hard working, productive people to give benefits to anyone, much less to lazy parasites. Those who truly need and deserve financial assistance may be given subsidies from the Federal spending budget, but the strict economic conservative view is that such help is best provided through State or Local government agencies or private charities.

The current tax code, even after the valiant reform effort of 1986, is so unfair to so many people that we at last have a majority of reasonable people who are convinced it should be thrown out and replaced with something much better. It is so broken it cannot be fixed. Some stop-gap measures may be needed if we have a severe economic downturn, but complete replacement should be delayed until we have thought through the tax-reform process. Does anyone disagree with my rating of 0 - Awful fairness for the current code?

If we can convince an intelligent liberal like Dick Gephardt that his plan (No. 2) with its escalating, "progressive" tax rates is inherently unfair, we will make a great leap forward in the tax-reform process. One of the best arguments on this point I have heard was given by Representative John Ensign (R-NV) during the hearings on "Alternatives to the Federal Income Tax" held by the House Ways and Means Committee (June 8, 1995,

rebroadcast on C-SPAN 2). In a one-on-one debate with Gephardt about his plan, Kemp asked if it is fair to tax Farmer A at a higher rate if he worked hard 7 days a week to make $100,000 in a year, and to tax Farmer B at a lower rate if he goofed off and worked only one day a week to make $10,000 in a year. Gephardt had no direct answer to that excellent question. Yet he and other liberals could become real statesmen if they would admit that their long-held advocacy of escalating tax rates is wrong and unfair, and that for the good of the country they now favor one low flat tax rate. In the meantime I must give the Gephardt plan a 0 rating in fairness.

Senators Nunn and Domenici also continue the unfair practice of escalating rates in their plan (No 3). However, they make a giant step forward in their attempt to eliminate taxation on savings and investment. I do not approve of their method because it keeps income from savings and investment in the tax formula. Nevertheless the fact that these prominent moderate conservatives have reached this milestone is an indication that we only have to convince the liberals that taxing what they term as "unearned" income on savings and investments is wrong and unfair. Hopefully they will soon realize that capital investment is needed to keep an economy growing, which in turn creates new jobs and increased standards of living, and that taxing capital or the gains from investment will slow or reverse this process. Regretably I must give the Nunn-Domenici plan a 2 rating.

If the Armey Plan (No 4) were to pass in its present form, it would be a major achievement in tax reform from the fairness and other standpoints. It would prove that we have reached the goals of eliminating escalating tax rates and replacing them with one low flat rate, eliminating taxes on savings and investments, and eliminating many deductions, credits, etc. One problem I have with his plan: he gives exemptions of $13,100 to single people, of $36,800 to married couples with two children, etc. Thus he will enlarge the class of non-taxpaying voters who naturally will use their increasing political clout to support elected officials who promise to maintain their status or increase their level of exemptions and their numbers in a never ending assault on the tax base, with increasing unfairness to the remaining taxpayers. I

fully realize that such large exemptions produce a "progressivity" such that those with higher rates will pay higher effective rates. That point alone may garner enough votes for passage from liberals who remain convinced that the only fair tax is one that taxes the "rich" at ever higher rates. The large exemptions also are a concession to social conservatives who want tax incentives for families, etc.; however, instead of a continuing set of headaches as each deduction is passed, they get only one large exemption in a lump sum. I do doubt they will vote in favor of the initial plan, but they will continue to tinker around the edges. Is it fair to give a big deduction to a handsome hunk who got a homely rich girl pregnant, had a shotgun wedding, and wound up in a cushy vice-president job in her father's office, and not give one to a hard working, ugly guy who cannot get a date much less get a girl to marry him? (I call that "facial discrimination"). Armey proposes a tax rate of 17%, which is reasonable. However, because it is an income-based tax, I would expect the liberal-conservative tug of war to raise or lower the rate to continue indefinitely. Also I see an ongoing battle to add escalating rates and to reinstate a tax on savings and investments. With those problems, I can give the Armey Plan only a 3 rating.

The Brown Plan (No. 5) is rated a 1 because it is slightly fairer than the current tax code, but unfairly hits the public with a double-based tax on both income and consumption. Instead of answering the important question as to whether income or consumption should be taxed on the Federal level, Brown takes the chicken way out and proposes to tax both. One of the greatest fears in the current tax reform debate is that a VAT will be introduced at a low rate in addition to the income tax, and that rather will be eliminated in spite of promises to the contrary. The Brown Plan starts out both with relatively low rates, but the risk is high that one or both will be raised routinely and unfairly.

If the Value-Added Tax Plan (No. 6) passes, and the income tax is eliminated, a great victory in the battle of income vs consumption taxes will have been won. If the income tax with all its inherent problems can be buried forever the focus of the debate can shift to which is better, the VAT or a retail sales tax. A VAT may be designed that could be reasonably fair to all concerned. However, if some European tricks are introduced, the total tax may be hidden from the customer, some items may be exempted (food, medicine, etc) which would be unfair to producers of other goods or services, and a bookkeeping nightmare

may hit the wholesalers and retailers. If the total cost to the consumer would be the same with either the VAT or retail tax, both may appear to be fair. However I expect that the costs to the wholesalers of paying their part of the VAT may be significant, especially if they have to tangle with the IRS or a Federal VAT office, so they would logically add those costs to their prices. Thus the customer would pay a higher price under the VAT plan. Even if the price and the tax would be the same, why not save the wholesaler the grief of calculating, recording, and transmitting their taxes (to the IRS), and have only one tax at the retail level. Because of the potential problems with the VAT I rate it a 3.

If the National Retail Sales Tax Plan (No. 7) passes (and the income tax is eliminated) it would mean that the VAT lost in the consumption tax debate. The customer should be better off than with the VAT. However, the retail business may be unfairly impacted by the entire weight of the new tax. Adding a Federal sales tax of say 20% to a state/local tax of 5 to 15% may scare away a lot of potential customers, at least initially. One suggestion under this type of plan is to hand a cash advance of $5,000 to every low income person in the country. That may be fine to recipients in small towns, but it would be grossly unfair to those in big cities where the cost of living is higher. Moreover, it would be unfair to the high income people, and the line between low and high cannot be drawn fairly on the national (or even the local) level. Another suggestion under this plan is to exempt some necessities from the sales tax, such as food, medicine, rent etc. Not only would that be unfair to producers of other goods and services, but also the tax dodgers would have a field day re-classifying to all brandy as "medicinal", etc. Some who advocate this plan indicate that the taxes would be sent from the retail businesses to the IRS. The number of IRS agents (probably in the form of secret police) spying on businesses may be much less than with the VAT, but there still would be too many prowling the country, and even a small number would put an unfair burden on the retailers. Even with these problems, I rate this plan as a 4.

Finally, we come to the fairest of them all, the Unified Retail Sales Tax Plan (No. 8), rated as a 5. If it passes, the income tax, the I.R.S., the 16th Amendment, the VAT, and many other taxes would be eliminated.

All consumer goods and services, with no exceptions, would be taxed at a uniform Federal rate throughout the country. All consumers would pay that tax, along with the State and local tax with no exceptions. However, two serious problems remain -- the heavy economic impact on retailers and the crushing blow to low income people who may no longer be able to afford bare necessities without economic assistance.

The degree of the impact on retailers will depend on the general economic condition at the time the tax is implemented. If budget reform is successful and Federal spending is reduced down to a reasonable level, the needed revenue would not be so great. Also, and probably closely related, the dual success of both budget and tax reform may allow the GDP to rise a major amount. Thus instead of 20%, the Federal sales tax may only need to be 10% or less. There still would be an impact on the retailers, but at such a low tax rate, it should not be so severe and should not last long.

If the Federal sales tax is to be 20%, at least those who previously paid income tax at an effective rate of 20% or more should break even or do better. Those who had an income tax rate of below 20% may need financial assistance. If the ill-conceived Social Security program could be phased out, low income workers may be exempted early, so the 7.5% F.I.C.A. tax taken out of their paycheck, plus the 7.5% in matching funds sent by the employer, could be added to their paychecks with the instant effect of a 15% raise. Retirees who depend on Social Security for most of their income may get a 20% cost of living increase to be paid out of the new sales-tax revenue (not the trust fund). Any of the above who still need help, low income workers who do not pay the F.I.C.A. tax, and non workers may apply for assistance at a local Community Aid Agency. The CAA can determine what is an adequate amount of assistance based on the need of the individual applicant (not give flat amount or "entitlement"). Funds may be provided by the Local, State, and or Federal revenues; other help may be provided by charities. Again, if the Federal sales tax tax can be lowered to say 10%, the amount of financial assistance would be much less.

9.) Quick - An ideal tax plan will be passed into law so rapidly, will be implemented so easily, and will be accepted so readily that the transition time to change from the current system is minimal. Of course, the current tax code (No. 1) has already been passed, so it gets a maximum 5 rating by default. The Gephardt (No. 2) and Brown (No. 3) plans do not appear to have much support, so they probably will not be passed and are given a 2 rating.

The Nunn-Domenici Plan (No. 3) already has been written and submitted to the Senate as bill number S-722. Because these two moderate conservatives are popular leaders in the Senate, and because they keep an income-based tax, their bill has a fairly good chance of passage, implementation, and acceptance in a fairly short time, so I rate it a 4. (However, I would be disappointed if that bill is considered the best tax reform we can get.)

The Armey Plan (No. 4) has been discussed widely and has much support, especially among House Republicans. It also is an income-based tax, so it too has a good chance of passage, implementation, and acceptance in a short time, so I rate it a 4 also.

The push for a change to a consumption-based tax is led by the Chairman of the House Ways and Means Committee, Bill Archer (R-TX). Although he has not yet decided on a sales tax, a VAT, or even a Nunn-Domenici type consumed income plan, he will have a strong voice in the direction of tax reform from his position in charge of that tax-writing committee. The Ranking Member, Sam Gibbons (D-FL) is working on a Value Added Tax (No. 6.) Sen. Richard Lugar (R-IN) has proposed a plan for a National Retail Sales Tax (No. 7) (but I have not seen it yet.) However, I rate both of these plans as a 3 - Fair, because in spite of the compelling logic to switch to a consumption-based tax, such a radical change from the current system will need to be widely debated both inside and outside of Congress before passage. My proposal for a Unified Retail Sales Tax (No. 8) is the most radical departure from the current plan, and until it gets a sponsor in Congress, I can rate it only as a 2.

The VAT and retail sales plans (Nos. 6, 7, 8) could be implemented quickly, but if they would have a high rate of 20% or more, they would raise everyones cost of living by that amount, and thus would not be readily accepted. Acceptance would be better if the rate is 10% or less, but that would require favorable economic conditions.

Acceptance of the switch to a consumption tax may come hard to some of us senior citizens who have paid a lot of taxes through the years on our hard-earned savings and investments. As we enter our retirement years, we now would be faced with an unexpectedly high tax when we use our nest egg for necessary consumption. Those of us who have appreciable investments should feel that their exemption from taxation is a fair tradeoff. Those who do not may be bitter. In the discussion on fairness (p. 20), I proposed that retirees who depend on Social Security for most of their income may get a 20% (or what ever the consumption tax rate is) cost of living increase to be paid out of the new consumption tax revenue (not the trust fund). That action may bring the others down the road to acceptance.

Many of the tax-reform plans include provisions for eliminating taxes on savings and investments. Such a policy is long overdue. However, before such plans are implemented, some arrangement must be made regarding tax-deferred investments with pre-tax money that have been placed in IRA's, 401K's, 403b's, etc. I suggest that all such money be taxed at a flat rate of 10%, and then all investment money should be treated the same under the new tax laws.

10.) Rigid - An ideal tax plan will be so rigidly constructed that there is no room for political manipulation (vote buying, pork barreling, log rolling, etc.), and that no longer will the tax code be used for social engineering, only to raise revenue. Again the current tax code rates a 0. I fear that the Gephardt (No 2) and the Kemp-Pomeroy (No 3) plans would be subject to such manipulation, so I rate them also as 0. I suspect that the Brown Plan (No. 5) is not much better so I rate it a 1.

The Armey (No 4) and VAT (No 6) plans are much more rigidly constructed, so I rate them each as a 3. However, they could be subjected to some manipulation. The National Retail Sales Tax (No. 7) could be twisted out of shape with a lot of exemptions etc., but I rate it a 4. I see my Unified Retail Sales Tax as being rock-solid rigid, with no room for political manipulation. A few years ago, I would not have had any hope that such a plan could be passed by Congress. But with the new leadership, I am mildly optimistic.

4.) Stable - An ideal tax plan will be so well prepared that no other tax plan will pass for at least 30 years. (May have minor adjustments of tax rates.) With such long-term stability, individuals and businesses can do more accurate financial planning. (Still have unknown rate of inflation.)

The current tax code is doomed and the current fever for tax reform so it is rated a 0 again. The Gephardt (No. 2) and Nunn-Domenici (No. 3) Plans appear to me to be so unbearable that they probably would not last as much as five years, so I rate them also as 0. If the Brown Plan (No. 5) ever passed, it might last a while longer because many would want to give the VAT part a chance, so I rate it a 1.

The Dorney Plan (No. 4) has at least a fair chance at longevity, so I rate it a 3. However, I fear that a liberal-conservative tug-of-war would break out with wide swings of raising and lowering of tax rates, depending upon who is in power. The swings would have to be at least a year or two apart, because it would take that much time to pass new laws on an income-based tax.

The VAT Plan (No. 6) is also rated a 3. If it is passed, it may last a few years, but I foresee so many problems with regulation by the IRS, that there may be a nationwide revolt, especially by wholesalers to have it repealed.

The National Retail Sales Tax (No. 7) is given a 4 because it could last many years if the regulations of the retailers by the IRS does not get out of hand. The Unified Retail Sales Tax (No. 8) is given a 5, because as the ultimate in tax reform it could last forever.

The income-based tax plans are not stable in the long run, but they are the most run because the political process moves so slowly. On the other hand, the VAT and sales taxes are more stable in the long run, but the rates may be changed often, if economic conditions dictated, and the tax law would permit such adjustments by an independent board of reasonable experts. Market forces would keep any such adjustments in a narrow range.

Would it be wonderful if we could make our friends' plans and have some hope that the tax code would last 30 years or more?! (We would still have the unknown evil of inflation, but does anyone want to join my movement to phase out the Fed and reinstitute the gold standard.)

1[illegible]) Liberating - An ideal tax plan will result in the abolition of the Internal Revenue Service and repeal of the 16th Amendment to the U.S. Constitution (which brought us the income tax in 1913).

The current tax code, the Gephardt Plan (No 2), the Nunn-Domenici Plan (No. 3) and the Brown Plan (No 5) are so tied to both the IRS and the income tax concept that they all are rated as 0-Useful. The Armey Plan (No 4) is based on the 16th Amendment, but it could reduce the role of the IRS so it is rated as 2-Poor. The VAT Plan (No 6) is more dependent on the IRS but not the 16th Amendment, so it is rated also as 2. The National Retail Sales Tax (No 7) is less dependent upon the IRS, so it is rated as 3.

Only under the Unified Retail Sales Tax Plan (No 8) would it be possible to both abolish the IRS (may replace it with a Federal Tax Office to collect the revenue from the States) and repeal the 16th Amendment. Under this plan, it would be possible to abolish the IRS and keep the 16th Amendment on the books, but we would always dread the possibility of the return of the income tax. We need to get rid of both to restore some of our lost liberty, and increase our freedom from fear.

Chairman Bill Archer is our heroic leader and standard bearer in this movement to "pull the present income tax system up by its roots", abolish the IRS and repeal the 16th Amendment. These goals appear to be so important to him that it seems as if he wants these to be the first priorities of tax reform. However, I believe they belong at the end of the analysis of the qualities of tax reform in logical order. Thus they will be magnificent rewards at the end of the glorious tax reform process!

Sam Thompson III
UTEP P.O. Box 68306
El Paso, Texas 79968-9991

June 22, 1995

JUNE 9, 1995

PHILIP MOSLEY- CHAIRMAN
WAYS AND MEANS COMMITTEE
UNITED STATES HOUSE OF REPRESENTATIVES
LONGWORTH HOUSE, WASHINGTON, D.C. 20515

SUBJECT: HEARINGS REGARDING FEDERAL TAX SYSTEM

ATTENTION: MR. PHILIP MOSLEY

DEAR MR. MOSLEY:

WE APPRECIATE THIS OPPORTUNITY TO HAVE A DIRECT VOICE IN THIS VERY CRUCIAL ISSUE PRETAINING THE FEDERAL TAX SYSTEM.

WE WOULD LIKE TO SEE THE INTERNAL REVENUE SERVICE ABOLISHED. MOST OF OUR HARD EARNED MONEY IS GOING FOR TAXES. THE I R S IS GAINING MORE AND MORE CONTROL. IF YOU HAVE A PROBLEM, YOU ARE GUILTY UNTIL PROVEN INNOCENT.

AS SMALL BUSINESS OWNERS BESIDES BEING CITIZEN TAXPAYERS, WE HAVE HAD MORE THAN OUR SHARE OF PROBLEMS WITH THE IRS. SOMETIMES THESE PROBLEMS HAVE TAKEN MONTHS TO RESOLVE. THEY ARE EXTREMELY DISORGANIZED AND EVEN WITH CANCELLED CHECKS AND COMPLETE BACKUP RECORDS, THE AVERAGE PERSON HAS EXTREME DIFFICULTY IN PROVING THEIR CASE BECAUSE THE IRS WILL NOT LISTEN. WE HAVE BEEN HARASSED, THREATENED ETC AND WE ARE REALLY SICK OF THEIR TACTICS.

LETS GET BACK TO THE CONSTITUTION AS IT WAS WRITTEN. LETS GET BACK TO A GOVERNMENT RUN BY THE PEOPLE, FOR THE PEOPLE.

VERY TRULY YOURS,

GAIL E. TIEMAN

ROGER K. TIEMAN

14206 MINES RD. LIVERMORE,CA. 94550

United States of America
Zero National Debt and
National Economic Stimulus Foundation

"Zero Debt"

Became a project of mine in early 1993 after seeing Senators Rudman and Tsongas on television, addressing the deficit and the lack of action to reduce it, or even make it Revenue Consumption Neutral, or even slow the pace of ever increasing debt.

During this approximate time frame, I read an article, "Paying Back Your Uncle" - "One Man's Plan to Put a Dent in the National Debt" by John Rothchild in the local, national, print media: Kay Fishburn, a registered nurse, of New Berlin, Wisconsin, formed a group, "Citizen's for a Debt-Free America"; utilizing mailing lists; sent cards to addresses, soliciting donations to the Bureau of the Public Debt, Dept. "G", Washington, DC.

The result of this effort was 20 million dollars donated by the addresses from 1982 to 1993. If this amount was applied against the National Deficit, and this was converted to annual taxes, it would amount to two million dollars in annual taxes that did not have to be paid or could be used for some other purpose.

The immediate effect on me was, all of this without any real incentive, only the patriotic generosity of the citizens, who populate this wonderful United States of America. What would be the result of a program, which included an understandable incentive - ***MONEY?***

The people desperately want to help their country and at the same time help themselves. The government has not provided a medium by which they can participate in this reformation.

This program must be self-supporting, uncomplicated, with immediate payment action, and perpetual endurance.

The main bi-product of this program is new employment, with a living wage and benefits: The Postal Service, New Revenue; the Foundation Banking Facility, New Accounts with increasing volume of deposits, and finally, the Foundation Staff required, around the clock, to produce and process the print, out and in, generated to successfully conclude each unit in this perpetual cycle.

The rethink, rewrite process over this approximately two year period can be addressed descriptively in a poem which originated in my mind in late 1993:

HOPE
By W. E. McLeod

May your dreams become expectations
May your expectations become possibilities
May your possibilities become probabilities
And
May your probabilities become facts

The public awaits your positive action in the establishment of this foundation, in order that they may begin their financial assistance in this reformation to make a positive change, regardless of how small, in our individual condition.

The "Zero Debt" presentation follows and I have the implementation in mind. Initial contact has been made with the telephone/computer entity capable of successfully completing the project in minimum time.

I shall proceed in the private sector; however, I favor Government action. I am available at your convenience for your questions, and may God bless you all.

W.E. McLeod

VETS HOME OF CA
PO Box 1200
Yountville, CA 94599-1297

(707) 944-0462

(800) ZERO DEBT
(800) 376-3328

(800) GRANTXR
(800) 472-6897

HELP YOUR COUNTRY - HELP YOURSELF

United States of America
Zero National Debt
and
National Economic Stimulus Foundation
"ZERO DEBT"

DEDICATION

I dedicate this foundation to my mother, Johni, who gave her life for mine at my birth; my grandmother and grandfather, Maggie C. and John H. Givens, of Laurel Hill, Okaloosa County, Florida, who gave me their best for the remainder of their lives; my family(ies); my children, their children, et. seq.; Harry Martin, Editor and Publisher, Napa Sentinel, and Napa Sentinel the Magazine, "North American Investigative Journal", who rendered invaluable assistance; my publisher and contributors, who had faith and took a chance on this unknown; the endless dear friends and wonderful people throughout our great country and the world, with whom I have very special friendships, associates, acquaintances, and or have met only briefly in passing; those with whom I have differed in not seeing eye-to-eye on issues, as well as those who have been unable to utilize my qualifications for whatever reasons; and those, who, I hope, even in some small way, through the effect(s) of our effort(s) in this fellowship, may benefit in improving their lives. I am eternally grateful, and my sincere thanks to you all.

W.E. McLeod
Founder

HOPE
By W.E. McLeod

May your dreams become expectations
May your expectations become possibilities
May your possibilities become probabilities
and
May your probabilities become facts

© W.E. MCLEOD 1994

HELP YOUR COUNTRY - HELP YOURSELF

United States of America
Zero National Debt
and
National Economic Stimulus Foundation
"ZERO DEBT"

"A Non-Profit Foundation"

Not affiliated with the U.S. Government, or any other government, state, county, or city

CHARTER

The State of _____

PURPOSE

Receive grant applications with donations and/or fees; account for; and prudently manage same.

ACTIVITY

Disposal of donations and/or fees received, in one million dollar, $1,000,000, units, less actual, prudent, foundation expenses, to the "Deficit Reduction Fund", created by the President of the United States, through Executive Order 12858 of August 4, 1993, and to disseminate timely national economic stimulus grants of one million dollar, $1,000,000, units to individual applicants.

W.E. McLeod
Founder

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United States of America

A Non-Profit Organization

Help Your Country - Help Yourself

United States of America
Zero National Debt
and
National Economic Stimulus Foundation
"ZERO DEBT"
"A Non-profit Foundation"

Not affiliated with the U.S. Government, or
any other government, state, county, or city

Information concerning Economic Stimulus Grants

ONE MILLION DOLLARS

Readily available

PLEASE CALL TOLL-FREE
1 (800) Zero-Debt
1 (800) 376-3328

_____

Location)

© W.E. MCLEOD 1994

"ZERO DEBT" Voice Tape

You have reached "Zero Debt", _____.
(location)

For information concerning your application for a National Economic Stimulus Grant of one million dollars

at the tone:

please leave your name, and mailing address. Complete information and instructions will be mailed to you.

Your name and mailing address will be used for this mailing, only, and will be destroyed immediately upon completion of this mailing.

Thank you for your interest

Beep:

© W.E. MCLEOD 1994

"ZERO DEBT" Mailgram

HELP YOUR COUNTRY - HELP YOURSELF

United States of America
Zero National Debt
and
National Economic Stimulus Foundation
"ZERO DEBT"

"A non-profit foundation"

Not affiliated with the U.S. Government, or any other government, state, county or city

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Receive grant applications with donations and/or fees; account for; and prudently manage same.

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Disposal of donations and/or fees received, in one million dollar, $1,000,000, units, less actual, prudent, foundation expenses, to the "Deficit Reduction Fund", created by the President of the United States, through executive order 12858 of August 4, 1993, and to disseminate timely national economic stimulus grants of one million dollar, $1,000,000, units to individual applicants.

Dear fellow American,

I feel sure, that you have been made aware of the existing and estimated future condition of our national debt and our economy, by the newspapers, TV, etc.

This deplorable situation motivated me, hopefully, with the support of my fellow Americans, to found the above described foundation for the purpose of making a positive change, regardless of how small, in our individual condition.

The successful effects of this program are dependent upon the financial assistance from those of you, who desire to be a part of this reformation.

PLEASE HELP YOUR COUNTRY - HELP YOURSELF!

Please make your grant application donation and/or fee payable to "ZERO DEBT". Please place your grant application and donation and/or fee, $20.00, in the envelope enclosed. Please do not send cash!

Upon receipt of your grant application and donation and/or fee, a letter of receipt, containing an identifying application number, will be mailed to you.

All donations and/or fees shall be utilized as described above, and this program shall be conducted by the undersigned as described above, and in accordance with all applicable law(s).

Thank you,

W.E. McLeod
Founder
© W.E. MCLEOD 1995

"ZERO DEBT" National Economic Stimulus Grant Application

HELP YOUR COUNTRY - HELP YOURSELF

United States of America
Zero National Debt
and
National Economic Stimulus Foundation
"ZERO DEBT"

"A non-profit foundation"

Not affiliated with the U.S. Government, or any other government, state, county, or city

I, hereby, declare, that I am a legal adult, and I apply for a National Economic Stimulus Grant of one million dollars, $1,000,000, from the United States of America, Zero National Debt and National Economic Stimulus Foundation, "ZERO DEBT".

I understand, that it is necessary that I complete this grant application with an accompanying donation and/or fee, $20.00, to constitute a filing; that the grant will be made to one of the 100,000 applicants comprising each unit; one application number being selected at random from each unit of 100,000 applications and donations and/or fees received, as received; that application identifying number 100,000 shall end each unit, with the next application and donation and/or fee being applied to and beginning the next unit, 100,000; and that I may apply again to any new unit.

I understand, further, that a portion of my donation and/or fee will be utilized to pay on reducing our national debt through the payment of one million dollar units to the "Deficit Reduction Fund", created by the President of the United States, through executive order 12858 of August 4, 1993, and prudent, foundation related expenses.

A letter of receipt, containing an identifying application number, will be mailed to me, by the foundation, upon the receipt of my application and donation and/or fee; however, a donation and/or fee drawn on "Insufficient Funds", releases "ZERO DEBT" from any and all obligation(s) to the applicant.

$ _____ .00 Date: _____

_____ _____
Signature Address

_____

_____ _____
Name: First - Initial - Last

Please do not write below this line

$ _____ .00 IDENTIFYING NUMBER

__/_ _ _ _/_ _ _ _

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"ZERO DEBT" National Economic Stimulus Grant Application Receipt

HELP YOUR COUNTRY - HELP YOURSELF

United States of America
Zero National Debt
and
National Economic Stimulus Foundation
"ZERO DEBT"

"A non-profit foundation"

Not affiliated with the U.S. Government, or any other government, state, county, or city

Dear fellow American,

Thank you for your fellowship, support, and participation, your grant application and donation and/or fee, $20.00, in the program, "HELP YOUR COUNTRY - HELP YOURSELF", of the United States of America, Zero National Debt and National Economic Stimulus Foundation, "ZERO DEBT".

I hope that your interest and participation will continue, as subsequent grants are funded and granted, and a grant application form, and a, "POSTAGE PAID", return envelope is enclosed with each grant application receipt. Subsequently, should you find yourself without a grant application form, you may call, TOLL FREE, 1-800-ZERO-DEBT-376-3328, and the items/information will arrive immediately.

Information concerning the disposition of your donation and/or fee is as follows:
(name of bank and location)
50% "Zero Debt" General Account and the "Deficit Reduction Fund" Trust Account
50% National Economic Stimulus Grant Trust Account.

The active disposition of the accounts will be made on the next bank working day after the individual unit total reaches two million dollars, $2,000,000 or 100,000 applicants with $20.00 filing donations and/or fees; the one million dollar, $1,000,000, National Economic Stimulus Grant procedure will begin; the recipient of the National Economic Stimulus Grant will be notified via Western Union at the mailing address contained in the grant application; the balance in the "ZERO DEBT" General Account will be transferred to the "Deficit Reduction Fund" Trust Account; and the interest from the two trust accounts will be transferred to the "ZERO DEBT" General Account to meet prudent foundation expenses prior to the arrival of sufficient grant applications with donations and/or fees for the subsequent unit.

The remuneration to the founder will be a fee of one-tenth-of-one percent, 0.1%, decimal 0.001, or one thousand dollars, $1,000, from each one million dollars, $1,000,000, received, plus prudent personal, foundation related expenses, supported by valid receipts.

I trust, that the foregoing information is sufficient to satisfy your interest in the disposition of your donation and/or fee; your continued interest is appreciated; and your identifying application number appears below.

Date: _____ $ _____ .00 Number: __/__ __ __-__ __ __

Thank you

W.E. McLeod
Founder

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"ZERO DEBT" National Economic Stimulus Grant Application

HELP YOUR COUNTRY - HELP YOURSELF

United States of America
Zero National Debt
and
National Economic Stimulus Foundation
"ZERO DEBT"

"A non-profit foundation"

Not affiliated with the U.S. Government, or any other government, state, county, or city

I, hereby, declare, that I am a legal adult, and I apply for a National Economic Stimulus Grant of one million dollars, $1,000,000, from the United States of America, Zero National Debt and National Economic Stimulus Foundation, "ZERO DEBT".

I understand, that it is necessary that I complete this grant application with an accompanying donation and/or fee, $20.00, to constitute a filing; that the grant will be made to one of the 100,000 applicants comprising each unit; one application number being selected at random from each unit of 100,000 applications and donations and/or fees received, as received; that application identifying number 100,000 shall end each unit, with the next application and donation and/or fee being applied to and beginning the next unit, 100,000; and that I may apply again to any new unit.

I understand, further, that a portion of my donation and/or fee will be utilized to pay on reducing our national debt through the payment of one million dollar units to the "Deficit Reduction Fund", created by the President of the United States, through executive order 12858 of August 4, 1993, and prudent, foundation related expenses.

A letter of receipt, containing an identifying application number, will be mailed to me, by the foundation, upon the receipt of my application and donation and/or fee; however, a donation and/or fee drawn on "Insufficient Funds", releases "ZERO DEBT" from any and all obligation(s) to the applicant.

$ _____ .00 Date: _____

_____ _____
Signature Address

_____

_____ _____
Name: First - Initial - Last

Please do not write below this line

$ _____ .00 IDENTIFYING NUMBER

__/__ __ __/__ __ __

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Western Union Mailgram

Congratulations,

Your faith, support, and participation in the program, "Help Your Country - Help Yourself", of the United States of America, Zero National Debt and National Economic Stimulus Foundation, "Zero Debt", has resulted in your being selected to receive the National Economic Stimulus Grant Unit "___", of one million dollars, $1,000,000. Please telephone, toll free, 1-800-GRANTXR, 472-6897 to discuss the arrangements for transferring this grant to you. Looking forward to hearing from you soon.

Sincerely,

W.E. McLeod
Founder

© W.E. MCLEOD 1994

WESTERN UNION FSI
RENO, NEVADA 89502-2375

WESTERN UNION MAILGRAM

014128001744 08/06/93 OKAC

W E MCLEOD
VETS HOME OF CALIFORNIA C220B PO BOX 120
YOUNTVILLE CA 94599

THIS IS A CONFIRMATION COPY OF THE FOLLOWING MESSAGE:

7079440462 TDBN YOUNTVILLE CA 38 08-06 0555A EST
93218099927026 73-1

PRESIDENT BILL CLINTON
WHITE HOUSE DC 20500

DEAR MR PRESIDENT

RESPECTFULLY REQUEST "A CERTIFIED TRUE COPY" OF EXECUTIVE ORDER CREATING "DEFICIT REDUCTION TRUST FUND". MY HUMBLE OPINION: HISTORY WILL EQUATE THIS/YOUR USE OF EXECUTIVE POWER ON THE VERY HIGHEST ORDER. THANK YOU VERY MUCH.

RESPECTFULLY,

W E MCLEOD
(707) 944-0462
VETS HOME OF CALIFORNIA C220B PO BOX 1200
YOUNTVILLE CA 94599

14959

12:09 EST

MGMCOMP

To reply by Mailgram Message, see reverse side for Western Union's toll-free numbers.

THE WHITE HOUSE

WASHINGTON

October 26, 1993

W. E. McLeod
Post Office Box 1200
Yountville, California 94599-1297

Dear Friend:

Thank you for your letter regarding the economic package I signed into law on August 10, 1993.

The passage of this plan will help us put America back in control of its economic destiny, create 8 million new jobs, and improve our standard of living. To accomplish these goals, my plan will cut the deficit by over $500 billion over five years. Half of this reduction will come from the largest decrease in deficit spending in the history of our nation, cutting over $250 billion through more than 200 specific budget cuts.

The other nearly $250 billion in deficit reduction will come from restoring fairness to the tax code, by asking those who have the most to contribute the most to reducing the deficit. For every $10 of deficit reduction, more than $5 will come from spending cuts, almost $4 will be paid by the wealthiest Americans -- those making more than $100,000 per year -- and only $1 will be paid by the middle class. The working poor -- those earning less than $27,000 per year -- will be protected by a tax break. Moreover, to lock in these savings, every penny of spending cuts and tax increases will be put in a Deficit Reduction Trust Fund.

Since I proposed my plan, home mortgage interest rates have fallen to their lowest level in more than 20 years, and over 1 million new jobs have been created. The low interest rates that this plan can help us maintain and the plan's tax incentives for small businesses will help us to continue this economic growth and job creation.

America has chosen change over gridlock. I hope I can count on your future support.

Sincerely,

Bill Clinton

PRESIDENT OF THE UNITED STATES
Executive Order 12858 of August 4, 1993 -- By the President of the United States of America: Deficit Reduction Fund
(FEDREGISTER 58 FR 42185 08/06/93; 93 lines.)
Presidential Documents
Item Key: 19245
--- --- --- --- --- --- --- --- --- --- --- --- --- --- --- --- --- ---

Executive Order 12858 of August 4, 1993

Deficit Reduction Fund

By the authority vested in me as President of the United States by the Constitution and the laws of the United States of America, including sections 1104 and 1105 of title 31, United States Code, it is hereby ordered as follows:

Section 1. Purpose. It is essential to guarantee that the net deficit
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reduction achieved by the Omnibus Budget Reconciliation Act of 1993 is dedicated exclusively to reducing the deficit.

Sec. 2. Deficit Reduction Fund.

(a). Establishment of the Fund. There is established a separate account in the Treasury, known as the Deficit Reduction Fund, which shall receive the net deficit reduction achieved by the Omnibus Budget Reconciliation Act of 1993 as called for in subsection (b) of this order.

(b) Amounts in Fund. Beginning upon enactment of the Omnibus Budget Reconciliation Act of 1993, the Deficit Reduction Fund shall receive any increases in total revenues resulting from enactment of such Act on a daily basis. In addition, on a daily basis, the Secretary of the Treasury shall enter into such account an amount equivalent to the net deficit reduction achieved as a result of all spending reductions resulting from such Act. The cumulative fiscal year amounts for the combination of all such revenue increases and spending reductions shall be equal to:

(1) for fiscal year 1994, $ 60,292,000,000;

-More- (Q = Quit, G = Go, Space Bar = Next Line, Return = Next Screen)
(2) for fiscal year 1995, $ 70,437,000,000;

(3) for fiscal year 1996, $ 92,061,000,000;

(4) for fiscal year 1997, $ 125,881,000,000;

(5) for fiscal year 1998, $ 146,939,000,000.

Within 30 days of enactment of the Omnibus Budget Reconciliation Act of 1993, the foregoing amounts may be adjusted by the Director of the Office of Management and Budget to reflect the final scoring of such Act.

(c) Status of Amounts in Fund. (i) The amounts in the Deficit Reduction Fund shall be used exclusively to redeem maturing debt obligations of the Treasury of the United States held by foreign governments in the amounts specified in subsection (b)

(ii) The amounts in the Deficit Reduction Fund as set forth in subsection (b) that result from increases in total revenues and spending reductions shall not be available for new spending or to finance measures that increase the deficit for purposes of budget enforcement procedures under the Balanced Budget and Emergency Deficit
-More- (Q = Quit, G = Go, Space Bar = Next Line, Return = Next Screen)
Control Act of 1985 (2 U.S.C. 901-922).

(d) Effect on Other Funds. Establishment of and transfers to the Deficit Reduction Fund shall not affect trust fund transfers that may be authorized or required by provisions of the Omnibus Reconciliation Act of 1993 or any other provision of law.

Sec. 3. Requirement for the President To Report Annually on the Status of the Fund. The Director of the Office of Management and Budget shall include in the President's Budget transmitted under section 1105 of title 31, United States Code, information about the Deficit Reduction Fund, including a separate statement of amounts in and Federal debt redeemed by that Fund.

Sec. 4. Implementation. The Secretary of the Treasury and the Director of the Office of Management and Budget shall each take such actions as may be necessary, within their respective authorities, promptly to carry out this order.

Sec. 5. Effective Date. This order shall take effect upon enactment of the Omnibus Budget Reconciliation Act of 1993.

WILLIAM J. CLINTON
-More- (Q = Quit, G = Go, Space Bar = Next Line, Return = Next Screen)

WILLIAM J. CLINTON
-More- (Q = Quit, G = Go, Space Bar = Next Line, Return = Next Screen)

-More- (Q = Quit, G = Go, Space Bar = Next Line, Return = Next Screen)-

THE WHITE HOUSE,

August 4, 1993.

Editorial note: For the President's remarks on signing this Executive order, see issue 31 of the Weekly Compilation of Presidential Documents.

[FR Doc. 93-19101

Filed 8-5-93; 10:30 am]

Billing code 3195-01-P

Press return to display next item or enter GO, BACK, HELP or STOP

STATEMENT OF VHA INC.
TO THE COMMITTEE ON WAYS AND MEANS
OF THE UNITED STATES HOUSE OF REPRESENTATIVES
ON REPLACING THE FEDERAL INCOME TAX

Submitted by Mr. Daniel P. Bourque
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VHA Inc. (formerly, Voluntary Hospitals of America, Inc.) appreciates the opportunity to submit this testimony on proposals to replace the current Federal income and estate taxes. Structural tax reform is of great interest to not-for-profit organizations nationwide, and a serious matter for charitable hospitals throughout the United States.

VHA is the largest alliance of not-for-profit hospitals in the United States. It is comprised of more than 1,200 health care organizations. The purpose of VHA is to offer health care organizations information, products, and services to improve community health, clinical quality, and operational efficiency.

VHA's mission is directly related to the viability of the charitable not-for-profit community hospital in the face of increasingly competitive economic pressures. Indeed, the need to develop economic strategies to preserve the not-for-profit hospital's charitable mission, and at the same time ensure its financial survival, is the principal policy goal which underlies VHA programs and activities.

Role of the Not-for-Profit Sector

Historically, the not-for-profit sector has filled an important role in American society. First, it has served to lessen the burdens of Federal and State government. It has done so by taking on tasks which might otherwise fall to governmental agencies, but which are handled more efficiently and humanely by publicly supported charities. Such tasks have included providing food and shelter for the poor, and urgent and routine medical care for the indigent. Second, it has provided goods and services deemed to be inherently beneficial to the public--e.g., education, care for the elderly, and community-focused health care. Traditionally, the not-for-profit sector has used volunteers and funds provided by charitable contributions to subsidize the cost of such goods and services so that they may be distributed more widely.

Today, the not-for-profit sector has an even larger role. Nearly one million charitable, educational, religious, health and social welfare organizations nurture and sustain the values that frame American life. They promote altruism in a society that rewards individual achievement; and pluralism in a society sometimes threatened with divisiveness. In so doing, they teach, mediate, inspire and heal.

Struggling to contain and ultimately eliminate deficit spending, the U.S. Congress is considering substantial cutbacks in the Federal government's funding of education, various social welfare and insurance programs (including Medicare and Medicaid), and the arts. Budgetary cuts in these areas would put even greater pressure on not-for-profit organizations to provide these important services and programs.

Special Role of Not-for-Profit Health Care

Not-for-profit hospitals continue a centuries-old tradition of healing and comforting those who suffer -- the sick and dying, victims of accidents and crime. Through them, the burdens of meeting the health care needs of communities and the special populations within them are shared with government. Historically, they have shouldered with the Federal, State and local governments the responsibility for meeting a broad range of health care needs of the communities in which they are located. Indeed, throughout American history, most general

hospital care, institutional outpatient services, and formal home care have been provided by not-for-profit, non-governmental organizations. Moreover, many of the critical improvements in medical care have been developed at not-for-profit institutions.

Not-for-profit hospitals, which comprise approximately 60% of all community hospitals in the United States, have consistently provided a different and broader range of services than their for-profit counterparts. Not-for-profit hospitals provide more medical research, education, community health care services, and specialty services than their proprietary counterparts. They are also committed to providing essential -- if sometimes unprofitable -- services such as 24-hour emergency rooms, neonatal intensive care, burn units and care for AIDS patients. Not-for-profit hospitals are social charities as well as providers of medical services. Volunteers provide a wide range of practical help from transportation to hospital visits.

Not-for-profit hospitals today have grown into sophisticated health care provider organizations, but their charitable role is no less important. Moreover, Congress' decision not to enact health reform legislation mandating universal coverage suggests that voluntary hospitals may be required to assume even greater burdens now and in future years. Impending Medicaid and Medicare budget cuts will pose additional challenges for community-based health care providers. As in the past, not-for-profit charitable hospitals will be called upon to meet community health needs that government is unable or unwilling to fulfill.

Importance of Tax Benefits for Not-for-Profit Organizations

The exemption from income tax of charitable and other not-for-profit organizations is long-standing.[1] The exemption from income tax permits not-for-profit organizations to set aside or retain earnings for future capital improvements. It also provides a uniform foundation for many state tax exemptions.

A second key provision is the deduction for charitable contributions. Congress has long sought to encourage charitable donations through the tax system. The deduction for charitable giving has existed almost as long as the income tax itself. Charitable giving goes hand in hand with volunteering as the primary means by which many not-for-profit organizations are able to carry out their mission. In the health care context, individual and corporate contributions are essential funding sources for medical research and education.

A third tax provision that directly benefits charitable organizations is the exclusion for tax-exempt bond interest. Charitable organizations with significant capital needs, such as hospitals and universities, rely on tax-exempt financing to lower their cost of capital. Since not-for-profit hospitals cannot by law issue stock to raise money through the equity markets, debt and retained earnings are their only sources of capital for much needed expansions, renovations and consolidations.

Income Tax Restructuring

VHA strongly supports the Congress' efforts to make the federal tax system simpler and more efficient. It also applauds Chairman Archer for pursuing reforms that would encourage savings and investment, improve the international competitiveness of U.S. business and increase tax revenues from the underground economy and non-compliant taxpayers. In addition, VHA appreciates the Chairman's decision to defer offering a specific consumption tax proposal until he has had an opportunity to fully examine the various alternatives.

However, the movement to completely replace the federal tax system poses a number of problems for not-for-profit organizations. It is our hope that these problems will be

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[1] Prior to the enactment of the first corporate income tax, the tax "exemption" of non-profits existed primarily by statutory omission. Customs and excise taxes applied only to specified business entities and activities. When the income tax of 1894 imposed a flat two percent rate on all corporate income, Congress provided exemption for not-for-profit charitable, religious and educational organizations, as well as certain not-for-profit mutual organizations. Comparable measures were subsequently enacted after the Sixteenth Amendment was ratified, firmly establishing the principle of tax exemption of not-for-profit organizations.

faced squarely and resolved creatively so that the unique role of not-for-profit organizations will not be compromised or their influence eroded.

Issues Posed for Not-for-Profit Organizations by Structural Tax Reform

Structural tax reform could adversely affect many not-for-profit organizations. Issues that particularly concern VHA as an alliance of not-for-profit health care organizations include the following:

- Whether the New Taxes Will Apply to Not-for-Profit Organizations

  Most, but not all, of the proposed consumption taxes apparently would apply to not-for-profit organizations that provide goods and services. Exemption from such taxes may be tied to a particular service or product, rather than the type of entity that supplies it. Moreover, it is unclear whether the "Business Tax" portion of the proposed "Flat Tax" would apply to tax the income that not-for-profit organizations derive from activities related to their exempt purpose.[2] **VHA believes that Section 501(c)(3) organizations should be exempted from any such new taxes, except with respect to unrelated business income (or valued-added) that would be subject to tax under current law.**

- Whether Exemption from a Consumption Tax May Result in Partial Taxation

  Exemption from income tax completely eliminates tax on not-for-profit organizations. Exemption from a consumption tax only exempts the value added by the not-for-profit organization from tax, not the tax on the goods and services it purchases from other businesses. Under Canada's goods and services tax ("GST"), charitable not-for-profit organizations are exempt with regard to most of their services, but also are allowed a 50 percent input credit.[3] **VHA strongly suggests that the Committee consider a mechanism to enable a not-for-profit organization to receive a credit for tax previously paid on inputs, as well as an exemption for its own valued added.**

- Whether Essential Tax Incentives Will be Eliminated or Diluted

  Not-for-profit organizations depend not only on exemption from income tax, but also on current law incentives for charitable deductions and tax-exempt bond financing. Many of the reform proposals, by eliminating or diluting the exclusion for tax-exempt bond interest, would sharply increase not-for-profit hospitals' "cost of capital" at a time when they simply cannot afford it. Such proposals would also eliminate or restrict the tax incentives for individual and corporate donations that fund medical research and community health initiatives. **VHA would like to work with Chairman Archer and his staff to maintain appropriate incentives for meeting not-for-profit hospitals' capital needs and charitable giving objectives.**

- Whether a Consumption Tax Will be Imposed on Value Added When Goods or Services are Provided at Low or No Cost

  Although it may seem absurd to even suggest that hospitals' "charity care" or university scholarships could be subject to a consumption tax, the staff of the Joint Committee on Taxation has noted that under some consumption tax theories, tax would be imposed on all value added by a

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[2] See Staff of the Joint Committee on Taxation, Description and Analysis of Proposals to Replace the Federal Income Tax (JCS-18-95: June 5, 1995), p. 36.

[3] Id. at p. 102, fn. 175.

not-for profit organization or governmental entity, including any foregone profit or subsidy element in goods or services offered at no charge or at "below-market" prices.[4] **VHA strongly urges the Committee to reject any approach that would impose tax on charity or subsidized care.**

- Any Erosion in the Federal Tax Exemption for Charitable Health Care Organizations May Trigger Increased State Taxes

  Many State tax exemptions derive at least in part from exemption from federal income tax under Section 501(c)(3). Even hospitals that operate on extremely narrow margins or at a loss for income tax purposes would have substantial property tax liability if exemption standards were altered. In addition, repeal of Section 501(c)(3) could trigger adverse income and sales tax consequences in many States. **VHA urges the Committee to retain Section 501(c)(3) even if it changes the basic framework of the tax code.**

Summary

The not-for-profit sector contributes significantly to the public good by lessening the burdens of government. It provides many essential services efficiently and compassionately. It promotes and nurtures American values of altruism, volunteerism, and pluralism. In view of anticipated cuts in Medicaid and Medicare, not-for-profit hospitals and health care organizations will be challenged to do more than ever before to maintain access to quality care for all Americans.

Although VHA strongly supports Chairman Archer's structural tax reform initiatives, it has several concerns regarding the possible impact of any new tax system on not-for-profit organizations. These include concerns regarding (i) the scope and applicability of a consumption or flat tax, (ii) the difficulty of fashioning revenue-neutral exemptions, (iii) the possible elimination of essential tax incentives, such as the exclusion for tax-exempt financing or the deduction for charitable contributions, and (iv) the theoretical imposition of a consumption tax on the value of goods and services provided for free or on a subsidized basis.

VHA looks forward to the opportunity to work with Chairman Archer, the Members of the Committee, and their respective staffs to address these concerns in a creative and appropriate manner.

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[4] Id. at pp. 102-106.

MICHAEL WARD
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6-15-95

MR. PHILLIP MOSELY
COMMITTEE ON WAYS + MEANS

SIR:

I BELIEVE THE PRESENT TAX SYSTEM IS UNFAIR, DESTRUCTIVE, AND FAR TOO COMPLEX.

I BELIEVE A NATIONAL SALES TAX IS THE BEST SOLUTION, AS IT WOULD ALLOW THE IRS TO BE ELIMINATED.

ANY SYSTEM EXCEPT A VAT TAX WOULD BE BETTER THAN WHAT WE HAVE NOW.

SINCERELY,

Michael Ward

DEAR SIRS:

AN I.R.S. STORY (TRUE)

(HOTTUB)

MY SON STARTED A SPA MANUFACTURING BUSINESS HE GOT HIS PRODUCT LINE TO MARKET AFTER THE ECONOMIC DIP OF APROX. ~~1986~~ 1985-1986

HE LOST ALL OF HIS INVESTMENT IN THE BUSINESS, HE LOST HIS HOUSE AND EVERYTHING ELSE.

IN AN EFFORT TO TRY TO SAVE HIS BUSINESS, I LOANED HIM $18000.00. THIS MONEY WAS ALSO LOST IN THE PROCESS.

THEN COMES THE I.R.S. THEY PULLED HIS BANK RECORDS + SAID THE MONEY I LOANED HIM, WAS INCOME. THEY SAID BECAUSE HE DIDNT HAVE TO PAY FOR HIS HOUSE, THAT HE OWED INCOME TAX ON THAT MONEY. I BELIEVE THEY REFFERED TO IT AS RELIEVED DEBT?

ALL TOTALED WITH FINES PENALTIES THEY SAID HE OWED JUST SHY OF $250000.00, AND SAID HE SHOULD SEND IN A CHECK TO PAY THIS AMOUNT IMMEDIATLY.

I HAVE A PROBLEM WITH THE WAY THEY DO BUSINESS. I DONT BELIEVE THAT THE PEOPLE SHOULD HAVE TO FEAR THE GOVERNMENT. I BELIEVE THAT THE I.R.S. IS AN ILLEGAL CORP. ACCORDING TO THE CONSTITUTION.

THANK YOU

RON WILSON

Ron Wilson

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Jeff Wimer
P.O. Box 502
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June 5, 1995

Longwirth Building
co Ways and Means Committee
Washington, DC 20515

RE: taxes

Dear ladies, gentlemen, honorable, dishonorable (that ought to cover all the bases):

Something to strive for: 10% of tax revenues saved over 9 years, accumulated interest over 9 years, expenditures flat or preferably declining over 9 years, equals no taxes every 10 years and a declining national debt.

Please make this a way of life and a part of the record.

Sincerely,

Jeff Wimer

Enclosed: 6 copies

Wren Services

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Thank you for the opportunity to express my views to the House Ways and Means Committee. The reason I am here is to indict the Congress for violations of the basic law of the land, the U.S. Constitution, and to straighten out the mess you have made as a result of your violating the law. The purpose of the hearing is stated as being a "review of problems with the current Federal income, estate, and gift taxes, and examine various alternative tax systems, including consumption taxes, a flat tax, and the Unlimited Savings Account tax proposal".

We, the People, the real government of the United States, a government of the people, by the people, and for the people, have delineated in the Constitution, article one, section 8, those few tasks that we as states united wish the Congress to do on our behalf. The Congress has proceeded to do many things that it as no power to do, and those things that we have told it to do, it does not do. In the area of taxes, we have empowered the Congress to lay and collect taxes. The purpose is to pay the debts of the country. We have empowered the Congress to borrow money for that purpose. We have empowered the Congress to coin money, regulate the value thereof, and of foreign coin, and fix the standard of weights and measures. We as sovereign individuals have decreed that the States may not use any Thing but gold and silver coin as a tender in payment of debts, article one, section ten.

So the purpose of taxing is to pay the bills. To pay the bills, we need money. Money is gold and silver coin. In a famous desegregation case, the Supreme Court said that it would be unthinkable that the Constitution would impose a lesser obligation upon the Federal government than it imposes on the states. That was in regard to segregation in the Federal enclave, Washington, D.C. If the states cannot make any thing but gold and silver coin a tender in payment of debts, then the federal government cannot make any thing but gold and silver coin a tender in payment of debts. Payment requires specie. No specie, no payment.

Borrowing likewise requires specie. If We, the People, gave the Congress the power to borrow money and coin money, then what should that coined money be? It has to be gold and silver coin, because the states need gold and silver coin for the purpose of carrying on business, charging court fees and fines, levying taxes, and for the settlement of financial obligations. It follows, therefore, that the Congress of the United States must coin such gold and silver money. If the only thing that can be

coined is gold and silver money, then it follows that the only thing that can be borrowed is coined gold and silver money. Nothing else in this country is money. The Congress has not been empowered to print money, and it has not been empowered to monetized the debt. Since the Congress has not coined any money since the 60's, it follows that it has not borrowed any money since the 60's. There is no 4 trillion dollar debt, that is a figment of someone's imagination.

What the Congress has done is issue debt, bonds, bills, and notes when no money was borrowed. This monetizing of the debt is clearly beyond the powers of the Congress, it is illegal, immoral, and fraudulent. The Congress has no hidden power to tax by way of inflating the so-called money supply. Inflation is against the law here in the States United.

When talking about the debt, about taxes, and about the budget, the term "dollar" is used. Many people believe that the pieces of green paper we use as money are "Dollar Bills". But a careful research of the terms, "Dollar" and the term "Bill", will bring us the te amazing conclusion tat our currency is neither a dollar nor a bill, and in fact is not even money.

The truth is, the paper we use as money clearly states on its face that it is a "Federal Reserve Note". Now, the term "Note", means something different from the term "bill". A bill is short term debt, i.e., 30 an 90 day T-bills. Notes, however, intermediate-term debt, i.e., five and ten year Treasury Notes. Therefore, our currency declares itself to be intermediate-term debt.

If, then, we are holding notes, whose debt are we holding, and what was borrowed? Since the Federal Reserve iis merely thhe fiiscal agent for the Treasury, and since the note iis signed by both the Secretary of the treasury and the Treasurer of the United States, it appears as though the Congress has perhaps borrowed some money.

This then brings us to the definition of a dollar. Legally, the dollar is a silver coin, 371 1/4 grains of silver, 9/10ths (.90) fine, as defined by the Coinage Act of 1792. The Coinage Act arises from article one, section eight, clause five of the Constitution, wherein We, the People, the real government of the United States, empower the Congress to "coin money, regulate the value thereof, and of foreign coin, and fix the standard of weights and measures". The Congress has also been given the power (under clause two) to borrow money; and article one, section 10, declares that money is gold and silver coin. So the Congress has the power to coin gold and silver money, borrow such money, and pay the debts of the country with such money.

Clause 5 empowers the Congress to fix the standard of weights and measures, and so the Congress has established the standard of linear measurements, the inch, the foot, and the yard; and the standards for dry and liquid measures. Under this same power, it likewise fixed, it established for all time (that's what the word "fix" means), what our standard of value would be. Standard of value means 'what is the thing by which we will measure the value of goods and services, what will be the common denominator that we will use for the buying and selling of goods and services? What will be the pricing mechanism, the medium of exchange that we would use, instead of barter, for commerce?'

The Congress declared our fixed standard of value to be a certain weight and fineness of silver coin, called that silver standard the dollar, and put us on the silver standard. Since a standard cannot be changed (if it were changeable, it would not be "fixed"; "fixed" means unchanging), we are thus still on the silver standard today. For those who wish to go back to a gold standard, they must realize that in order to go off the silver standard or adopt some other standard, the Constitution would have to have been amended, and clause five of article one, section eight would have to have been deleted or changed. Since that has not happened, a case can be made that we have never really legally been on a gold standard.

Under the Coinage Act of 1792, Congress allowed for the coining of gold coins along with silver coins, but the gold coins were called "Eagles", and were of the "value of so-many dollars". For example, there was a twenty dollar gold eagle. That particular gold coin was of the value of twenty silver dollars, based on the ratio of gold to silver as established by law. The standard, however, was always, and still is, silver.

If you argue that a piece of paper, which says that it is a note, is a dollar, while in fact, that piece of paper says that it is a note (debt), then how can the Congress borrow debt? The Congress is only empowered to borrow money, and article one, section 10, says that "No State shall....make any Thing but gold and silver Coin a Tender in Payment of Debts." If the states

cannot use anything but gold and silver coined money for the payment of debts, i.e., court costs, fines, state and local taxes, the settling of financial obligations, then the Federal government is limited in like manner. The Federal government, the United States, is merely the states united for the few limited tasks found in article one, section eight, that We, the People gave to the Congress to perform on our behalf. In addition, the Supreme Court has stated that it would be unthinkable that the Constitution would impose a lesser obligation upon the Federal government than it imposes on the States, so if the states are prohibited from using any Thing but gold and silver coined money, then that prohibition likewise extends to the Federal government as well.

If the Congress is empowered to fix the standard of weights and measures, it cannot change or devalue the standard of value. Would we not think it ludicrous if some Congressman were to propose a law to devalue the inch for the purpose of giving everyone in the country a bigger house? Likewise, it is just as ludicrous to suggest that the dollar (the silver coin, remember?) can be devalued. That would be illegal. Congress has been empowered to "fix" the standard of value. It did just that, and the standard it adopted is the silver coin. If the Congress has not coined any dollars in over thirty years, then the Congress has not borrowed any dollars in over thirty years. There is therefore, no 4 trillion dollar debt, and the paper that you hold in your hand is bogus, it is illegal. Congress is issuing notes, bonds, and bills, without borrowing money. It is monetizing the debt, an act that is clearly beyond its power. Continuing this activity will lead to further depreciation of the "fiat currency", the Federal Reserve Note, erroneously called a dollar.

The only solution to the attendant problems caused by monetizing the debt (i.e., usurious interest rates, a falling currency, rising prices) is a return to law, to the coining of gold and silver coin. This does not mean that we cannot have paper currency, but any paper currency circulating must be redeemable on demand for the borrowed money. History has shown that a failure to address this problem always results in a eventual total repudiation of the fiat paper "money" and an economic crash.

Such a disaster can be avoided by the restoration of sound money. The existing illegal debt must be legitimized. This can be done by immediately putting Congress on a cash basis and by restructuring our tax system to collect taxes in advance of the fiscal year in which they will be spent. This will eliminate borrowing and the need for a Balanced Budget Amendment by requiring that spending be limited to the amount raised. With borrowing eliminated, that portion of the yearly budget that services the interest on the debt would soon be available to begin retiring the principal on the illegitimate debt.

These problem did not happen overnight, but began decades ago. I suggest that one year of sacrifice would put this problem behind us quickly, and the one year of sacrifice would be worth it to get ourselves out of debt. I call my proposal "The Year of the Double-Tax".

Under the present system, tax funds are coming in as expenditures are going out. The present system of income, corporate, and estate taxes would run for one final year while a National Sales Tax would run alongside of it. The old tax system would be funding the present spending, while the National Sales Tax would be collected by the states in advance of the fiscal year in which it would be spent. At the beginning of the following fiscal year, the states would turn these funds over to the Congress with the admonition, "Here is what you can spend, don't spend a penny more, don't' go into debt, and don't borrow". That would be the last year for the income tax and the current system would be trashed. A Washington think tank has suggested that a National Sales Tax in the amount of 20% would raise an amount in line with current expenditures. There would be no need for a Balance Budget Amendment to the Constitution, as the Congress would be limited in its spending to that amount raised by the previous year's tax levy.

Now, once the borrowing was ended, many good things would happen. First off, the Treasury would no longer be coming to the credit markets every three months to suck 30 to 40 billion out of that market. Interest rates would therefore be very favorable for business, and the cost of goods and services would reflect that. A great boom would result with the elimination of high interest rates, and with the elimination of the income tax. Once people realized they could work as hard as they wanted, and not be penalized, industry would boom. Once the world saw that we had finally put our fiscal house in order, our currency would soar vis-a-vis the other currencies of the world, and investment funds would pour into this country. The Congress would go back to coining gold and silver coins, and the dollar would once again become the premier money of the world. The monetized debt currency would be gradually changed from a fiat currency to one that was once again convertible and redeemable in real money. The restoration of precious metal coinage would create a boom in our mining industry, and the need for new mining equipment would be a boost to our manufacturing sector. Both of these areas are creators of real wealth.

Now, if you do not go back to obeying the law, if you do not implement this or some similar plan, one day you will wake up and find out that this country has become nothing more than a banana republic, and a shock wave will roll through the economy that will close the stock, credit, and currency markets. An economic Pearl Harbor looms before us because of your ignorance and violation of the law. I demand that you cease and desist in your unlawful behavior before it is too late. Thank you.

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